

## HKE<sub>x</sub> LISTING DECISION

HKE<sub>x</sub>-LD41-1(November 2004) (Updated for rule reference in September 2009)

[Streamlined and incorporated into the Guide for New Listing Applicants in January 2024]

Summary	
<b>Category</b>	Listing Decisions Series 41-1 (LD41-1)
<b>Name of Party</b>	Company A and its subsidiaries (the “Group”) - a Main Board listing applicant
<b>Subject</b>	<p>In view of there being a material disparity between the IPO price of the shares of Company A (the “Shares”) and the effective cost to the pre-IPO shareholders of Company A of the shares acquired by them in transactions shortly prior to listing:-</p> <p>a. What would be the applicable standard of review when examining the legality of those transactions?</p> <p>b. What disclosure was required in the prospectus?</p>
<b>Listing Rules</b>	Rules 2.13; 8.04; 8.05(1)(c); and 11.07
<b>Decisions</b>	<p>In view of there being a material disparity between the IPO price of the Shares and the effective cost to pre-IPO shareholders of the shares acquired by them in transactions shortly prior to the IPO, Company A was required to demonstrate to the Exchange the legality of the various pre-IPO share acquisitions of and injections of capital in a member of the Group that resulted in the above material disparity.</p> <p>The prospectus was required to include prominent disclosures in this respect (see particulars below) and consideration was required to be given whether to include such disclosures as risk factors.</p>

### SUMMARY OF FACTS

1. In preparation for the initial public offer (the “IPO”) of the shares of Company A (the “Shares”), a group reorganisation was effected shortly before the IPO. Pursuant to the reorganisation, the shares of the only operating company of Company A (the “Principal Subsidiary”) were exchanged for the Shares of Company A, such that, at the time of listing, Company A became the holding company of the Principal Subsidiary and the shareholders of the Principal Subsidiary became the shareholders of Company A.

2. The pre-IPO shareholders had previously acquired the shares of the Principal Subsidiary (through share acquisitions and injections of capital) at different times during the track record period but all shortly before the IPO. It was submitted by the sponsor that the consideration paid for each of the acquisitions and injections of capital by the pre-IPO shareholders was established by reference to the total net asset valuation of the shares of the Principal Subsidiary as valued by independent valuers at the relevant time. Independent valuations were required as the above transactions involved disposals of assets by vendor companies which were PRC State-owned entities.
3. There was a material difference in the net asset value shown in the accountants' report included in the prospectus prepared for the IPO in accordance with the Listing Rules and the net asset value of the Principal Subsidiary as shown in the valuation reports prepared by independent valuers for the purpose of the various share acquisitions by the pre-IPO shareholders which took place shortly prior to the IPO. All the valuations were purported to establish the net asset value of essentially equivalent assets, and yet the valuations had increased substantially within a short interval. In addition, the Exchange also noted a material disparity between the IPO price of the Shares and the effective cost to the pre-IPO shareholders of the shares acquired by them in recent pre-IPO transactions.
4. The material difference in the asset valuations occurring within such a short period of time gave rise to a concern whether the interests of the PRC State-owned entities which disposed the shares of the Principal Subsidiary might have been unfairly prejudiced in these transactions. This concern led to the question of whether the disposals by those PRC State-owned entities could be legally challenged.
5. Furthermore, the significant difference in value between the IPO price of the Shares and the effective cost to pre-IPO shareholders of the shares acquired by them in recent pre-IPO transactions meant that the new purchasers of the Shares would suffer a material degree of dilution in share value (by comparing the IPO price to the pro forma adjusted combined net tangible book value of the Shares as stated in the prospectus). In contrast, the shareholders of Company A would experience a gain in share value by reason of their recent pre-IPO acquisitions of the shares of the Principal Subsidiary at a price based on a substantially lower net asset valuation.

## **THE ISSUES RAISED FOR CONSIDERATION**

6. In view of there being a material disparity between the IPO price of Shares and the effective cost to the pre-IPO shareholders of the shares acquired by them in transactions shortly prior to listing:-
  - a. What would be the applicable standard of review when examining the

legality of the previous acquisitions of shares of and injections of capital shortly prior to IPO?

- b. What disclosures would be required in the prospectus?

## **APPLICABLE LISTING RULES**

7. The Main Board Listing Rule 8.04 provides that “*both the issuer and its business must, in the opinion of the Exchange, be suitable for listing*”.
8. The Main Board Listing Rule 8.05(1)(c) requires a new applicant to have ownership continuity and control for at least the most recent audited financial year.
9. The Main Board Listing Rules 2.13 and 11.07 and GEM Listing Rules 2.18 and 6.57 [*now GEM Listing Rule 6A.35*] contain general guidance on presentation of information in, amongst other documents, the listing documents, which require directors and/or sponsors to ensure that information that is required to be disclosed under the Listing Rules is accurate and complete in all material respects and not misleading or deceptive.
10. For GEM listing applicants, Paragraph B9(e) of Checklist 1.F under the heading “Additional information to be submitted” as contained in the *Revised Guidance for New Listing Applications (GEM Board)* also requires the sponsor to disclose to the Listing Division the following:-

*“In respect of the shares held by shareholders, the cost of investment in such shares (in total and per share basis), and details of each subscription/acquisition/disposal including the date of subscription/transfer, the identity of the disposing/acquiring shareholder, subscription money/consideration paid, number of shares and percentage of equity interest received, the basis for the consideration paid, etc.”*

## **ANALYSIS**

### ***Standard of review of the listing application***

11. When interpreting the requirements of the Listing Rules, in particular Main Board Rules 8.04 and 8.05(1)(c), the Listing Division customarily requires that the shareholders of the listing applicant have good title to the shares of the listing applicant in that they are free from third party claims. The burden of proof is on the sponsor and the directors of the applicant to demonstrate, by a clear preponderance of evidence in the materials submitted for review, that the pre-IPO shareholders of a listing applicant hold the shares of the listing applicant in good faith and in accordance with all relevant laws and regulations.

12. When reviewing a listing application, if the facts reveal a material difference in the valuations of all or a material portion of the assets of the listing applicant or those of its predecessor within a short period of time prior to listing, such facts would give rise to a concern of whether the title to the shares of the listing applicant or of its predecessor could be challenged by the vendors of those shares due to undervalued pre-IPO sale and purchase transactions. In these circumstances, the Exchange is empowered under the Listing Rules to require a higher level of assurance from the listing applicant and its professional advisors to ensure the legality of all previous share acquisitions of or injections of capital for shares in any member of the group before listing.
13. Applying the above analysis, and based on the facts and circumstances of the cases which revealed a material disparity in the valuations of the Shares within a short period of time, the Exchange determined that it was appropriate to require a higher level of assurance from Company A, the sponsor and its advisers for the purpose of demonstrating to the Exchange the legality of the various acquisitions of shares of and injections of capital in the Principal Subsidiary which took place shortly before listing.
14. Based on the further submissions from the sponsor and the legal opinions of the PRC legal adviser that Company A had complied with all relevant PRC laws and regulations, the Exchange was satisfied that Company A had provided proper evidence to demonstrate the legality of the pre-IPO share acquisitions and injections of capital.

***Prospectus disclosure***

15. In view of the materiality of the information regarding disparity in value between the IPO share price and the historical acquisition costs to existing shareholders of the same shares, the Exchange expects that the directors of listing applicants and sponsors assume the responsibility under the Main Board Listing Rule 2.13 and 11.07 and GEM Listing Rules 2.18 and 6.57 [*now GEM Listing Rule 6A.35*] to ensure that such information, to the extent the information is material, is included and given appropriate prominence in the prospectus.
16. It is currently the practice of the GEM Board that the cost of investment in the shares of a GEM new listing applicant, in total and in per share basis, is disclosed in a tabular format in every GEM prospectus. There is no equivalent requirement specified in the Main Board Listing Rules.
17. Given the material disparity between the IPO price of the Shares and the price of those shares paid by pre-IPO shareholders shortly prior to the IPO, the Exchange considered that such information was material to investors for the purpose of making an assessment whether to invest in Company A. The Exchange therefore considered that prominent disclosure in the prospectus in this respect was required.

In addition, the prospectus was also required to contain statements regarding the legality of the acquisitions of shares of and injections of capital in the Principal Subsidiary prior to listing.

## **DECISIONS**

18. Based on the facts and circumstances of the case and given the material disparity between the IPO price of the Shares and the effective cost to pre-IPO shareholders of the shares acquired by them shortly prior to the IPO, Company A was required to demonstrate to the Exchange the legality of the various pre-IPO share acquisitions of and injections of capital in the Principal Subsidiary that resulted in such material disparity.
19. The prospectus was required to include prominent disclosures of the matters mentioned below, and consideration was required to be given whether to include such matters as risk factors:-
  - a. statements regarding the legality of the acquisitions of shares and injections of capital in the Principal Subsidiary prior to listing;
  - b. the historical costs paid by the pre-IPO shareholders and the valuations of the Principal Subsidiary at different points of time; and
  - c. quantitative disclosure of the dilution in share value that new investors purchasing Shares at the IPO would suffer. In the present case, the Exchange considered it acceptable that the dilution in share value be expressed as a comparison, on a per share basis, between the IPO price and the pro forma adjusted combined net tangible book value immediately after the IPO.