

**HKEx REJECTION LETTER**  
Cite as HKEx-RL8-05 (March 2005)

*[Withdrawn in March 2019; Superseded by HKEX-GL71-14]*

Summary	
<b>Listing Rule</b>	GEM Listing Rules 11.06 and 11.12
<b>Reason for rejection and the subsequent disposal of the case on review</b>	Failure to satisfy that the Company had a business that satisfied the substance and potential requirements of GEM Listing Rule 11.12.  Failure to demonstrate that the Company and its business were suitable for listing under GEM Listing Rule 11.06.
<b>Contents</b>	<b><u>LETTER 1:</u></b> Extracts of the response of the Head of Listing, the Stock Exchange of Hong Kong Ltd  <b><u>LETTER 2:</u></b> Extracts of the response of the Acting Secretary to the GEM Listing Committee on hearing the application of the Company to review the decision of the Listing Division

**LETTER 1**

*[Date]*

*[Name and Address of Sponsor]*

Dear Sirs

Re: Application for new listing of a GEM listing applicant  
(the “Company” together with its subsidiaries, the “Group” )

We refer to your Form 5A dated *[\*date\*month\*year]* applying, on behalf of the Company, for the listing of the shares of the Company on the Growth Enterprise Market, draft proofs of the Company’s prospectus and the related documents submitted. Terms used in this letter have the same respective meanings as defined in the draft prospectus dated *[\*date\*month\*year]*, unless the context requires otherwise.

**Background**

The Company, principally through its major operating subsidiary, *[Subsidiary A]*, is engaged in the *[\*]* industry. *[The industry that the Company is engaged in]* is a restricted industry in the PRC under *[applicable regulations in the PRC]* (the “Relevant Regulation”). *[Subsidiary A]* was converted from a PRC domestic enterprise into a sino-foreign equity joint venture in *[September 2003]* and further converted into a sino-foreign contractual joint

venture in *[September 2003]* (the “Conversion”). *[Subsidiary A]* accounted for substantially all of the group’s turnover and profits during the active business pursuit period.

Based on the draft prospectus and the information submitted to date:-

- (a) *[Subsidiary A]* was established as a sino-foreign contractual joint venture enterprise by way of conversion, which was approved by the *[city level of the relevant]* Foreign Investment Office *[in the PRC]* in *[September 2003]*. Under the terms of the joint venture, the Company being a foreign party, and the PRC party share *[Subsidiary A’s]* profits 90% and 10% respectively in the first 10 years and 10% and 90% respectively in the following 10 years (the “Profit Sharing Arrangement”).
- (b) According to the Regulations on the Direction Guidance to the Foreign Investment promulgated by the State Council, the *[Relevant Regulation]* applies to all forms of foreign investments in the PRC, including contractual joint ventures. Under the *[Relevant Regulation]*, the portion of the foreign investment may not, prior to 11 December 2003, be more than 49% of an entity *[engaging in the restricted industry in the PRC]*. We understand that, in the case of a contractual joint venture, this restriction is normally interpreted as meaning that the contractual joint venture must be controlled by the PRC party.
- (c) The Conversion was approved by the *[city level of the relevant]* Foreign Investment Office in *[September 2003]*.
- (d) At the Division’s request, the Company *[Portion of Letter Purposely Omitted]* was informed by the Ministry of Commerce that it should, pursuant to new regulations which had come into force in the interim (which had extended the relevant approval power to the provincial authorities) apply to the *[provincial level of the relevant]* Department of Commerce *[in the PRC]* for approval.
- (e) In *[mid-2004]*, the Company obtained from the *[provincial level of the relevant]* Department of Commerce the necessary regulatory approval for the establishment of *[Subsidiary A]* as a contractual joint venture.

## **Issues**

Given the terms of the Profit Sharing Agreement:

- (1) Does the Company’s business satisfy the substance and potential requirements of GEM Listing Rule 11.12?
- (2) Are the Company and its business suitable for listing under GEM Listing Rule 11.06?

## **GEM Listing Rules**

### ***Substance and Potential***

Under GEM Listing Rule 11.12(1), a new applicant must demonstrate that, throughout the

period specified in GEM Listing Rule 11.12(2), it has actively pursued one focused line of business and must make a statement in the listing document concerning that business which complies with the requirements of GEM Listing Rules 14.15 to 14.18.

Note 3 to GEM Listing Rule 11.12 further provides that a new applicant must be able to demonstrate that it has a business of both substance and potential. A business will, subject to GEM Listing Rule 11.14, only be regarded as having the requisite substance if the applicant can show that it has spent at least the 24 month period prior to the issue of the listing document, making substantial progress in building up that business. Examples of measurements of progress have been given under Note 4 to GEM Listing Rule 14.15. Among other things, item (j) under Note 4 to GEM Listing Rule 14.15 cites obtaining relevant regulatory approvals as a relevant measure of progress.

Where the company responsible for carrying on the active business is not the new applicant itself, GEM Listing Rule 11.13 requires such business to be carried on by a subsidiary or subsidiaries of the new applicant and that, among other things, the new applicant must have an effective economic interest of no less than 50% in any such subsidiary.

### ***Suitability for Listing***

GEM Listing Rule 11.06 requires that both the Company and its business must, in the opinion of the Exchange, be suitable for listing.

### **Analysis**

#### **Substance and Potential**

##### ***Profit Sharing Arrangement***

By entering into the Profit Sharing Arrangement, the Company has created an arrangement which will reduce the revenue stream from its principal business by 80%. Such arrangement creates the certainty of a substantial decrease in its operating revenues in the future in a manner likely to be disruptive, given the current absence of an alternative revenue stream. The pre-arranged decrease in the Company's economic interest in its principal operating subsidiary is also inconsistent with the principle of GEM Listing Rule 11.13, notwithstanding that it will occur some time in the future. Despite the availability of other legal structures that do not create volatility in the revenue stream, such as one involving a fixed profit sharing percentage during the entire contractual term, the Company opted for an arrangement involving substantial future volatility.

In light of the contractual term of the joint venture, the present substance of the Company's business does not reflect the substance of the Company after the change in the Profit Sharing Arrangement. The Listing Division considers that the Profit Sharing Arrangement therefore negatively affects both the present substance of the Company's operations as well as its future potential for purposes of Rule 11.12 in that the only certainty under the Profit Sharing Arrangement is a substantial future reduction in the revenue stream from its principal business.

Further, in our view no satisfactory explanation has been offered for the Profit Sharing Arrangement. The sponsor has submitted that the law allows parties to a co-operative joint venture to agree on a profit shareholding arrangement that may not reflect their relative equity interests. The sponsor has also submitted that the Profit Sharing Arrangement was entirely a “commercial decision” between the parties *[Portion of Letter Purposely Omitted]*. We consider the reasons given for the Profit Sharing Arrangement to be unpersuasive and not adequate to account for the choice made by the Company to substantially reduce the future revenue stream from its principal business. The fact that the Company may at a future time be able to convert *[Subsidiary A]* into a wholly-owned foreign enterprise does not detract from our present concern that no satisfactory explanation for the arrangement has been offered regarding the arrangement as it exists today.

### *Approval for Conversion*

GEM Listing Rule 11.12 requires that a new applicant have, for the purpose of making substantial progress in building up that business, obtained the regulatory approvals “prior to the issue of the listing documents”, rather than at some time in the future. GEM Listing Rule 12.09 also requires documents submitted to the Exchange with the listing application, including the draft listing document, to be in what the sponsor and the issuer believe to be “anticipated final form”, save for certain matters relating to the offering. Therefore, the Exchange normally expects, among other things, that a listing applicant should have obtained all relevant regulatory approvals, licences and permits prior to submitting its listing application to the Exchange.

In this case, the necessary approval for the Conversion was only obtained after the Listing Division raised queries on this issue.

### *[Portion of Letter Purposely Omitted]*

Thus, the necessary regulatory approval, being the yardstick laid down in Note 4(j) to GEM Listing Rule 14.15 for measuring progress during the active business pursuit period, was not obtained during that period and in the manner contemplated by GEM Listing Rule 12.09.

### *Conclusion*

In light of the analysis set forth above, in our view the Company has not demonstrated that it satisfies the substance and potential requirements under GEM Listing Rule 11.12 as:

- the only certainty under the Profit Sharing Arrangement is a substantial future reduction in the revenue stream from its principal business, and
- the Company had not obtained all relevant regulatory approvals, licences and permits prior to submitting its listing application to the Exchange.

## Suitability for Listing

The Company's Form 5A contained, among other things, a declaration by the Company and sponsor that all the qualifications for listing set out in the relevant chapters of the GEM Listing Rules had, insofar as applicable and required to be met or fulfilled prior to application, been met or fulfilled. This includes GEM Listing Rule 11.06 which requires the Company and its business to be suitable for listing. It was a formal statement for which the Company's directors also assume responsibility.

It is incumbent upon the Company and its sponsor to take all reasonable steps to satisfy themselves that all necessary approvals have been obtained and that the entity is legally and validly established. Respect for formal processes and the ability to demonstrate compliance with legal requirements in a timely manner are key attributes that distinguish public companies from private companies. In the present case, *[Subsidiary A]* was established before all necessary approvals had been obtained. The manner in which the necessary approval for the Conversion was obtained was in the view of the Exchange most unsatisfactory in that it occurred as a direct result of the Listing Division raising queries on the matter. The basis upon which the Conversion was originally presented to the Exchange as having been duly approved proved to be fundamentally flawed. Rather than resolving the problem prior to submission of the application to the Exchange for vetting, the problem was rectified by virtue of the vetting process itself. Had it not been for the vetting process and the queries raised by the Listing Division in this regard, the necessary approval for the Conversion might well have remained outstanding.

In view of the fact that *[Subsidiary A]* accounted for substantially all of the group's turnover and profits during the active business pursuit period and having regard to the unsatisfactory timing and manner in which the necessary approval for its establishment was obtained, the Listing Division has concluded that the Company and its business are not suitable for listing as required under GEM Listing Rule 11.06.

In light of the facts and circumstances of the case as presented to us to date and the analysis set forth above, the Listing Division has decided to reject the Company's listing application.

Pursuant to Chapter 4 of the GEM Listing Rules, the Company has the right to have this decision reviewed by the GEM Listing Committee.

*[Portion of Letter Purposely Omitted]*

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

*[Signed]*

Head of Listing

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## **LETTER 2**

*[Date]*

*[Name and Address of Sponsor]*

Dear Sirs,

Re: Review Hearing of the GEM Listing Committee  
(the "Review Hearing") regarding the Company  
Date of the Review Hearing: *[\* date \* month \* year]*

On *[\* date \* month \* year]*, the GEM Listing Committee of The Stock Exchange of Hong Kong Limited conducted a review hearing (the "Review Hearing") to consider an application from the Company for a review of the decision of the Listing Division set out in Division's letter dated *[\* date \* month \* year]*, (the "Decision").

The Review Hearing was conducted before the GEM Listing Committee comprising *[names of members purposely omitted]* (the "Committee").

*Note: Terms and expressions used and defined in the written submission of the Listing Division shall have the same meanings when used herein unless otherwise defined.*

### **Decision**

The Committee considered the submissions (both written and oral) made by the Company and the Listing Division. The Committee decided to uphold the Decision to reject the Company's listing application on the basis that the Company has failed to comply with Rule 11.06 of the GEM Listing Rules.

### **Reasons**

The Committee arrived at its decision for the following reasons:

1. The principal activities of the Company were conducted through *[Subsidiary A]* which was a sino-foreign cooperative joint venture entity in the PRC.

Under the relevant PRC laws and regulations in force at the time of the establishment of the joint venture, the Company's economic interest in the joint venture was limited to 50%.

The Profit Sharing Arrangement of the cooperative joint venture provided for the Company to be entitled to 90% of the distributable profits of *[Subsidiary A]* for the first 10 years whereas, the Company's entitlement would be reduced to 10% for the next 10 years of the cooperative joint venture period.

The Committee did not consider that these arrangements, which had the effect of distorting the underlying economic substance of the joint venture in the initial period of listing, to be acceptable for a company listed on the GEM Board.

2. The Committee noted that *[Parentco X]* was a shareholder of *[the other joint venture partner]* of *[Subsidiary A]*, which was owned as to 51% by *[Mr. X]* and 49% by *[Mr. Y]*. The Committee further noted that *[Parentco X]* agreed to transfer all its interests in *[Subsidiary A]* to the Group at a consideration calculated by reference to the net assets value of the latest audited financial statements of *[Subsidiary A]* and the percentage of capital contribution by *[Parentco X]* to the establishment of *[Subsidiary A]* (being *[less than 2%]* of the total registered capital of *[Subsidiary A]*) as and when the relevant PRC laws and regulations were relaxed to permit 100% foreign ownership of *[Subsidiary A]*.

The Committee was of the view that, in view of the involvement of connected parties and the fact that the purchase opinion was not based on the fair value of the interests in the joint venture at the time when the purchase opinion was to be exercised, there was no certainty that the purchase option would be exercised.

3. Given the above, the Committee was of the view that the Company and its business were unsuitable for listing under Rule 11.06 of the GEM Listing Rules.

The Company had failed to produce cogent reasons or to illustrate exceptional circumstances to convince the Committee to overturn the Decision.

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

*[Signed]*

Acting Secretary to the GEM Listing Committee