



Hong Kong

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HONG KONG STOCK EXCHANGE 2015 LISTING DECISIONS: REGULATORY BREACHES IMPACT CASH FLOW CALCULATION AND CONTROLLING SHAREHOLDERS' POST-IPO LOCK-UP EXPLAINED

INTRODUCTION

The Hong Kong Exchanges and Clearing Limited (the **Exchange**) has published two listing decisions in 2015:

- Listing Decision HKEx-LD85-2015¹ which applied the Listing Rules' 12-month lock-up restriction on disposals of shares following a new listing despite the controlling shareholder ceasing to be the listed company's controlling shareholder shortly after the listing; and
- Listing Decision HKEx-LD86-2015² which determined that cash flow generated during a period of regulatory non-compliance could not count towards the calculation of minimum cash flow required under GEM Rule 11.21A(1).

HKEx LISTING DECISION LD85-2015 (January 2015)

The question considered was whether a company which ceased to be a controlling shareholder of a listed issuer shortly after the latter's listing, is still bound to comply with the lock-up restriction under Listing Rule 10.07(1).

¹ Available at <http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld85-2015.pdf>.

² Available at <http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/LD86-2015.pdf>.

Background

According to the listing document, Company B owned more than 30% of Company A's shares at the time of listing. Companies A and B were established by the same person, the latter having been set up for estate planning purposes. The founder was an Executive Director who was actively involved in the management of Company A, while his son owned Company B.

Company A's global coordinator held an over-allotment option which it exercised after Company A's listing on the Exchange, which diluted Company B's interest in Company A to less than 30%. Company B ceased to be a controlling shareholder of Company A at that point.

Applicable Rules

The Exchange imposes restrictions on the disposal of shares by a controlling shareholder of a Hong Kong-listed company (being a person or persons who is/are entitled to exercise control over 30% or more of the voting power at general meetings of the listing applicant, or are in a position to control the composition of the majority of its board of directors)³ following a company's new listing.

³ Main Board Listing Rules 1.01 and 19A.14.

Main Board Listing Rule 10.07(1) prohibits persons named as controlling shareholders in the listing document from disposing of their shares in the listed issuer:

- in the period commencing on the date by reference to which disclosure of their controlling shareholding is made in the listing document and ending 6 months after the commencement of dealings in the listed issuer's securities on the Exchange; or
- in the 6 months commencing on the date on which the period referred to above expires, if the disposal would result in him/her ceasing to be a controlling shareholder.

Offers for sale contained in a listing document are not subject to the restriction.

Decision and Analysis

According to the Exchange, the intention behind Listing Rule 10.07(1) is to ensure that persons who are a company's controlling shareholder(s) when it lists on the Exchange demonstrate their commitment to the company, and to protect investors by preventing a material change in the shareholding structure in a company's first year of listing.

Taking into account the facts and circumstances of Company B and the rationale behind Rule 10.07(1), the Exchange required Company B to comply with the 12-month disposal restriction on the shares it held in Company A.

HKEx LISTING DECISION HKEx-LD86-2015 (April 2015)

The Exchange's listing decision HKEx-LD86-2015 considered whether cash flow generated by a listing applicant during a period of non-compliance with certain regulations should be excluded when determining whether the minimum cash flow requirement under Growth Enterprise Market (**GEM**) Rule 11.12A(1) is satisfied.

Background

The company in question (**Company A**) was applying to list on the Exchange's Growth Enterprise Market. It was in a business that required it to abide by certain regulations (the **Regulations**) which required full compliance with the Regulations in order to carry on the particular business. It was an imprisonable

offence to breach any of the Regulations. Company A failed to comply with the Regulations for 22 months (**Non-Compliance Period**) during its track record period.

Applicable Rules

GEM Listing Rule 11.12A(1) requires that a listing applicant:

"... must have an adequate trading record of at least two financial years comprising a positive cash flow generated from operating activities in the ordinary and usual course of business before changes in working capital and taxes paid. Such positive cash flow from operating activities carried out by the new applicant, or its group, that are to be listed, must be of at least HK\$20,000,000 in aggregate for the two financial years immediately preceding the issue of the listing document."

Implications of the Company's Non-Compliance

Company A's Non-Compliance-Period comprised 22 of the 24 months of its track record period. If Company A's cash flow from its Non-Compliance Period was considered to be generated from operating activities "in the ordinary and usual course of business" despite Company A's non-compliance with the Regulations, the cash flow requirement under GEM Rule 11.12A(1) would be satisfied. If not, Company A would not meet the minimum cash flow requirement.

The Analysis and Decision

Company A's legal advisers believed that the cash flow generated while in breach of the Regulations was legal, as neither the Regulations nor any other legislation stipulated otherwise. The company's sponsor believed that the non-compliance incidents should not affect the suitability and competence of Company A's directors because they were due mainly to the directors' lack of familiarity with the Regulations. Furthermore, the non-compliance was unintentional and involved no fraud or dishonesty on the part of the directors. The directors had since undertaken training on regulatory compliance.

Company A had also enhanced its internal controls by engaging a compliance consultant, requiring the approval of an executive director and a joint internal compliance coordinator for business governed by the Regulations, and implementing compliance measures that would be reviewed monthly by a member of its senior management.

In the Listing Decision, the Exchange considered the following points:

- that the legal operation of Company A's business depended on its compliance with the Regulations;
- a breach of the Regulations was an imprisonable offence and thus serious in nature;
- "operating activities in the ordinary and usual course of business" as contemplated in GEM Rule 11.12A(1) means that business must be carried out generally in accordance with relevant laws and regulations; and
- the Non-Compliance Period (of 22 months) constituted nearly the entire track record period (24 months).

For the above reasons, the Exchange concluded that the cash flow that Company A generated during the Non-Compliance Period could not be regarded as generated in the ordinary and usual course of its business. That cash flow could not therefore be counted in determining whether Company A had met the minimum cash flow requirement. Company A therefore failed to satisfy GEM Rule 11.12A(1) and was not eligible for listing.

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