



Hong Kong

June 2016

## HONG KONG STOCK EXCHANGE PUBLISHES NEW GUIDANCE ON IPO VETTING AND SUITABILITY FOR LISTING

The Hong Kong Stock Exchange (the **Exchange**) published new Guidance Letter HKEx-GL68-13A (the **Guidance Letter**) on 3 June 2016 setting out guidance on its approach to IPO vetting and suitability for listing. The guidance focuses on “shell” companies and calls sponsors’ attention to the need to ensure that they are aware of all material issues relevant to the consideration of a listing applicant’s suitability for listing at the time of submitting the listing application.

### Background

The Exchange’s rationale for the new guidance is that:

- In a number of cases, the controlling shareholders of newly listed companies changed or gradually sold down their shareholdings shortly after the expiry of the regulatory lock-up period. One possible explanation for this is the perceived premium attached to the listing status of such companies rather than the development of the underlying business assets;
- It believes that these companies will give rise to speculative trading activities once they are identified by potential investors. Such activities potentially create opportunities for market manipulation, insider trading and unnecessary market volatility post-listing, none of which is in the interest of the investing public. Furthermore, activities by these companies may be structured so that they are not subject to regulatory scrutiny under Listing Rule 14.06 and the Exchange’s Guidance Letters HKEx-GL78-14 on reverse takeovers and HKEx-GL84-15 on cash companies; and

- The Exchange has concerns in relation to listing applicants whose size and prospects do not appear to justify the costs or purpose associated with a public listing. This raises issues as to the reasons and justification for their listing, and therefore raises concerns regarding the suitability for such listings.

The Exchange conducted a review of all new listings on the Main Board and Growth Enterprise Market Board between 2012 and 2014 and selected companies in 2015 to identify the characteristics of these companies (**Target Companies**). The Exchange found that Target Companies have one or more of the following characteristics (together **Target Company Characteristics**) which are set out at paragraph 1.4 of the Guidance Letter:

- Small market capitalisation;
- Only marginally meet the listing eligibility requirements;
- Involve fund raising disproportionate to listing expenses (i.e. a high proportion of the listing proceeds were used to pay listing expenses);
- Involve a pure trading business with a high concentration of customers;
- Are asset-light businesses where a majority of the assets are liquid and/or current assets;

- Involve a superficial delineation of business from the parent whereby the applicants' business is artificially delineated from the parent, by geographical area, product mix or different stages of development; and/or
- Have little or no external funding at the pre-listing stage.

The Exchange considers that the above factors call into question the suitability for listing of such Target Companies and whether they should be subject to a more focused review by the Exchange.

## Relevant Listing Rules

The relevant Listing Rules are:

- Main Board Rule 8.04 (GEM Rule 11.06) requires that both the listing applicant 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 suitability for listing depends on many factors. Listing applicants should appreciate that compliance with the Listing Rules alone may not ensure their suitability for listing;
- Guidance Letter HKEx-GL68-13 provides guidance on the factors which the Exchange takes into consideration when assessing whether a listing applicant and its business are suitable for listing under Main Board Rule 8.04 (GEM Rule 11.06).

## Guidance

The Exchange regards suitability for listing as a key criterion and reviews all listing applications with a view to maintaining the quality and reputation of the Hong Kong market. It will give additional emphasis to applicants which exhibit some of the Target Company Characteristics. These characteristics do not however act as a bright-line test and the Exchange will take into account the facts and circumstances of each case. The list of Target Company Characteristics set out at paragraph 1.4 is not exhaustive and the relative weighting of these characteristics is likely to differ from applicant to applicant and from industry to industry. These Target Company Characteristics may also change over time.

## Substantiation of Applicant's Suitability for Listing

Where a potential listing applicant exhibits Target Company Characteristics (as identified in the Guidance Letter), the Exchange expects the listing applicant and its sponsor(s) to provide a robust analysis to substantiate that the applicant is suitable for listing including, among other things, in the following areas:

- **Use of proceeds** – the Exchange expects the listing applicant to:

- disclose specific uses for proceeds commensurate with the applicant's past and future business strategy and observed industry trends; and
- explain the commercial rationale for listing.

The Exchange will not be satisfied with generic descriptions such as: (a) using listing proceeds to increase reputation and brand awareness; (b) for potential acquisitions without an identified target and specific selection criteria; and/or (c) for expansion through the increase of headcount;

- **Future objectives and strategies** – the Exchange expects a comprehensive analysis to be provided to demonstrate that the applicant has a detailed strategic plan for its business operations and growth;
- **Profit and revenue growth** – a comprehensive analysis will be required to substantiate that the listing applicant's business is sustainable where it:

- has experienced decreasing or low profit and revenue growth; and/or
- is expected to record decreasing or low profit and revenue growth after listing; and

- **Potential sunset industries** – where a listing applicant is in a potential sunset industry or in an industry that has declining market prospects, it must be able to demonstrate that it is feasible and has both the ability and the resources to modify its business to respond to the changing demands of the market. The applicant should also demonstrate that the returns from the business justify the cost of listing.

The Guidance Letter reminds sponsors that before submitting a listing application to the Exchange on behalf of an applicant, they should ensure that they are aware of all material issues which, in their reasonable opinion, are necessary for consideration of whether the applicant is suitable for listing.

The Exchange may impose additional requirements or conditions on listing applicants with Target Company Characteristics or may reject the applicant's listing on the grounds of suitability. The Guidance Letter stresses that it is only part of the suitability assessment conducted by the Exchange, and that there may be other issues which could render a listing applicant not suitable or eligible for listing. Reference should be made to Guidance Letter HKEx-GL68-13 "Guidance on Suitability for Listing".

The Listing Department may be consulted on a confidential basis for an interpretation of the Listing Rules or specific issues raised in the Guidance Letter. The Exchange will not, however, give specific guidance on the suitability of an applicant as a whole for the purpose of the Guidance Letter as an assessment of suitability can only be made when a substantially complete application proof is provided.

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