



Hong Kong

April 2020

## HKEX UPDATES AND STREAMLINES GUIDANCE MATERIALS

On 28 February 2020, HKEx updated its listing guidance including guidance for mineral company listing applicants and on the IPO sponsor due diligence work and listing document disclosure required for distributorship business models. The updated materials include three revised Guidance Letters and eight sets of Frequently Asked Questions (**FAQs**). 15 Guidance Materials have also been withdrawn. The updates are part of a review process of over 200 guidance materials started by HKEx in early 2018 in response to professional advisers' suggestions that Guidance Materials should be streamlined. The first three sets of updates were published in July 2018,<sup>1</sup> March 2019<sup>2</sup> and April 2019,<sup>3</sup> respectively.

The latest update involves:

- **3 updated HKEx Guidance Letters**
  - Guidance Letter GL89-16 on issues related to "controlling shareholders" and related Listing Rules implications;<sup>4</sup>

- Guidance Letter GL52-13 on mineral companies;<sup>5</sup> and
- Guidance Letter GL36-12 on due diligence to be conducted by IPO sponsors and listing document disclosure of distributorship business models.<sup>6</sup>
- **8 updated FAQs**<sup>7</sup> – FAQ Series 1, 5, 8, 20, 24, 26, 31; and FAQ Nos. 008-2017 to 022-2017 and 023-2018.
- **15 withdrawn Guidance Materials**<sup>8</sup> – Eight Guidance Materials have been consolidated into the revised GL52-13 for mineral companies; four outdated Listing Decisions (LD106-1, LD46-3, LD21-2 and LD12-3) and three Interpretative Letters (RL4-05, RL6-05 and RL22-07) have been withdrawn.

This newsletter provides a summary of the guidance updates.

1 HKEx. Exchange updates and streamlines its guidance materials. July 2018. Available at: [https://www.hkex.com.hk/News/News-Release/2018/1807132news?sc\\_lang=en](https://www.hkex.com.hk/News/News-Release/2018/1807132news?sc_lang=en)

2 HKEx. Exchange updates and streamlines its guidance materials. March 2019. Available at: [https://www.hkex.com.hk/News/News-Release/2019/1903224news?sc\\_lang=en](https://www.hkex.com.hk/News/News-Release/2019/1903224news?sc_lang=en)

3 HKEx. Exchange updates and streamlines its guidance materials. April 2019. Available at: [https://www.hkex.com.hk/News/News-Release/2019/190426news?sc\\_lang=en](https://www.hkex.com.hk/News/News-Release/2019/190426news?sc_lang=en)

4 GL89-16 is available at [https://en-rules.hkex.com.hk/sites/default/files/net\\_file\\_store/new\\_rulebooks/g/l/gl8916.pdf](https://en-rules.hkex.com.hk/sites/default/files/net_file_store/new_rulebooks/g/l/gl8916.pdf)

5 GL52-13 is available at [https://en-rules.hkex.com.hk/sites/default/files/net\\_file\\_store/new\\_rulebooks/g/l/gl5213.pdf](https://en-rules.hkex.com.hk/sites/default/files/net_file_store/new_rulebooks/g/l/gl5213.pdf)

6 GL36-12 is available at [https://en-rules.hkex.com.hk/sites/default/files/net\\_file\\_store/new\\_rulebooks/g/l/gl3612.pdf](https://en-rules.hkex.com.hk/sites/default/files/net_file_store/new_rulebooks/g/l/gl3612.pdf)

7 HKEx. Rules and guidance: frequently asked questions. February 2020. Available at: <https://en-rules.hkex.com.hk/node/5074>

8 HKEx. Rules and guidance: archive. February 2020. Available at: [https://www.hkex.com.hk/Listing/Rules-and-Guidance/Archive?sc\\_lang=en](https://www.hkex.com.hk/Listing/Rules-and-Guidance/Archive?sc_lang=en)

## Updated HKEx Guidance Letters on Controlling Shareholders, Mineral Companies and Distributorship Business Models

### 1. HKEx Guidance Letter 89-16: Situation when there is no Controlling Shareholder

HKEx Guidance Letter GL89-16 has been updated to include guidance that in relation to the ownership continuity and control requirement that is a condition for meeting the financial requirement tests of Main Board Rule 8.05 (and the cashflow test of GEM Rule 11.12A(2)), the terms “controlling shareholder” and “group of controlling shareholders” in the situation where there is either no controlling shareholder or a group of controlling shareholders will mean: (i) the single largest shareholder; or (ii) the group of shareholders considered as the single largest shareholder.

### 2. HKEx Guidance Letter 52-13: Further Guidance for Mineral Company Listing Applicants

Updated HKEx Guidance Letter 52-13 streamlines and consolidates guidance for mineral companies set out in various guidance materials. HKEx Guidance Letter 22-10, Listing Decisions LD31-2012, LD32-2012, LD49-2013, LD50-2013, LD51-2013, and LD53-2013 and FAQ Series 12 have been withdrawn. FAQ Series 20 has been updated.

Revised HKEx Guidance Letter 52-13 provides comprehensive guidance on the following:

#### i) Prospectus Disclosure

The following specific disclosure requirements for the prospectus and Competent Person’s Report have been added:

##### a) “Summary” section

- A summary of exploration results (if applicable);
- Access of mines/ oilfields to major transportation networks, and mining rights which are pledged to secure the applicant’s banking facilities or a negative statement;
- Validity period and the approved production volume of mining and exploration licenses in tabular format;

- Specification of production volume of each major product during the track record period;
- b) *Competent Person’s Report (the CPR) and related disclosure*
  - The cut-off grade has to be an industry standard commonly used;
  - Prevailing commodity price assumptions;
  - The time frame required to address key recommendations in the CPR should be disclosed in the listing document’s “Business” section;
- c) *“Business” section*
  - Dispensing with the requirement to use a flow diagram or summary table to disclose construction details by key stages;
  - Description of how the applicant manages any upside and downside market developments;
  - Dispensing with the requirement to disclose the availability of contractors providing similar services on similar terms, and how the applicant manages the risks associated with the outsourcing arrangement and reliance on the contractors;
  - Dispensing with the requirement to disclose how the utility fees charged to an applicant compares with the market rates charged to other users;
  - Dispensing with the requirement to disclose whether the applicant is able to identify any alternative supplier at competitive prices, and salient terms of the utility contracts;
  - Dispensing with the requirement to disclose whether an applicant experienced any material disruptions as a result of shortage of utilities, including electricity and water;
  - Material differences and reasons for utilities not being charged at market rates;

- Dispensing with the requirement to disclose salient terms of the sales agreements, if any, and whether those terms are in line with industry standards;
  - Dispensing with the requirement to disclose whether an applicant has experienced any shortage of transportation capacity for its products during the track record period and up to the latest practicable date; and
  - Details of any requirement to rehabilitate the affected environment and regulations.
- ii) Main Board Rule 18.04 Exemption for Mineral Company Listing Applicants from Financial Requirements of Main Board Rule 8.05 (Listing Rule 18.04 Exemption)

Main Board Listing Rule 18.04 exempts a mineral company listing applicant from having to comply with the eligibility requirements of Main Board Listing Rule 8.05 – i.e. the profit test, market capitalisation/revenue/cash flow test or market capitalisation/revenue test, which also include the management continuity and ownership and control requirements. In order to rely on the Listing Rule 18.04 Exemption, a mineral company applicant has to fulfill the following two conditions:

a) *Path to commercial production*

To demonstrate a clear path to commercial production:

- the mineral company applicant must have conducted exploration and/ or development activities on some or all of its mining assets during part or all of the track record period (**PreProduction Mining Assets**). This means that if all its mining assets were under production throughout the track record period, it will not be able to satisfy this condition and must instead satisfy the requirements of HKEx Listing Rule 8.05;
- the Pre-Production Mining Assets must comprise a meaningful portfolio (in terms of quality and quantity) of Resources and Reserves; and
- the listing applicant must present a detailed plan, with reasonable assumptions, to achieve profitable commercial production with respect to the Pre-

Production Mining Assets. When assessing the feasibility of the plan, HKEx will consider the following factors, as applicable:

- a) life of the mine with the Pre-Production Mining Assets and project payback period;
- b) the development/ production stage of the Pre-Production Mining Assets;
- c) the Competent Person's view on the adequacy and reasonableness of the applicant's mine plan, production schedule and/ or Pre-feasibility Study;
- d) commodity price and demand for the applicant's products (e.g. binding commitments from existing/ potential customers);
- e) an estimate of cash operating costs and cost of proposed exploration and/ or development;
- f) feasibility of future fund raising (other than IPO) required to bring the project to the production; and
- g) the level of certainty as to whether the necessary mining permits and licenses will be obtained.

The listing document must include details of the plan to provide investors with sufficient information to perform an informed assessment on the value of a mineral company applicant.

b) *Directors' and management experience*

Directors and managers must have experience relevant to the exploration and/or extraction activity that a mineral company is pursuing (Main Board Listing Rule 18.04/ GEM Listing Rule 18A.04). Where the directors' or managers' experience in commodities or minerals is different from the listing applicant's operations, the HKEx will take into account:

- 1) whether such skills are transferable to the listing applicant's mining activities; and

- 2) his/ her academic and professional qualifications, significant mining related achievements/ awards, and contribution to the mining industry and/ or any mineral companies.

iii) Alternative Petroleum Reporting Standards

a) *Alternative reporting standards*

Main Board Listing Rule 18.32 (GEM Listing Rule 18A.32) requires disclosure of petroleum resources and reserves in accordance with Petroleum Resources Management System (**PMRS**) or any other code with respect to which HKEx is satisfied that it provides a comparable standard of disclosure and sufficient assessment of the underlying assets. Guidance Letter 52-13 has been revised to provide that in determining whether any other code meets this requirement, HKEx will consider:

- 1) whether the alternative reporting standards are well recognised internationally and comparable to the requirements of Chapter 18 of the Main Board Rules (Chapter 18A of the GEM Rules)<sup>9</sup>; and
- 2) why the applicant is adopting the alternative reporting standards instead of PMRS. For example, the applicant is listed on an overseas exchange or operates in a jurisdiction where the alternative reporting standard is a filing requirement.

b) *Pre-tax basis for presenting net present value*

There are circumstances under which the HKEx will allow presentation of net present value on pre-tax basis, namely if:

- 1) such disclosure is required or allowed under a widely adopted reporting standard; and
- 2) is in line with disclosure made by comparable listed companies.

<sup>9</sup> For example, it was stated in the 2009 Consultation Paper that the Canadian Standards of Disclosure for Oil and Gas Activities ("NI 51-101") and the U.S. Securities and Exchange Commission's Oil and Gas Disclosure Standards are globally recognised yardsticks for making oil and gas evaluations.

c) *Waiver for disclosure of economic values of Possible Reserves, Contingent Resources or Prospective Resources*

Main Board Rule 18.33(6) (GEM Rule 18A.33(6)) does not allow listing applicants to attach economic values to Possible Reserves, Contingent Resources or Prospective Resources because the measurement of such values usually lacks a widely accepted industry standard and their estimate has with a considerable level of uncertainty.

In the past, the HKEx has granted a waiver for disclosure of economic values of Possible Reserves, Contingent Resources or Prospective Resources which is prohibited under Main Board Rule 18.33(6) (GEM Rule 18A.33(6)). Revised Guidance Letter 52-13 outlines two situations in which this waiver has been granted:

- 1) The first case involved an applicant whose Petroleum Resources were located in Canada and subject to NI51-101, which permits disclosure of estimates of both the volumes and values of all reserves and resources, including Possible Reserves, Contingent Resources and Prospective Resources. This applicant's disclosure was in line with disclosures made by its comparable companies listed in Canada.
- 2) The second example concerned the existence of the applicant's Petroleum Resources (oil sand) which was more certain than typical Petroleum Resources such as oil, mainly because of the abundance of oil sand in the area where it operated, and the recoverability was largely within the applicant's control as it was mainly dependent upon the applicant's commitment to develop them.

iv) Competent Person's Report

Under Main Board Rule 18.05(1) (GEM Rule 18A.05(1)), a mineral company applicant must establish that it has at least a portfolio of Indicated or Contingent Resources substantiated in a Competent Person's Report, which must be disclosed in the listing document.

Given the considerable burden and impracticality of requiring an applicant to include every resource for a Competent Person's Report in its listing document, HKEx may grant a waiver to allow certain listing applicants to exclude part of their mining assets from the Competent Person's Report (**Excluded Projects**) on the following basis:

- 1) the Excluded Projects were not material to the applicant's portfolio of mineral/ petroleum Resource; and
- 2) the listing applicant demonstrated that the necessary information for the preparation of a CPR was not available (e.g. when the mine was at early exploration stage, or the applicant did not have the necessary information on the relevant entities or businesses which it planned to acquire or had an option to acquire).

HKEx will only grant the waiver under special circumstances. An example was where a mineral company applicant had no intention or plan to develop a mine due to its insignificant size and lack of commercial value.

Once a waiver is granted by the HKEx, applicants are required to fulfill the following obligations:

- 1) disclose relevant material information in the listing document including the proposed terms of acquisitions such as the location and size of the Excluded Projects, expected mineral quality, proposed purchase consideration and expected development cost, for investors' assessment on the potential of the Excluded Projects and the likely benefit of the acquisitions;
- 2) provide an update on the stage of development and the management's intention on the Excluded Projects in the annual reports in accordance with Main Board Rules 18.15 to 18.17 (GEM Rules 18A.15 to 18A.17), to enable investors to understand the progress of acquisition/ the development of the part of the portfolio of resources that are not previously reported on by a competent person; and
- 3) prepare and publish a Competent Person's Report in accordance with the relevant requirements under Chapter 18 and Appendix 25 of the Main

Board Listing Rules (Chapter 18A and Appendix 18 of the GEM Rules) when the relevant information becomes available.

### **3. Guidance Letter GL36-12: Guidance on due diligence to be conducted by the sponsor and disclosure in the listing document relating to a distributorship business model**

Updated Guidance Letter 36-12 provides more specific guidance on IPO sponsor due diligence work and prospectus disclosure requirements in relation to distributorship models to assist investors in assessing the quality of listing applicants' revenue.

The HKEx is primarily concerned with whether an applicant that sells its products to end-customers through multiple levels of third-party intermediaries can accurately assess end-customer demand.

#### i) Definitions of "distributors" and "sub-distributors"

The HKEx defines "distributors" and "subdistributors" as those who contractually resell or are expected to resell the listing applicant's products, which include franchisees and consignees. To identify the listing applicant's distributors, the Guidance Letter requires sponsors to assess the substance of the listing applicant's business relationship with its counterparties. Retail buyers who are not expected to further resell the applicant's products would not normally be considered a distributor, even if they occasionally resell the applicant's products to third parties.

#### ii) Steps required of sponsors to address major risks arising from a distributorship business model

##### *a) Channel stuffing*

It is possible that products are not reaching end-customers and remaining in the applicant's distribution network if a listing applicant's distributors or sub-distributors are subject to mandatory sales targets and/ or unusually long return policies.

IPO sponsors are expected to perform due diligence on whether sales correspond to actual end-customer demand, particularly where there are minimum sales targets or requirements. Listing documents are also required to disclose

the listing applicant's overall inventory control and management policy, including how the listing applicant monitors its distributors' inventory level and the amount of unsold inventory they hold distributors as at the end of each track record period and the latest practicable date.

The Guidance Letter also notes that even in the absence of required sales targets, sales may still not accurately reflect actual demand if the listing applicant offers long or extensive return/refund terms. Sales recognised may thus be reversed later if actual sales return is higher than the expected return rate. HKEx requires sponsors and reporting accountants to examine the listing applicant's goods return policy and the amount of returned goods during the track record period.

b) *Recoverability of Accounts Receivables*

The Guidance Letter notes that long outstanding accounts receivables from distributors or sub-distributors may be a red flag. A substantial increase in aged accounts receivable and debtors' turnover days heightens the risk of receivables' recoverability affecting the listing applicant's liquidity and sustainability. In these circumstances, the listing applicant's directors and the sponsors must give their views, and the basis for such views, on whether the applicant's credit management policy is appropriate. The directors and the reporting accountants are also required to substantiate their views as to adequacy of the provisions for accounts receivable.

The listing document must also include:

- 1) a discussion of the recoverability of accounts receivable and the subsequent settlement of the balance as at the latest practicable date; and
- 2) the impact of the increase in accounts receivable and debtors' turnover days on the listing applicant's liquidity and cash flow.

The sponsors must also assess the above risks with respect to sub-distributors to the extent the listing applicant or its distributors can control the sub-distributors and conduct appropriate due

diligence. HKEx recognises that, in the absence of a written agreement, a listing applicant may have no control over its distributors or its sub-distributors. A discussion of the listing applicant's degree of control, direct and indirect, over its distributors or sub-distributors needs to be included in the listing document together with a relevant risk factor.

iii) Prospectus Disclosure

The HKEx gives updated guidance on prospectus disclosure to facilitate investors' understanding of the arrangements and the control a listing applicant has over its distributors and assessment of the risks associated with the distributorship business model. Disclosure is required of:

- the extent to which historical sales are non-recurring, the reasons therefor and the associated risk;
- reasons for using the particular distributorship business model;
- the listing applicant's different distribution channels and their respective revenue contribution during the track record period;
- if the listing applicant is adopting a cannibalisation strategy, a discussion of the rationale for this strategy and its impact on the applicant's historical and expected financial performance;
- whether the distributor is an independent third party or has any other relationship with the listing applicant (e.g. the distributor is controlled by the applicant's former or current employees, uses the applicant's brand/name or has received any material advance or financial assistance from the applicant);
- a discussion of the listing applicant's revenue recognition and unsold goods return/ refund policies;
- the principal terms of the distribution/ consignment/ franchise agreements including whether there are any terms:
  - a) requiring a minimum purchase amount or a minimum sales target;
  - b) restricting the appointment of sub-distributors;

- c) that mandate selling price(s) to sub-distributors or end-customers; and
  - d) relating to a goods return policy and whether this policy is in line with industry practice. If not, the applicant must disclose the number of sub-distributors (if any) during the track record period and the listing applicant's control (if any) over the sub-distributors;
- the turnover rates and movement in the number of distributors during the track record period and reasons for any major changes

The Guidance Letter update has removed the requirement to disclose the amounts of sales to, and goods returned from, distributors during the track record period.

v) Distribution through social media platforms

In view of the rise of social media platforms and key opinion leaders as a means to promote and sell goods, sponsors are expected to perform sufficient due diligence on the platform and key opinion leaders to assess the substance of a listing applicant's relationship with its counterparties to identify the distributors.

### **Eight Sets of Updated FAQs<sup>10</sup>**

- FAQ Series 1 (HKEx Listing Rule requirements relating to listing criteria issues): of the 44 questions, the HKEx has updated 20 to rephrase the questions and provide more direct answers, and/ or remove outdated guidance/ rule references, and withdrawn 10 mainly because the relevant guidance is already covered in the HKEx Listing Rules or other Guidance Materials.
- FAQ Series 5 (HKEx Listing Rule amendments relating to GEM Review): of the 34 questions, the HKEx has updated 15 to combine similar questions and provide more direct answers and detailed explanation of its current practices, and withdrawn 18 mainly because the market is already familiar with the relevant GEM requirements which were introduced in 2008.
- FAQ Series 8 (HKEx Listing Rule amendments relating to the 2008 Combined Consultation): of the 53 questions, the HKEx has updated 17 to provide more direct

answers, and withdrawn 10, mainly because the market is already familiar with the relevant requirements which were introduced in 2008.

- FAQ Series 20 (HKEx Listing Rule requirements relating to notifiable transactions, connected transactions and issues of securities): of the 26 questions, four related to mineral companies have been withdrawn and the relevant guidance is included in revised GL52-13.
- FAQ Series 24 (HKEx Listing Rule changes to complement the Securities and Futures Commission's new Sponsor Regulation effective on 1 October 2013): of the 14 questions, the HKEx has updated five to rephrase the questions and to provide more direct answers; one related to administrative arrangements on hearing invitations has been withdrawn, which the market is already familiar with.
- FAQ Series 26 (Questions relating to the new Companies Ordinance (**New CO**) and its impact on issuers): Only editorial amendments have been made to the eight questions, which still provide valid and useful guidance.
- FAQ Series 31 (Questions relating to the Review of Listing Rules on Disclosure of Financial Information with reference to the New Companies Ordinance and Hong Kong Financial Reporting Standards and Proposed Minor/Housekeeping Rule Amendments): of the 14 questions, the Exchange has updated four to rephrase the questions and provide direct answers, and withdrew seven which provided guidance on the certain Rule amendments in 2015.
- FAQ No.008-2017 to 022-2017 and 023-2018 (Questions relating to the Review of The Growth Enterprise Market (GEM) and changes to the GEM and Main Board Listing Rules): of the 16 questions, three have been updated to provide clearer guidance, and three on providing guidance on the arrangements in relation to the Rule amendments in 2018 have been withdrawn.

### **15 Withdrawn Guidance Materials<sup>11</sup>**

In addition to the eight Guidance Materials that have been consolidated into the revised GL52-13 as mentioned above, four outdated Listing Decisions (LD106-1, LD46-3, LD21-2 and LD12-3) and three Interpretative Letters (RL4-05, RL6-05 and RL22-07) have been withdrawn.

<sup>10</sup> See footnote 7

<sup>11</sup> See footnote 8

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