HKEX GUIDANCE LETTER
HKEX-GL106-19 (October 2019) (Updated in October 2020)

Subject	**Guidance on sufficiency of operations**
Listing Rules	**Main Board Rule 13.24** **GEM Rule 17.26**

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 Department on a confidential basis for an interpretation of the Listing Rules or this letter.*

I. BACKGROUND AND PURPOSE

1. On 1 October 2019, amendments to Rule 13.24 came into effect. The amended Rule 13.24 imposes a continuing listing obligation on a listed issuer to maintain a business with a sufficient level of operations and assets of sufficient value to support its operations to warrant its continued listing.

2. In recent years the prevalence of backdoor listings has resulted in a substantial increase in the value of a listing status, leading to extensive activities related to investors acquiring controls of listed issuers for their listing platforms (rather than the underlying business) for eventual backdoor listings, and listed issuers undertaking corporate actions (such as disposals of businesses) to facilitate the sale of their listing platforms. There were also cases where the listed issuers, after disposing of or otherwise winding down their principal businesses, established or acquired new businesses that have very low barriers of entry and/or can be easily established and discontinued without significant costs. These actions may leave listed issuers with minimal operations or businesses without substance. This, in turn, leads to speculative trading activities and opportunities for market manipulation, and undermines investors' confidence in our market. Where an issuer undertakes shell creation or maintenance activities, the Exchange would apply Rule 13.24(1). Where the Exchange considers that an issuer is not operating a business of substance, it may also question the issuer's suitability for continued listing under Rule 6.01(4) (see Guidance Letter on Listed Issuer's Suitability for Continued Listing (GL96-18)).

3. This letter provides guidance on the purpose behind and the general approach relating to the Exchange's application of Rule 13.24 after its amendments becoming effective. All Rule references in this letter are to the Main Board Listing Rules. As GEM Rule 17.26 is the same as Main Board Rule 13.24, the guidance set out in this letter also applies to GEM issuers.

II. RULE 13.24

4. Rule 13.24 states:

"(1) An issuer must carry out, directly or indirectly, a business with a sufficient level of operations and assets of sufficient value to support its operations to warrant the continued listing of the issuer's securities.

Note: Rule 13.24(1) is a qualitative test. The Exchange may consider an issuer to have failed to comply with the rule in situations where, for example, the Exchange considers that the issuer does not have a business that has substance and/or that is viable and sustainable.

The Exchange will make an assessment based on specific facts and circumstances of individual issuers. For example, when assessing whether a money lending business of a particular issuer is a business of substance, the Exchange may consider, among other factors, the business model, operating scale and history, source of funding, size and diversity of customer base and loan portfolio and internal control systems of the money lending business of that particular issuer, taking into account the norms and standards of the relevant industry.

Where the Exchange raises concerns with an issuer about its compliance with the rule, the onus is on the issuer to provide information to address the Exchange's concerns and demonstrate ~~to the satisfaction of the Exchange~~ its compliance with the rule.

(2) Proprietary trading and/or investment in securities by an issuer and its subsidiaries (other than an issuer which is an investment company listed under Chapter 21) are normally excluded when considering whether the issuer can meet rule 13.24(1).

Note: This rule would not normally apply to proprietary securities trading and/or investment activities carried out in the ordinary and usual course of business by a member of an issuer's group that is:

(a) a banking company (as defined in rule 14A.88);

(b) an insurance company (as defined in rule 14.04); or

(c) a securities house (as defined in rule 14.04) that is mainly engaged in regulated activities under the SFO. It should be noted that proprietary securities trading and/or investment is not a regulated activity under the SFO and accordingly, this exemption is not available where proprietary securities trading and/or investment constitutes a significant part of the business of the securities house."

5. The objective of the amendments to Rule 13.24 is to address the issue of "shell companies" in a more effective manner. In particular,

(a) Under Rule 13.24(1), an issuer must carry out a business with a sufficient level of operations to warrant its continued listing. An issuer that holds significant assets but does not carry out a sufficient level of operations is not compliant with the amended Rule.

(b) Under Rule 13.24(2), an issuer's proprietary trading and/or investment in securities is normally excluded when examining its sufficiency of operations and assets under Rule 13.24(1)[1].

The exception applies to proprietary securities trading and/or investment activities carried out in the ordinary and usual course of business by a member of an issuer's group that is a banking company, an insurance company or a securities house, provided that, in the case of a securities house, that member is mainly engaged in regulated activities under the SFO. It should be noted that proprietary securities trading and/or investment is not a regulated activity under the SFO and accordingly, this exemption is not available where proprietary securities trading and/or investment constitutes a significant part of the business of the securities house.

[1] Before the amendments to Rule 13.24, there were cases where proprietary securities trading was employed to maintain listed shells and was not demonstrated to be a business of substance. Also see paragraphs 11 to 15 of this guidance letter.

6. Where an issuer fails to meet Rule 13.24(1), the Exchange would suspend trading in the issuer's securities under Rule 6.01(3). The issuer would generally be given a period to remedy the issue, failing which the Exchange may cancel the listing of the issuer's securities[2].

III. GENERAL APPLICATION OF RULE 13.24(1)

(A) Listed issuers with minimal operations

7. The Exchange notes a number of cases where the listed issuers completely or substantially ceased their operations or otherwise maintained only minimal operations. This might have resulted from (a) the issuers having gradually scaled down or discontinued their principal business (or a material part thereof), or (b) continual deterioration of the issuers' business due to, for example, decline in the demand for the relevant products or services or deterioration in the business condition of the specific industry. In these circumstances, they failed to maintain a viable and sustainable business to comply with Rule 13.24(1)[3].

8. Among other situations, a listed issuer with the following characteristics would normally be considered not to have a viable and sustainable business that meets Rule 13.24(1):

   (a) The issuer maintains a very low level of operating activities and revenue, raising an issue that the size and prospect of the issuer do not appear to justify the costs or purpose associated with a public listing. This may happen, for example, where the issuer's business does not generate sufficient revenue to cover corporate expense, resulting in net losses and negative operating cashflow.

   (b) This current scale of operation does not represent a temporary downturn, as the issuer's business has been operating at a very small scale and incurring losses for years.

   However, an issuer experiencing a temporary reduction or suspension of operations due to market conditions or business strategies would not be considered to have failed Rule 13.24(1) only because of the temporary circumstances. For example, a mining issuer with its mines being suspended on a temporary basis would not be considered to fail Rule 13.24(1).

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2 See Rules 6.01A and 6.10 and Guidance Letter on Long Suspension and Delisting (GL95-18).

3 See the note to Rule 13.24(1)

(c) The issuer fails to demonstrate that it has sufficient assets to support an operation that generates sufficient revenue and profits to warrant a continued listing.

An assessment of sufficiency of assets is with reference to and commensurate with the particular nature, mode and scale of the issuer's operations. It is acknowledged that there are asset-light businesses which, compared to asset-heavy businesses, require assets of lesser value to support their viability and sustainability. Assets that are not used to support an issuer's operations are disregarded.

9. As examples, two issuers were considered not to comply with Rule 13.24(1):

(a) In Listing Decision LD115-2017, the issuer's businesses included coal exploration which never generated any revenue due to regulatory prohibitions and coal trading which generated about HK$11 million only from a few customers with a segment loss for each of the last three years. The issuer had also fully impaired the values of its mining right licences. The size of such operations did not justify a continued listing.

(b) In Listing Decision LD118-2018, the revenue of the issuer's retail sales of second-hand motors dropped by 95% to less than HK$5 million over the past five years, resulting in net losses and negative operating cashflows. The continued deterioration of such business resulted in the issuer maintaining only minimal operations that did not justify a continued listing.

Other examples of non-compliance include Listing Decisions LD105-2017 and LD116-2017.

10. Based on our experience, other circumstances that may lead to issuers having minimal operations and failing to comply with Rule 13.24(1) include:

(a) financial difficulties which seriously impair an issuer's ability to continue its business or which lead to the suspension of some or all of its operations;

(b) the issuer becoming insolvent, as may be evidenced by an uncontested petition for winding up, an order of winding up or the appointment of a liquidator (provisional or not); or

(c) the issuer losing its major operating subsidiaries.

(B) Business of no substance

11. Where an issuer's business or a material part of its business is not demonstrated to have substance, the Exchange would also consider that the issuer does not have a viable and sustainable business to comply with Rule 13.24(1)[4].

12. The Exchange notes that there were cases where the issuers, given their specific business models and the specific facts and circumstances, were not operating a business of substance. These issuers carried on their activities for the purpose of maintaining their listing status rather than genuinely developing their underlying businesses. Certain types of businesses, such as money lending and indent trading[5], are commonly employed for such purpose.

13. In its assessment, the Exchange would examine the specific facts and circumstances of the issuer's business including the business model, operating scale and history, source of funding, size and diversity of customer base and internal control systems of the business of that particular issuer, taking into account the norms and standards of the relevant industry.

14. For example, subject to the specific facts and circumstances, a business of money lending or indent trading with the following business models would raise a concern that the business is operated to maintain the issuer's listing status rather than being operated commercially, hence a concern that the business does not have substance:

    (a) Money lending business – the business is carried out without a clear business objective or strategy, a reliable source of funding, or an appropriate infrastructure of credit evaluation, risk management, collections and other functions that are typical of a publicly-listed money lending business. The business maintains a minimal scale of operation, with only a few employees, a high concentration of customers and a small loan portfolio which comprised mainly short term and unsecured loans.

    (b) Indent trading business – the business involves only the issuer sourcing products from suppliers and selling them to a few customers on a back-to-back basis. The issuer provides limited value added services, and does not have demonstrable competitive advantages in procuring new sales orders or expanding customer base. The business is operated by a few employees and generates minimal revenue or gross profits.

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4 See the note to Rule 13.24(1).

5 There were also cases where proprietary securities trading was employed to purportedly maintain a listing status. Under the new Rule 13.24(2), subject to a few specific exceptions stated therein, such business is excluded when examining an issuer's compliance with Rule 13.24(1). See paragraph 5 of this Guidance Letter.

15. Based on our experience, other circumstances that may lead to a concern about the substance of a business include:

    (a) reliance on a limited number of transactions or customers, and/or a single source of business (for example, referrals by a connected person or a particular employee);

    (b) the business in question being of a type which has a very low barrier of entry, can be easily established and discontinued without significant costs and/or is asset-light; and

    (c) the basis for generating substantial fees/revenue from the relevant transactions being unclear or questionable.

IV. APPLICATION OF RULE 13.24(1) TO SHELL ACTIVITIES

16. As elaborated below, to facilitate sales of "listed shells", some listed issuers conducted corporate actions such as disposals of businesses, leaving behind minimal operations. There were also cases where the listed issuers, after disposing of or otherwise winding down their principal businesses, established or acquired new businesses unrelated to their original businesses for purported compliance with Rule 13.24(1). Where an issuer undertakes shell creation or maintenance activities, the Exchange would apply Rule 13.24(1).

(A) Corporate Action

17. Based on our experience, some listed issuers structured their corporate actions to substantially scale down its operations through, for example, (i) disposing of the core business which generated the majority of revenue or profit, or (ii) artificially carving out a substantial part of the core business (see examples in subparagraphs (a) and (b) below). This caused a significant reduction in their assets, revenues and profits, leaving behind minimal operations which were loss making or generated minimal profits. An issuer conducting a corporate action involving a disposal of or having the effect of discontinuing its principal business (or a material part thereof) must satisfy the Exchange that after the corporate action, it would maintain a business which is viable and sustainable and has substance to comply with Rule 13.24(1). Otherwise, the Exchange will suspend trading in the issuers' securities upon completion of their corporate actions (see Rule 6.01(3)).

(a) In Listing Decision LD97-2016, the issuer proposed to dispose of its construction business accounting for a large majority of total revenue and assets since initial listing, leaving its property and trading businesses with a track record of less than one year and minimal revenue which did not cover corporate expenses. The proposed corporate action would result in the issuer becoming a listed shell without a business which was viable and sustainable to justify a continued listing.

(b) In Listing Decision LD99-2016, the issuer manufactured communication products under different brands and proposed to sell the major brands, which constituted the bulk of its assets and operations and had been profitable, back to the controlling shareholder. While the issuer asserted its intention to continue the business, the proposed sale would result in the remaining business only consisting of minor brands that were historically loss making and would not generate sufficient revenue and profits to justify a listing. This proposed corporate action would also leave the issuer with a minimal operation that was not viable and sustainable to meet Rule 13.24.

Other examples include Listing Decisions LD35-2012, LD88-2015, LD98-2016 and LD112-2017.

(B) Newly established or acquired business

18. We have also noted cases where an issuer, after disposing of or otherwise substantially scaling down its business, established or acquired a new business to purportedly comply with Rule 13.24(1). Such business may be unrelated to its original business, may not be viable or sustainable and/or may not have substance, having regard to the specific facts and circumstances including, for example, such business being of a limited scale and operated only by a few employees, lacking management expertise (for example, the board of directors having no relevant experience), and/or falling within the situations described in paragraphs 12 to 15 above.

19. In such cases, the Exchange would consider that the issuers do not comply with Rule 13.24. For example,

(a) In Listing Decision LD105-2017, the issuer ceased its principal business and commenced a number of new trading businesses which were asset-light, had low entry barriers and relied on a few customers and suppliers to maintain a very low level of operations. Such businesses were not demonstrated to be viable and sustainable. The issuer was in effect a listed shell.

(b) In Listing Decision LD118-2018, the issuer sought to rely on its new business of wholesaling newly branded motor vehicles in the PRC to meet Rule 13.24(1). Without a track record of performance, a reliable customer base, a credible projection of revenue and profit or other supportive information, the new business was not demonstrated to be viable and sustainable.

(c) In Listing Decision LD112-2017, the issuer's newly acquired advisory business had a significant increase in revenue in recent months. However, the issuer failed to demonstrate the viability and sustainability of the business, having regard to the heavy reliance on connected person(s) or particular employee to generate business and questionable basis for the substantial fees/revenue generated from the relevant transactions.

Other examples include Listing Decisions LD115-2017 and LD116-2017.

V. General obligations of listed issuers and the Exchange's assessment process

20. It is a listed issuer's continuing listing obligation under Rule 13.24 to maintain a business with a sufficient level of operations and assets of sufficient value to support its operations to warrant its continued listing. To demonstrate compliance, an issuer must ensure that it makes adequate disclosure of its business affairs, operation status and financial performance. In particular, an issuer is specifically required to publish financial results and reports in compliance with under Rules 13.46 to 13.49 and disclose inside information required to be disclosed under the Inside Information Provisions[6]. These disclosures provide transparency to the market and enable the Exchange to monitor its compliance with Rule 13.24.

21. As part of its regulatory supervision on listed issuers, the Exchange monitors issuers' activities and compliance with the Listing Rules primarily on the basis of their disclosures. Based on an issuer's periodic financial results and other disclosures, the Exchange makes a preliminary assessment of the issuer's compliance with Rule 13.24 on an ongoing basis.

22. If the Exchange is concerned with a particular issuer's compliance with Rule 13.24 upon such preliminary assessment, the Exchange may write a letter to the issuer setting out the observations giving rise to the concern and requesting the issuer to provide a written submission within a specified time period (normally three weeks) showing cause with reasons as to why, despite the matters set out in the letter, it still complies with Rule 13.24 and hence the Exchange should not commence the procedure to cancel its listing. The Exchange will make a ruling on the basis of the information available to it upon the expiry of the specified time period.

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[6] Part XIVA of the Securities and Futures Ordinance

23. In response to the Exchange's request, the issuer must provide information to address the Exchange's observations and concerns set out in the letter. Without prejudice to the generality of such request, the issuer is also specifically expected to provide the following information (if not in the issuer's public documents) to demonstrate that it has a business which is viable and sustainable and has substance:

    (a) the business objective, strategy and plan;

    (b) the business model including how the business operates and generates revenue and profits, and the source of funding;

    (c) the operating scale, management expertise and scale of staff or manpower;

    (d) the size and diversity of customer base and source of supply;

    (e) the role of and relationship with key business stakeholders;

    (f) the infrastructure and other functions in support of the operation (e.g. internal systems or controls), together with a comparison with industry norms and standards if appropriate; and

    (g) the board's views on the business prospect supported by a credible profitable forecast, if any, which is prepared on the basis of substantiated evidence.

24. Rule 13.24 is a qualitative test and is assessed based on the specific facts and circumstances of individual cases. Therefore, a numerical comparison with other listed issuers (for example, in terms of revenue, profit or assets) would not be an appropriate approach for an issuer to address the Exchange's concerns.

25. If the issuer fails to address the Exchange's concerns, the Exchange will inform the issuer of its decision that the issuer does not meet Rule 13.24. The issuer should publish an announcement on the Exchange's decision and its reasons before 8:30 a.m. on the next business day after it received the decision letter. In addition, the issuer should also include a statement that the trading in its shares will be suspended[7] after the expiry of seven business days from the date of the decision letter, unless the issuer applies for a review of the decision in accordance with its rights under Chapter 2B[8]. The issuer should make a further announcement on the suspension or its decision to review.

[7] Under Rule 6.01(3) trading in an issuer's securities will be suspended where the Exchange considers that the issuer has failed to comply with Rule 13.24.

[8] Under Chapter 2B, the issuer has the right to have the Listing Division's decision referred to the Listing Committee for review. Any request for review must be served on the Secretary of the Listing Committee within seven business days from the date of the decision.

26. Further, as a general principle, Rule 2.03(2) requires that the issue and marketing of securities are conducted in a fair and orderly manner and that potential investors are given sufficient information to enable them to make a properly informed assessment of an issuer. Where the Exchange has raised a concern about the issuer's compliance with Rule 13.24 and this concern is not addressed, it will normally refuse to grant listing approval for any issuance of new securities by the issuer.