

Guidance on sufficiency of operations

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.~~

1. BACKGROUND AND PURPOSEBackground and purpose

- 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.
- 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 leading to the issuer operating a business with minimal operations, the Exchange would apply Rule 13.24(1). Where the Exchange considers that an issuer is not operating a business of substance, it may apply Rule 13.24, and 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)~~Guidance on listed issuer's suitability for continued listing (HKEX-GL96-18)).
- This letter provides guidance on the purpose behind and the general approach relating to the Exchange's application of Rule 13.24, with an appendix setting out examples to illustrate how the Exchange applies 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. In addition, ~~listing decisions and~~ Listing Review Committee decisions on Rule 13.24 also offer

guidance on this subject.

II. ~~RULE 13.24~~ 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 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. One of the objectives of ~~the amendments to~~ Rule 13.24 is to address the issue of “shell companies” ~~in a more effective manner~~. Shell companies are often associated with issuers operating at a low level of activities whose size and prospects do not support the costs or purpose associated with a public listing. 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~~this 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.

6. An assessment of Rule 13.24 is generally based on the current operations of the issuer. 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 securities².

III. ~~GENERAL APPLICATION OF RULE 13.24(1)~~General application of Rule 13.24(1)

(A) Listed issuers with minimal operations

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 14 of this guidance letter.

² See Rules 6.01A and 6.10 and ~~Guidance Letter on Long Suspension and Delisting (GL95-18)~~Guidance on long suspension and delisting (HKEX-GL95-18).

(i) Business deterioration / discontinuation

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 prospects 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 operations 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 circumstances⁴.

- (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.

(ii) Corporate actions leading to minimal operations

9. The Exchange also notes other cases where the issuers structured their corporate actions to substantially scale down their 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. 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

³ See the note to Rule 13.24(1)

⁴ Examples include:

- (i) An issuer suspended its breeding farms and slaughter house in early 2018 upon the outbreak of the Asian Swine Flu in Mainland China. It then refurbished the facilities, redesigned the quality control procedures, maintained continuous dialogue with the government and reapplied for licenses. In late 2020, the issuer obtained licenses to recommence part of its operations.
- (ii) A small property development consultant experienced significant business downturn in the past few years due to the US-China trade dispute and tightened housing policies affecting small developers. Recently, the government lifted certain restrictions which would stimulate market demand. The issuer provided a profit forecast (supported by signed contracts with customers) which demonstrated recovery in its operations.
- (iii) A mining issuer with its mines being suspended on a temporary basis.

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)).

(iii) Other circumstances

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 model that lacks business 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)⁵.
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 trading⁶, are commonly employed for such purpose.
13. 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

⁵ See the note to Rule 13.24(1).

⁶ 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](#).

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.

14. 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.

(C) Newly established or acquired business

15. 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 have a limited historical track record to demonstrate its viability and sustainability. While the Exchange would consider its business forecast, such forecast must be supported by a concrete and credible business plan, with projections based on signed contracts and supportable customer demand.

16. We have also noted cases where an issuer asserted that the new businesses had some relationships with its original business and should be regarded as a continuation or reactivation of the same business, and the historical track record of the original business should be considered in assessing the viability and sustainability of the new business. The Exchange noted that while those businesses were in the same industry, they operated ~~very different business models~~ with different product types, geographical locations, operating model (e.g. trading vs manufacturing) or required different management expertise. In this circumstance, the historical track record of the disposed (or discontinued) business and/or its management had little or no relevance in assessing the viability and sustainability of the new business.

IV. The Exchange's assessment process and general obligations of listed issuers

17. In our assessment of an issuer's compliance with Rule 13.24, the Exchange would review the

following areas:

- (i) *Business model* – The issuer must operate a business that is viable and sustainable. The Exchange would review the business model with reference to the industry norm, including whether the business is operated with the proper infrastructure (e.g. property, plant and equipment, patents, experienced personnel), processes and controls normally associated with businesses in those industries; managed by officers with expertise in the business; and whether the size of the business and the level of activities are sufficient to support the costs associated with a listing.
- (ii) *Operating scale and history* – An assessment of Rule 13.24 would generally be based on the current operations of the issuer, with reference to its historical track record. For a new business without sufficient operating history, the Exchange would also take into account its future prospects, including its business plans and forecasts. However, the issuer should also have concrete and credible business plans and strategies to support its projections, including, for example, signed contracts or other evidence of customer demand to support its forecasts.

Where there are questions about the credibility of the business plans or forecasts, the issuer would not be considered to comply with Rule 13.24. It would have a remedial period (as noted in paragraph 6 above) to demonstrate that its business plans and forecasts are credible.

- (iii) *Sufficient assets to support its operations* – Rule 13.24 also requires the issuer to have sufficient assets to support its operations. This would include, among others, whether it has sufficient funds to develop the business and implement the business plan.
- (iv) *Business of substance* – Businesses with little or no substance would not comply with Rule 13.24. These would include businesses that rely on a limited number of transactions or customers, have very low barriers of entry and can be discontinued without significant cost (see paragraphs 11 to 14 for further details). This aligns with the objective of the amendments to Rule 13.24 to address the issue of “shell companies” in a more effective manner.

18. 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, the status of its operations 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 Provisions⁷. These disclosures provide transparency to the market and enable the Exchange to monitor its compliance with Rule 13.24.
19. 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.
20. If the Exchange is concerned with a particular issuer’s compliance with Rule 13.24 upon such

⁷ Part XIVA of the Securities and Futures Ordinance

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.

21. 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 operations (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.
22. 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.
23. 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 suspended⁸ 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 2B⁹. The issuer should make a further announcement on the suspension or its decision to review.
24. 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

⁸ 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.

⁹ 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.

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.

Appendix

This appendix sets out the cases to illustrate how the Exchange applies Rule 13.24 in circumstances described in the guidance letter.

A. Listed issuers with minimal operations
(i) Business deterioration/ discontinuation
<ul style="list-style-type: none">▪ 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.▪ 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. <p>Other examples of non-compliance include Listing Decisions LD105-2017 and LD116-2017.</p>
(ii) Corporate actions leading to minimal operations
<ul style="list-style-type: none">▪ 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.▪ 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 level of operations that was not viable and sustainable to meet Rule 13.24. <p>Other examples include Listing Decisions LD35-2012, LD88-2015, LD98-2016 and LD112-2017.</p>
C. Newly established or acquired business
<ul style="list-style-type: none">▪ 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.

- 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.
- 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.
- An issuer previously built and operated online shops for clients on e-commerce platforms, and commenced a trading business to sell branded and non-branded products through online platforms and other channels about a year ago. While the issuer asserted that it had expertise in e-commerce, most of the revenue in the last year were generated from trading of products on an indent basis, with minimal revenue generated from the online platforms and other channels. The forecast revenue of over \$100 million was not supported by historical track record or contracts with customers. It only had a few contracts with corporate customers for trading products at a low profit margin which in any event, would be insufficient to cover its corporate expenses.
- A GEM issuer originally traded electronic products on an indent basis on a small scale with few customers and failed to meet GEM Rule 17.26. It commenced trading of computer servers on an indent basis with secured sales orders of over \$80 million, and started providing data centre maintenance services with sales of approximately \$20 million and 5 customers. It planned to acquire two data centres.

The new business did not meet GEM Rule 17.26 because the computer servers trading business was not a business of substance as it had a simple business model, operating on an indent basis with limited value add. The profit margin was small and would not substantially improve the issuer's performance. The data center maintenance business was insignificant with a few customers and small revenue. While the issuer claimed this business to be similar to its original business, none of the directors appeared to have sufficient experience in operating this new business. Its plan to acquire two data centres were preliminary.

- An issuer's sportswear export business substantially diminished after the departure of its key management. It commenced a new cloth business which sourced products for a small number of customers with limited value added services provided. The cloth business was different from the original export business in terms of the product type, market location and operating model. The new directors lacked relevant experience in the business. Despite an increase in revenue to HK\$40 million in the last interim period, the segmental profit was minimal at HK\$1 million. The issuer also failed to demonstrate that it had credible business plans to substantially improve its performance and expand the customer base. Even if the issuer could achieve its

~~forecasted sales of over HK\$120 million, the segment profit would still be small and the issuer would continue to be loss-making.~~

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

Temporary reduction of operations due to market conditions (see paragraph 8(b))

~~These issuers experienced temporary reduction in their operations but were considered to continue to meet Rule 13.24:~~

- ~~▪ An issuer suspended its breeding farms and slaughter house in early 2018 upon the outbreak of the Asian Swine Flu in Mainland China. It then refurbished the facilities, redesigned the quality control procedures, maintained continuous dialogue with the government and reapplied for licenses. In late 2020, the issuer obtained licenses to recommence part of its operations.~~
- ~~▪ A small property development consultant experienced significant business downturn in the past few years due to the US-China trade dispute and tightened housing policies affecting small developers. Recently, the government lifted certain restrictions which would stimulate market demand. The issuer provided a profit forecast (supported by signed contracts with customers) which demonstrated recovery in its operations.~~
- ~~▪ A mining issuer with its mines being suspended on a temporary basis.~~

This appendix sets out cases to illustrate how the Exchange applies Rule 13.24 in circumstances described in the guidance letter.

<u>Case number</u>	<u>Description</u>
<u>Case 1</u>	<u>Issuer with minimal operations due to business deterioration</u>
<u>Cases 2, 3 and 4</u>	<u>Issuer who sought to rely on newly established or acquired businesses to support its continued listing after discontinuing or substantially scaling down its principal businesses</u>
<u>Cases 5 and 6</u>	<u>Issuer with minimal operations after disposing of its principal business</u>
<u>Cases 7 and 8</u>	<u>Issuer who sought to rely on newly established or acquired businesses to support its continued listing after disposing of its principal business</u>

Note: While these cases happened before the amendments of Rule 13.24 (or GEM Rule 17.26) in October 2019, such amendments would not change the analysis and conclusion in these cases.

<u>Case number / Listing Rule reference</u>	<u>Background and Decision</u>
<p>Case 1</p> <p><u>Rule 13.24</u></p>	<p><u>Background</u></p> <p><u>1. Company A and its subsidiaries (Group) were engaged in coal mining and coal trading.</u></p> <p><u>(a) The coal mining business had not generated any revenue since Company A acquired the mining rights of its coal mines about nine years ago. The Group’s mining exploration activities had been restricted due to regulatory prohibitions and it had fully impaired the values of the mining rights.</u></p> <p><u>(b) The coal trading business commenced about three years ago. Its revenue decreased from HK\$30 million in the first year to about HK\$11 million in each of the last two financial years. It had a few customers only and recorded a segment loss over the last three years.</u></p> <p><u>2. The Group recorded substantial losses (in the range of HK\$25 million to HK\$140 million) and negative operating cash flows over the last five financial years. As at the latest year end date, it had total assets of HK\$20 million comprising mainly cash and bank balances and trade and other receivables. Its net liabilities amounted to HK\$60 million.</u></p> <p><u>3. Company A submitted that it had plans to improve its business operations and financial position.</u></p> <p><u>(a) Company A intended to increase the number of customers to up to seven within two years to expand its coal trading business. It also planned to cut the administrative costs and expenses of the Group and raise funds through placing of new shares to repay outstanding indebtedness and reduce finance costs.</u></p> <p><u>Based on the above, Company A expected that the Group would record a significant increase in revenue from the coal trading business to more than HK\$120 million and HK\$140 million in the current and next financial year. It would start making net profits of about HK\$6 million in the next financial year.</u></p> <p><u>(b) Company A had also identified some potential acquisition targets for business expansion and diversification and expected to complete one within 12 months.</u></p>

	<p><u>Decision</u></p> <p><u>4. The Exchange considered that Company A had failed to comply with Rule 13.24 because:</u></p> <p><u>(a) The Group maintained a low level of operations. Its coal trading business recorded revenue of HK\$11 million only from a few customers with a segment loss, while its coal mining business had never generated any revenue due to regulatory prohibitions. This situation was not a temporary decline or downturn.</u></p> <p><u>(b) The Group's plans to improve its business operations and financial position were preliminary and not substantiated. Company A did not provide any detailed information about its business plans or acquisition targets to support a substantial improvement of the Group's scale of operations and financial results as projected. Company A failed to demonstrate that its businesses were viable and sustainable.</u></p> <p><u>(c) The Group had total assets of HK\$20 million only and net liabilities of HK\$60 million. As noted above, the operation of these assets did not generate sufficient revenue and profits to support a continued listing.</u></p>
<p><u>Case 2</u></p> <p><u>Rule 13.24</u></p>	<p><u>Background</u></p> <p><u>1. Company A and its subsidiaries (Group) were principally engaged in retail sales of second-hand motor vehicles (Second-hand Vehicles Business) in Hong Kong. It started a money lending business (Money Lending Business) two years ago. These businesses were operated by a small number of employees.</u></p> <p><u>2. Over the past five years, the Second-hand Vehicles Business had diminished substantially, with its revenue dropped by 95% to less than HK\$5 million. The Group had recorded net losses and negative operating cashflows. As at the latest financial year end, the Group had total assets and net assets of HK\$50 million and HK\$40 million respectively.</u></p> <p><u>3. Company A would cease the Second-hand Vehicles Business and reallocate its resources to wholesale distribution of new branded motor vehicles in the PRC (Vehicles Wholesale Business). The Money Lending Business would continue to generate minimal revenue.</u></p> <p><u>4. Company A submitted that it was able to satisfy Rule 13.24 because:</u></p> <p><u>(a) The Group commenced the Vehicles Wholesale Business following the relaxation of relevant PRC regulation a few months ago. It sourced new branded motor vehicles in fleet from overseas suppliers and sold them to a small number of car dealers in the PRC on an indent basis.</u></p>

(b) According to Company A's forecasts, the Vehicles Wholesale Business would significantly increase its revenue for the second half of the current financial year. This was based on a few confirmed orders, non-legally binding framework agreements with a few customers, and an assumption about the average monthly increase in the sales volume during the forecast periods (for which Company A did not provide a clear basis). Company A expected to incur a loss for the current financial year and only record a minimal profit in the next financial year.

Decision

5. The Exchange considered that Company A had failed to comply with Rule 13.24 because:

(a) The Group's existing level of operations had, for years, remained very low and recorded net losses and negative operating cashflows. It would cease the Second-hand Vehicles Business and did not expect the Money Lending Business to grow substantially in the future.

(b) Company A sought to rely on the Vehicles Wholesale Business and its revenue forecasts for the next two financial years to meet Rule 13.24. However, the Exchange noted that:

- The Vehicles Wholesale Business had a short operating history and a limited customer base. Its business model was substantially different from that of the Second-hand Vehicles Business. The Vehicles Wholesale Business was a business of wholesale distribution of new branded motor vehicles in the PRC conducted on an indent basis relying on a small number of car dealers, compared to the Second-hand Vehicles Business involving retail sales in Hong Kong of second-hand motor vehicles selected and acquired by Company A.
- A significant portion of the revenue projections from the Vehicles Wholesale Business was based on non-legally binding framework agreements and assumptions which were not supported by signed agreements or committed sales orders.
- Without a track record of performance, a reliable customer base and credible financial projections, the Vehicles Wholesale Business was not demonstrated to be viable and sustainable.

(c) The Group's assets comprised mainly cash, and trade and other receivables. As noted above, the operation of these assets did not generate sufficient revenue and profits to support a continued listing.

<p>Case 3</p> <p><u>GEM Rule 17.26</u></p>	<p><u>Background</u></p> <ol style="list-style-type: none">1. <u>Company A and its subsidiary (Group) were originally engaged in trading of metals and beverage products. It also held exploration rights of iron mines. It had been loss making for many years.</u>2. <u>About six months ago, Company A:</u><ol style="list-style-type: none">(a) <u>failed to renew the exploration rights of iron mines and fully impaired its mining assets of about HK\$150 million;</u>(b) <u>discontinued its metal trading business which was the Group's main business and generated 90% of its revenue (about HK\$12 million) in the last financial year; and</u>(c) <u>started a number of new businesses including trading of cosmetics and skincare products, stainless steel wire, nephrite, listed securities and chartering of vessel (New Businesses). The New Businesses had no correlation with each other. They were mostly trading businesses relying on one to two customers and each operated by a small number of employees.</u>3. <u>The remaining beverage trading business and the New Businesses together generated revenue of HK\$30 million in the last six months. The Group recorded a gross profit of HK\$6 million, which was insufficient to cover its expenses, resulting in a net loss of HK\$60 million. It had net liabilities amounted to HK\$400 million.</u>4. <u>Company A was of the view that it was able to meet GEM Rule 17.26. It submitted that:</u><ol style="list-style-type: none">(a) <u>the New Businesses would enable the expansion of its business portfolio, diversify its income sources and enhance its financial performance;</u>(b) <u>its revenue had increased to HK\$50 million for the first nine months of the current financial year. The performance of the New Businesses was in line with the management's projection; and</u>(c) <u>based on its financial forecast, the Group would continue to maintain growth in revenue from the New Businesses and exercise effective control over its corporate expenses. It expected to record revenue of about HK\$100 million and a substantial loss in the coming 12 months.</u>
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	<p><u>Decision</u></p> <p>5. <u>The Exchange considered that Company A had failed to comply with GEM Rule 17.26 because:</u></p> <p>(a) <u>The Group had substantially ceased all its principal businesses after discontinuing the metal trading business. The remaining business in trading of beverage products recorded minimal revenue and a segment loss.</u></p> <p>(b) <u>Company A failed to demonstrate the viability and sustainability of the New Businesses:</u></p> <ul style="list-style-type: none"> ▪ <u>The New Businesses had no correlation with each other and involved a low level of activities. They were mostly trading businesses relying on a few customers and suppliers and operated by a few employees. In the last six months, it generated minimal revenue which was insufficient to cover its expenses. Despite its projection of an increase in revenue, the Group would continue to record a substantial loss during the forecast period.</u> ▪ <u>Company A had not provided any concrete business plan for the New Businesses or otherwise demonstrated the prospects of substantially improving the scale of its operations.</u> <p>(c) <u>The Group had a significant net liabilities position. As noted above, the operation of its assets did not generate sufficient revenue and profits to support a continued listing.</u></p>
<p><u>Case 4</u></p> <p><u>Rule 13.24</u></p>	<p><u>Background</u></p> <p>1. <u>Company A and its subsidiary (Group) were principally engaged in the manufacturing and sale of fashion accessories (Fashion Accessories Business) and the development and sale of software related applications (Software Business).</u></p> <p>2. <u>Over the past few years, the Group had gradually scaled down the Fashion Accessories Business by disposing of its manufacturing arms, outsourcing such function to other subcontractors, and closing its retail shops. Revenues from this business segment decreased from about HK\$200 million to HK\$9 million during the last five financial years. Company A had decided to discontinue this business, and the revenue of HK\$9 million in the latest financial year was mostly generated from the sale of obsolete inventories.</u></p> <p>3. <u>Company A started the Software Business through its acquisition of a company (Acquisition) engaging in such business about a year ago. It was noted that:</u></p>

(a) In the latest financial year, the Group recorded revenue of around HK\$6 million from this business and an impairment loss of HK\$9 million on goodwill arising from the Acquisition. As at the latest year end date, the Group had total assets of HK\$280 million which included (i) goodwill of HK\$140 million arising from the Acquisition; (ii) a deposit of HK\$31 million paid for the acquisition of certain trademarks relating to the Fashion Accessories Business under an agreement signed two years ago; and (iii) cash and trade receivables.

(b) The Group's auditor had issued a disclaimer opinion on the Group's financial statements due to, among others, issues concerning the revenue recorded from the Software Business and the carrying value of the goodwill. In particular, the auditor had raised concern about the carrying value and recoverability of the goodwill having considered the short history of the Software Business, the difficulties faced by the management in executing the business plan and the lack of supporting information relating to the revenue from this business. Further, there was insufficient evidence to satisfy the auditors as to the recoverability of the deposit paid for the acquisition of trademarks.

(c) Towards the end of the latest financial year, all the staff for the development team of the Software Business left their employment, resulting in suspension of its operation. The operation resumed only after new staff were recruited three months later.

4. Company A submitted that it had plans to improve its business operations:

(a) The Group had entered into sales contracts of about HK\$16 million for the Software Business and was in discussion with potential customers on new contracts of HK\$6 million. Company A expected a significant increase in revenues from this business to HK\$23 million and HK\$35 million in the current and the next financial year respectively, but did not provide details or basis for its business plans or forecasts.

(b) Company A also planned to commence certain regulated activities under the Securities and Futures Ordinance (**Securities Business**). It expected to obtain the relevant licenses within 3 months and record revenue of about HK\$2.5 million from this business in the next financial year.

(c) Based on the above, Company A expected that it would record net profits of about HK\$2 million and HK\$16 million in the current and next financial year respectively.

Decision

5. The Exchange considered that Company A had failed to comply with Rule 13.24 because:

(a) Company A had a low level of operations. Its original Fashion Accessories Business had diminished substantially, causing the Group to record losses and negative operating cashflows in each of the last five years. Company A had decided to discontinue this business.

(b) Company A failed to demonstrate the viability and sustainability of its new businesses:

- The Software Business had a short operating history. It generated minimal revenue of HK\$6 million in the latest financial year, which was insufficient to cover the corporate expenses.

- Company A expected to record total revenue of HK\$58 million from the Software Business in the current and next financial years, of which Company A had entered into sale contacts of HK\$16 million only. Company A had not provided any details of its business plans to support a substantial increase in the scale of operations of the Software Business as projected.

- The Securities Business was still in at the planning stage and had not commenced operations. Based on Company A's projection, even if the business would proceed to operate as planned, it would generate revenue of HK\$2.5 million only in the next financial year.

(c) The Group's auditors had raised concerns about the recoverability of the goodwill relating to the Software Business and the deposit paid for acquisition of trademarks, which accounted for a majority of its assets. As noted above, Company A failed to demonstrate that it had sufficient assets to support the operation of a viable and sustainable business.

Case 5

Rule 13.24

Background

1. Company A and its subsidiaries (**Group**) were engaged in the manufacturing and distribution of multimedia and communication products.

2. Subsidiary B, a major operating subsidiary of Company A, was engaged in the manufacturing and distribution of communication products of a major brand of Company A (**Disposal Business**). It accounted for about 90% and 75% of the Group's revenue and assets. It was loss making in the latest financial year and recorded a profit of over HK\$30 million in each of the past few years.



3. Company A and Mr. X (the controlling shareholder of Company A) proposed to enter into the following transactions:

(a) Company A would sell Subsidiary B to Mr. X for cash (**Disposal**).

(b) Mr. X would sell his entire shareholding in Company A to Mr. Y who would then make an offer to acquire all the remaining shares in Company A from other shareholders. This transaction was conditional on the completion of the Disposal.

4. Upon completion of the Disposal, Company A would continue its existing business in the manufacturing and distribution of multimedia and communication products, excluding the product line owned by Subsidiary B (**Remaining Business**).

5. Company A submitted that the product line of Subsidiary B was loss making and the Disposal would allow it to focus on other product lines with better prospect and more profitable. Company A would use the proceeds from the Disposal as general working capital and for future business opportunities.

6. Company A was of the view that it would be able to meet Rule 13.24 upon completion of the Disposal because:

(a) The Remaining Business comprised distinct product lines and operated independently from the Disposal Business with its own manufacturing and distribution teams. It recorded revenue and profit of over HK\$200 million and HK\$4 million for the latest financial year. Based on Company A's profit forecast, the Remaining Business would continue to record profit and grow steadily.

(b) Upon the Disposal, Company A would have total assets of about HK\$450 million, including trade and other receivables, cash, inventories, fixed assets and trademark.

(c) The Disposal would improve Company A's financial performance by disposing of the loss making business.

Decision

7. The Disposal formed part of the arrangements between Mr. X and Mr. Y and was made to facilitate the sale of a controlling interest in Company A.¹ Company A had been engaged in the Disposal Business and Remaining Business since its listing on the Exchange. The Disposal Business accounted for the bulk of Company A's existing businesses and had been profitable in the past except in the latest financial year. The Exchange considered that Company A would not meet Rule 13.24 upon completion of the Disposal because:

	<p><u>(a) While Company A asserted that the Disposal would improve its financial performance, it failed to support its case or demonstrate that the Remaining Business was viable and sustainable. The Remaining Business only consisted of minor brands which were historically loss making and recorded a minimal profit in the latest financial year. It did not generate sufficient revenue and profits to justify a listing. The profit forecast submitted by Company A also failed to show substantial improvement in its operations and financial performance after the Disposal.</u></p> <p><u>(b) The assets of the Remaining Business mainly included trade and other receivables, cash, inventories, fixed assets and trademark. As noted above, the operation of these assets did not generate sufficient revenue and profits to justify a continued listing. The other asset of Company A would be the cash proceeds from the Disposal, but it failed to demonstrate how the cash retained by it would enable it to substantially improve its operations.</u></p> <p><u>Note 1: Rule 14.06E (which restricts an issuer from disposing of all or a material part of its existing business at the time of, or within 36 months from, a change in control) would also apply in the circumstances described in this case.</u></p>
<p>Case 6</p> <p><u>Rule 13.24</u></p>	<p><u>Background</u></p> <p><u>1. Company A was principally engaged in event operation and entertainment business through Subsidiary B (a major subsidiary of Company A in terms of operations and assets).</u></p> <p><u>2. Company A proposed to (i) sell a 25% interest in Subsidiary B to Company C (Disposal); and (ii) grant a call option (Call Option) to Company C over the remaining 75% interest in Subsidiary B upon completion of the Disposal.</u></p> <p><u>3. Company A was of the view that it would be able to meet Rule 13.24 upon completion of the proposal (i.e. the Disposal and the grant of the Call Option) because:</u></p> <p><u>(a) Until and unless Company C exercised the Call Option, Company A would continue to control Subsidiary B and therefore its business operations and assets.</u></p> <p><u>(b) The Call Option was not exercisable until 24 months after the Disposal. By the time it was exercised, Company A would have been expanded into other businesses.</u></p> <p><u>Decision</u></p> <p><u>4. The Exchange considered that Company A would not meet Rule 13.24 upon completion of the proposal because:</u></p>

- (a) Company A's business operations and assets were primarily carried out and held through Subsidiary B.
- (b) The exercise of the Call Option was entirely at Company C's discretion. By granting the Call Option, Company A was prepared to lose its ownership and control over Subsidiary B. As Company A had no other material business operations or assets, it would no longer be suitable for listing upon completion of the proposal. Whether and when Company C would exercise the Call Option was irrelevant.
- (c) Company A stated its intention to carry out other businesses, but it could not demonstrate that it would have a new business suitable for listing upon completion of the proposal.

Case 7

Rule 13.24

Background

1. Company A and its subsidiaries (**Group**) were engaged in the property construction and related business (**Construction Business**) since its listing on the Exchange. Since last year, the Group had diversified into property management business (**Property Business**) and trading of financial products (**Trading Business**).
2. Company A proposed to sell the Construction Business to Mr. X (**Disposal**). Mr. X was a director of certain subsidiaries of Company A that carried on the Construction Business. He ceased to be Company A's controlling shareholder about three years ago when he sold his entire interest in Company A to the existing controlling shareholder.
3. Company A submitted that the Construction Business had been loss making in the last two years, and the Disposal would allow it to diversify into other businesses with growth potential. The sale proceed would be used by the Group as general working capital.
4. The Disposal would reduce the Group's revenue and assets by about 70%. Company A submitted that it would be able to meet Rule 13.24 upon completion of the Disposal because:
 - (a) The Group would continue to carry out the Property Business and the Trading Business (together, **Remaining Businesses**).
 - (b) The Property Business involved the provision of management services to a number of small-scale property developers in the PRC and would provide a stable source of income to the Group in the coming years. The Group recorded minimal revenue and a segment loss from the Property Business in the last financial year because it only acquired this business for a few months. Company A expected the Property Business to generate revenue of about HK\$20 million and a segment profit of over HK\$10 million in the current financial year.



(c) Company A commenced the Trading Business last year and recorded revenue and a segment profit of over HK\$500 million and HK\$1 million. This business was expected to double its revenue and segment profit in the current financial year.

(d) Company A also held a residential property overseas (**Property**) with a book value of about HK\$20 million. It planned to re-develop the Property for re-sale.

Decision

5. The Exchange considered that Company A would not meet Rule 13.24 upon completion of the Disposal because:

(a) The Disposal would substantially reduce the Group's scale of operations and assets. After the Disposal, the Group would be left with the Remaining Businesses that were acquired or established for less than one year. These businesses recorded a loss or minimal profit in the latest financial year. Based on Company A's projections in the current year, the Property Business would record revenue of HK\$20 million and a segment profit of HK\$10 million only. The segment profit from the Trading Business would also be minimal as it was only trading products on an indent basis with a very low profit margin. The scale of the Remaining Businesses was insufficient to justify a listing.

(b) While Company A asserted its intention to re-develop the Property, there was no detail about the re-development plan. Company A failed to demonstrate how it could substantially improve the Group's operations and financial performance after the Disposal.

(c) The assets of the Remaining Businesses were mainly cash, trade receivables and the Property. As mentioned in above, the operations of these assets could not generate sufficient revenue and profits to justify a listing.

Case 8

Rule 13.24

Background

1. Company A and its subsidiaries (**Group**) had been engaged in the manufacturing and sale of packaging products (**Packaging Business**) since its initial listing on the Exchange in 20x1. The Packaging Business accounted for the Group's entire revenue and net profit until Company A acquired a company (**Subsidiary B**), which operated an advisory business (**Advisory Business**), from Mr. X in November 20x6.

2. Before acquired by Company A, Subsidiary B recorded minimal revenue of HK\$3 million for the 30 months from January 20x4 to June 20x6. This revenue was generated from providing corporate secretarial services. Subsidiary B recorded net losses and net liabilities in 20x4 and 20x5.



3. Subsidiary B's revenue increased significantly from July 20x6 onwards. For the 10 months between July 20x6 and April 20x7, it recorded total revenue of approximately HK\$230 million, resulting in a net profit of HK\$48 million for 20x6 and HK\$19 million for the first four months in 20x7. Of such revenue of HK\$230 million, only 2% was generated from recurring corporate secretarial services with the remaining 98% generated from different types of new services, mostly non-recurring in nature, including advice on financial accounting, valuation, merger and acquisition, loan referral, property agency, project agency and strategic planning. Of such revenue of HK\$230 million, 70% was derived from one transaction with one client whilst 10% was derived from another transaction with the second largest client.
4. In April 20x7 Company A proposed to sell the Packaging Business to an independent third party (**Disposal**) as the profitability of the Packaging Business had persistently decreased in the past three years. The sale proceeds would be used by the Group to settle its liabilities.
5. Company A submitted that the Group would meet Rule 13.24 upon completion of the Disposal because:
 - (a) The Advisory Business had recorded substantial revenue and profits since July 20x6.
 - (b) It had secured advisory contracts for over HK\$50 million in the next two financial years which would ensure the stability and continuity of the Group's income stream.
 - (c) The Advisory Business was a substantiable business. It had established relationship with a number of new clients through Mr. X's personal network and referrals by those new clients.

Decision

6. The Exchange considered that Company A would not meet Rule 13.24 upon completion of the Disposal. In particular, the Exchange questioned the viability and sustainability of the Advisory Business after considering:
 - (a) The history of Company A's operation and management of the Advisory Business was very short (less than 6 months when the Disposal was proposed).
 - (b) The Advisory Business recorded minimal revenue and net losses in previous years. While such business recorded a significant increase in revenue in recent months, it had a very small customer base and a large majority of the revenue was generated from one transaction. The Exchange was concerned with the substance of this transaction, and the work performed by Subsidiary B to earn the substantial fees and the basis of determination of such fees.

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| | <p><u>(c) Company A failed to demonstrate the viability and sustainability of the Advisory Business given its limited customer base and heavy reliance on Mr. X to generate business and the questionable basis for the substantial fees from the transaction with one client.</u></p> <p><u>(d) After the Disposal, the Group's assets would mainly comprise the goodwill arising from the acquisition of the Advisory Business, a vacant property and some cash. As noted above, Company A failed to demonstrate that these assets could support the operation of a viable and sustainable business.</u></p> |
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Note: Listing Review Committee decisions on Rule 13.24 also offer guidance on this subject.

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 Division on a confidential basis for an interpretation of the Listing Rules, or this letter.