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[online version](http://www.charltonslaw.com/hong-kong-stock-exchange-publishes-guidance-letter-on-suitability-for-listing-and-listing-decision-on-the-suitability-for-listing-of-applicants-which-had-conducted-business-in-countries-subject-to-san/)

# Hong Kong Stock Exchange Publishes Guidance Letter on Suitability for Listing and Listing Decision on the Suitability for Listing of Applicants which had Conducted Business in Countries Subject to Sanctions

## Introduction

The Hong Kong Stock Exchange (the **Exchange**) has published Guidance Letter [GL68-13](http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/iporq/Documents/gl68-13.pdf) ([see archive](gl68-13.pdf)) providing guidance on the factors considered by the Exchange when assessing whether a listing applicant and its business are suitable for listing under Main Board Rule 8.04 (GEM Rule 11.06). Separately, the Exchange has published Listing Decision [LD76-2013](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld76-2013.pdf) ([see archive](ld76-2013.pdf)) in relation to whether the listing applicants the subject of the decision were suitable for listing given that they had conducted businesses in certain countries which were subject to trade or economic sanctions imposed by overseas governments before and during the track record period. This newsletter provides a summary of Guidance Letter GL68-13 and the listing decision referred to above.

## Hong Kong Stock Exchange Publishes Guidance Letter on Suitability for Listing

The following provides a summary of Exchange Guidance Letter GL68-13 (the **Guidance Letter**) which expands on and consolidates previous guidance given as to the factors relevant to an assessment of a listing applicant’s suitability for listing.

### Relevant Listing Rules

* Main Board Rule 8.04 (GEM Rule 11.06) states that both the issuer and its business must, in the opinion of the Exchange, be suitable for listing.
* Main Board Rule 2.06 (GEM Rule 2.09) states that there a number of factors that will determine suitability for listing and that compliance with the listing rules does not necessarily mean that an applicant is suitable for listing.
* GEM Rule 11.06 also provides, by way of example, that an applicant would not normally be regarded as suitable for listing if its assets consist wholly or substantially of cash or short-dated securities (generally referring to securities such as bills, bonds or notes which have less than a year to maturity), except where the applicant or group is solely or mainly engaged in the securities brokerage business.

### Guidance

When considering an application, the Listing Division will focus on whether the applicant is eligible for listing as set out in the Listing Rules (e.g. whether the Listing Rules’ financial requirements are met and whether the applicant complies with relevant laws, rules and regulations), its suitability for listing, as well as any material disclosure deficiencies. Examples of matters considered in determining an applicant’s suitability for listing include the sustainability of the business, the degree of reliance on the parent company and the suitability of the applicant’s directors, including shadow directors.

However, there is no conclusive rule for determining whether an applicant and its business are suitable for listing. Each case is looked at individually and determined based on its own factual circumstances.

### (a) Suitability of director and controlling shareholders

Having a previous non-compliance or conviction record does not necessarily mean that a person cannot be accepted as a director of a listed company. However, if the non-compliance or conviction record raises serious concerns as to the individual’s integrity and he/she is likely to exert substantial influence on the applicant after listing (e.g. a director and controlling shareholder), this may result in the listing applicant not being considered suitable for listing and/or the individual not being considered to be suitable to act as a director under Main Board Rules 3.08, 3.09 and 8.15 (GEM Rules 5.01, 5.02 and 11.07(1)).

Where the person is a controlling shareholder, it is likely his or her majority vote will be decisive in the appointment of the applicant’s directors. Consequently, it will be highly likely that he/she will exert substantial influence over the operation and management of the listing applicant. In these circumstances, the person may be considered a ‘shadow director’ despite not being formally appointed. Further, the Exchange noted that if the suitability of the controlling shareholder is problematic, refraining from acting as director may not solve the issue of the listing applicant’s lack of suitability.

Relevant listing decision: [HKEx-LD96-1](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld96-1.pdf) ([see archive](ld96-1.pdf)).

### (b) Non-compliance Incidents

The Exchange noted that systematic, intentional and/or repeated breaches of laws and regulations by an applicant may affect its suitability for listing. The following factors will be considered by the Exchange in determining the impact of non-compliance incidents on the listing:

1. the nature, the extent and the seriousness of the breaches;
2. the reasons for the breaches, whether they were intentional, fraudulent, due to negligence or recklessness;
3. impact of the breaches on the applicant’s operation and financial performance;
4. rectification measures adopted; and
5. precautionary measures put in place to avoid future breaches.

In cases such as non-compliant bill financing arrangements, the Exchange will look for evidence that for a reasonable period (generally 12 months): (a) the applicant would be financially sound and could operate without reliance on the non-compliant bill financing arrangements; and (b) it has effective internal controls to avoid future non-compliance of a similar nature.

In other previous cases where serious non-compliance incidents did not have a direct impact on the financial position of the applicant (such as failure to obtain a necessary licence), listing was only approved after the applicants had demonstrated continued compliance for a reasonable period of time.

Where the Exchange determines that material non-compliance incidents can be resolved by way of disclosure, the Exchange expects applicants to follow the six disclosure elements set out in Guidance Letter [HKEx-GL63-13](http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/iporq/Documents/gl63-13.pdf) ([see archive](gl63-13.pdf)).

Refer to: [HKEx-LD50-5](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/documents/ld50-5.doc) ([see archive](ld50-5.pdf)); [HKEx-LD97-1](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld97-1.pdf) ([see archive](ld97-1.pdf)); and [HKEx-LD19-2011](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld19-2011.pdf) ([see archive](ld19-2011.pdf)).

### (c) Deteriorating financial performance

The Exchange articulates in the Guidance Letter that the assessment of suitability is a continuous process and the listing applicant must be suitable for listing at the time of listing. The actual performance after the latest audited period, the profit forecast and other projected information submitted by the applicant in relation to its business and financial position after listing will also be considered in determining suitability.

Notwithstanding that an applicant meets the financial requirements for listing under Main Board Rule 8.05, any deterioration in its financial performance subsequent to the track record period may indicate to the Exchange that there is a fundamental deterioration of commercial or operational viability. This is understood to go to the core of determining sustainability and suitability for listing.

Relevant listing decision: [HKEx-LD73-2013](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld73-2013.pdf) ([see archive](ld73-2013.pdf)).

An applicant may also be considered unsuitable for listing if there are signs of significant decline in the applicant’s group forecast profit, in combination with the applicant undertaking new business by virtue of an acquisition. The rationale for considering the applicant unsuitable in these circumstances is that the track record results may not be indicative of the applicant’s future business.

Relevant rejection letter: [HKEx-RL19-07](http://www.hkex.com.hk/eng/rulesreg/listrules/interltr/documents/rl19-07.doc) ([see archive](rl19-07.pdf)).

Although no profit requirement is imposed on companies seeking to list on GEM, uncertainty regarding financial performance is likely to cast doubt on its sustainability. The precedent from HKEx-LD37-2012 being that an applicant with a deteriorating financial performance during the track record period with no sign of improvement in the forecast period will be found to be unsuitable. Further, where a company’s business model is believed to be unsustainable, the applicant will be considered unsuitable for listing.

Relevant listing decision: [HKEx-LD37-2012](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld37-2012.pdf) ([see archive](ld37-2012.pdf)).

### (d) Reliance on parent group/ connected persons/ major customer

The Exchange explains that where the degree of dependence is excessive, this would translate into a concern as to suitability for listing.

Examples of reliance that may raise issues as to suitability for listing include:

1. Reliance on a parent or parent group for certain important functions such as sales and procurement functions; or operational and financial reliance on the applicant’s parent.

* Paragraph 27A of Appendix 1A to the Main Board Rules provides that the listing document should include a statement explaining how the applicant is satisfied that it is capable of carrying on its business independently of the controlling shareholder after listing, and evidence for how it reached this conclusion.
* In making the assessment, the Exchange will consider the applicant’s specific circumstances, including financial independence, operational independence and management independence.
* Refer to: [HKEx-LD46-1](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/documents/ld46-1.doc) ([see archive](ld46-1.pdf)); [HKEx-LD46-2](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/documents/ld46-2.doc) ([see archive](ld46-2.pdf)); [HKEx-LD51-1](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/documents/ld51-1.doc) ([see archive](ld51-1.pdf)); [HKEx-LD69-1](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/documents/ld69-1.pdf) ([see archive](ld69-1.pdf)); [HKEx-LD30-2012](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld30-2012.pdf) ([see archive](ld30-2012.pdf)); and [HKEx-RL12-06](http://www.hkex.com.hk/eng/rulesreg/listrules/interltr/documents/rl12-06.doc) ([see archive](rl12-06.pdf)).

1. Dependence on the parent company when there are overlapping directors, the applicant and its parent are in the same industry sector, and there are inadequate arrangements to manage conflicts of interest and delineation of businesses.

* The GEM and Main Board Rules differ in this respect. The GEM Rules provide that an applicant would not be unsuitable for listing on the basis that a director or shareholder has an interest in a competing business (GEM Rule 11.03), whereas the Main Board Rules require disclosure of the applicant’s ability to function independently of, and at arm’s length from the competing business of the controlling shareholder (Main Board Rule 8.10(a)(iii)).
* Refer to: [HKEx-LD51-3](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/documents/ld51-3.doc) ([see archive](ld51-3.pdf)) and [HKEx-RL21-07](http://www.hkex.com.hk/eng/rulesreg/listrules/interltr/documents/rl21-07.doc) ([see archive](rl21-07.pdf))

1. Deriving a significant proportion of its turnover and net profit from transactions with closely related parties and connected persons.

* While profits from transactions with connected persons or related parties will not necessarily have to be disregarded in assessing whether the requirements of Main Board Rule 8.05 are met, when these transactions are excessive, this may give rise to concerns as to the applicant’s suitability for listing. The Exchange will be concerned in particular as to whether the applicant’s business is sustainable without these connected transactions and whether the connected transactions are designed to enable the applicant to meet the requirements of Rule 8.05.
* Refer to: [HKEx-LD92-1](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/LD92-1.pdf) ([see archive](LD92-1.pdf))

1. Heavy reliance on a major customer

* Of concern in this situation is the sustainability of the business if the relationship is jeopardised. In these circumstances the Exchange will take into account the applicant’s ability to find substitute customers, the likelihood for the level of reliance to decrease in the future, the industry landscape, any long-term contracts, whether the reliance is mutual and complimentary, and whether the applicant is capable of maintaining its revenue and profitability in the future.
* In LD-107-1 the Exchange considered that full disclosure, a decreasing trend of reliance and an effort to diversify would solve the reliance issue.
* Refer to: [HKEx-LD107-1](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld107-1.pdf) ([see archive](ld107-1.pdf))

1. A captive business model, i.e. the sourcing of the applicant’s principal raw materials and its principal customer are dominated by the same party.

* Where the applicant’s supply and sales are dominated by the same party, the applicant’s relationship with this party will be fundamental to its business. The relationship is therefore likely to raise concerns as to the applicant’s suitability for listing unless it is able to show that it is capable of carrying on its business independently of the third party.
* Relevant rejection letter: [HKEx-RL20-07](http://www.hkex.com.hk/eng/rulesreg/listrules/interltr/documents/rl20-07.doc) ([see archive](rl20-07.pdf)).

### (e) Gambling

An applicant which engages in gambling will only be considered suitable for listing if it satisfies the requirements in the Exchange’s [announcement](http://www.hkex.com.hk/eng/newsconsul/hkexnews/2003/030311news.htm) ([see archive](gambling_activities.pdf)) on “Gambling Activities Undertaken by Listing Applications and/ or Listed Issuers” and the [Listing Committee Report 2006](http://www.hkex.com.hk/eng/listing/listcomrpt/documents/annualrpt_2006dec.pdf) ([see archive](annualrpt_2006dec.pdf)). The Exchange’s announcement provides that it would not be considered as contrary to public interest for a listing applicant or listed issuer to be involved in gambling activities which are not unlawful under the Gambling Ordinance (i.e. the gambling activities take place outside Hong Kong and the bookmaking and parties to the transactions are outside Hong Kong) and do not violate any applicable laws in the region in which it operates.

Relevant rejection letter: [HKEx-RL25-09](http://www.hkex.com.hk/eng/rulesreg/listrules/interltr/documents/rl25-09.pdf) ([see archive](rl25-09.pdf)).

### (f) Contractual arrangements (**VIE**s)

Applicants adopting contractual arrangements of the nature described in Listing Decision [HKEx-LD43-3](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/LD43-3.pdf) ([see archive](LD43-3.pdf)) (i.e. structured contracts) may be considered unsuitable for listing unless they satisfy the conditions set out in that Listing Decision, including closely tailoring the use of such arrangements to the applicant’s needs.

### (g) Reliance on unrealised fair value gains to meet profit requirement

The Exchange articulates that even if an applicant is able to satisfy the profit test under Main Board Rule 8.05(1)(a), if it is relying on the unrealised fair value gains of its investment properties to do so, the applicant will need to demonstrate that it has a sustainable business after such gains are excluded.

The Exchange may find the business suitable if the applicant demonstrates the existence of property projects under development as at the date of the listing document, or significant recurring income (e.g. rental income) generated in the applicant’s ordinary and usual course of business during the track record period which is expected to continue after listing.

## Hong Kong Stock Exchange Publishes Listing Decision (LD76-2013) in relation to whether the Applicants were Suitable for Listing under Rule 8.04 given that they had Conducted Businesses in Certain Countries which were Subject to Trade or Economic Sanctions Imposed by Overseas Governments Before and During the Track Record Period

The Exchange published listing decision [LD76-2013](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld76-2013.pdf) ([see archive](ld76-2013.pdf)) regarding the suitability for listing of two applicants (the **Applicants**) that had conducted businesses in countries that were subject to trade or economic sanctions imposed by foreign governments. The Exchange decided that since the companies had taken steps to minimise the potential negative impact on the companies and their stakeholders, including terminating the relevant sanctionable activities before listing, the past business would not render them unsuitable for listing. It was considered that the issue could instead be addressed by disclosure.

### Facts

Certain governments, including those of the United States, the member states of the European Union and Australia impose trade or economic sanctions on certain countries (such as Iran, Cuba, Syria and Sudan). This is achieved by restricting their domestic enterprises from making goods or services available to individuals or entities that are subject to sanctions, or controlled by persons subject to sanctions. Some sanctions are very broad in scope and may have extra-territorial effect on persons who are not nationals of the countries whose governments impose the sanctions. They may also have implications for activities or investments which may, directly or indirectly, be regarded as financing, facilitating or contributing to the improvement of a sanctioned country’s ability to develop specific products or industries.

Given this, the Exchange was concerned about sanctions risks faced by listing applicants with projects or businesses in countries subject to sanctions, their potential investors, shareholders and other entities involved in the listing process. Consequently, the Exchange’s concern was whether these risks made the Applicants unsuitable for listing under Listing Rule 8.04.

### Case 1

In the first case, Company A, incorporated and based in the PRC, entered into several engineering or construction contracts with certain companies in a sanctioned country during the track record period. The revenue derived by the company from its business in the sanctioned country accounted for less than 1% of its total revenue during the track record period.

The issue that arose was whether the proposed listing of the applicant’s shares could be regarded as having the effect of facilitating or financing a sanctionable activity under the applicable laws and regulations. Implications of approving the listing were questioned with regard to the sanctions risk posed to the company itself, its investors and shareholders and other parties who might be involved in permitting the listing, trading and clearing of the applicant’s shares including the Exchange and its related group companies.

To minimise the sanctions risk, Company A terminated all contracts in the sanctioned country before listing. Since sanctions laws may change, the company also disclosed in its prospectus that it might undertake new business in the sanctioned countries if this did not expose the company to sanctions risk, and it was in the interests of the company and its shareholders to do so. To achieve this, Company A implemented a number of measures to control its exposure to sanctions risk including regular training programs, the creation of a risk management committee and a commitment to fully disclose any business in sanctioned countries in its financial reports and to publish an announcement on the Exchange’s website if it believed that its business in sanctioned countries put shareholders at risk. Further, Company A undertook that it would not use the IPO proceeds, directly or indirectly, to finance or facilitate any projects or businesses in the sanctioned countries, or pay any damages required for terminating the contracts. Company A’s prospectus also disclosed that according to legal opinions from US, EU, United Nations and Australian advisers, sanctions risk to Company A, its investors and shareholders, and the Exchange and its related group companies, would be very low based on the measures implemented by the company. The prospectus also disclosed the opinion of Company A’s PRC legal advisers that Company A had not breached any PRC laws regarding the business in the sanctioned country.

### Case 2

In the second case, Company B which is also incorporated and based in the PRC, entered into several engineering contracts with companies in sanctioned countries. The revenue generated from these arrangements accounted for 3-8% of Company B’s total revenue during the track record period. The same issues were raised here as with Company A, specifically concerning the impact of the business on stakeholders.

Company B submitted that it would implement a number of measures to ensure any negative impact on stakeholders was minimised. These included:

* restructuring to terminate or transfer to other parties all ongoing projects and trading business in the sanctioned countries, and closing all representative offices in those countries before listing;
* undertaking not to use the proceeds of the offering to fund activities or business connected with sanctions related activities. Company B also agreed to open and maintain separate bank accounts to be designated for use of deposit and deployment of the listing proceeds;
* implementing a number of measures to control exposure to sanctions risk including the establishment of a dedicated export control office that reported to an operation and risk management committee to monitor risk and activity and organising regular training for senior management and relevant personnel on sanctions and export control laws in the PRC and United States. Company B also promised full disclosure on the Exchange’s website of any potential or actual violation of sanctions laws in the future.

### Decision

In determining whether the Applicants were suitable for listing, the Exchange took into account, among other things:

1. that the applicants’ projects/ businesses in the sanctioned countries would be terminated or transferred before listing, and there would be no material adverse impact on the Applicants as a result of this;
2. relevant legal advice given to, or analysis made by listing applicants, that the sanctions risk posed to the Applicants, their investors and shareholders, and the Exchange and its related group companies was very low;
3. the enhancement of the Applicants’ internal control measures and their undertakings to the Exchange to minimise their exposure to sanctions risk;
4. the extent of the revenues derived from the Applicants’ projects/businesses in the sanctioned countries as a percentage of their total revenue during the track record period. The Exchange commented that while the extent of revenues derived may not be relevant if it can be demonstrated that the listing applicant would not be exposed to sanctions risk, if the projects/businesses are subject to sanctions risk, then the nature and size of the projects/businesses would be relevant in assessing the effectiveness of measures to ring-fence or minimise the sanctions risk, and the financial and operational impact of these measures on the Applicants’ business operations and profitability;
5. the Applicants’ listing document disclosure of (i) past and any potential future projects or businesses in the sanctioned activities; (ii) legal opinions covering sanctions in major countries/regions (including the US, EU, UN and Australia) on the risk of sanctions violations resulting from the Applicants’ projects/businesses in the sanctioned countries and the potential impact on the Applicants, their investors and shareholders and the Exchange and its related group companies; (iii) the termination or transfer of existing projects/businesses in sanctioned countries before listing, and the resulting financial and operational impact on the Applicants; (iv) the legal consequences and maximum penalties (if any) for terminating or transferring these projects/businesses; (v) the Applicants’ undertakings to the Exchange not to use any of the IPO proceeds or any other funds raised through the Exchange to directly or indirectly finance or facilitate any projects or businesses in the sanctioned countries or pay damages for terminating or transferring the contracts in the sanctioned countries; (vi) the risk of possible delisting of the Applicants’ shares if the Applicants breached their undertakings; and (vii) details of the internal controls measures adopted to control and monitor the Applicants’ exposure to sanctions risk, and the views of the sponsor(s) and directors as to the adequacy and effectiveness of these measures to protect the interests of the Applicants, their investors and shareholders, and the Exchange and its related group companies.

Having considered the above facts and circumstances, in particular the steps taken to minimise the risk of sanctions, including terminating or transferring the relevant contracts before listing, the Exchange determined that the Applicants’ past businesses in the sanctioned countries would not render them unsuitable for listing under Rule 8.04. Instead, the issue could be dealt with through disclosure under Rule 2.13(2).

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