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# Hong Kong Stock Exchange Publishes Guidance On The Reasons For Returning Certain Listing Applications

## Introduction

The Hong Kong Exchanges and Clearing Limited (the **Exchange**) published Listing Decision [HKEx-LD48-2013](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld48-2013.pdf) (**Listing Decision**) ([see archive](ld48-2013.pdf)) on 21 January 2013, providing a detailed analysis of the reasons for its return of certain listing applications. Main Board Rule 9.03(3) requires listing applicants to submit to the Exchange an advanced proof of the prospectus with the listing application form. This is intended to enable the Exchange to commence its review of the listing application immediately upon lodgement of the application. The Sponsor of a GEM listing applicant is required to ensure that the draft listing document has been verified in all material respects prior to submission. If the Exchange considers that the prospectus submitted in connection with a Main Board listing application is not in an advanced form, or that a draft listing document submitted by a GEM listing applicant is insufficiently finalised, the Exchange will not commence its review of the application and will return all relevant documents and the initial listing fee to the sponsor.

The Listing Decision sets out a critical analysis of six different Main Board listing applicants (Companies A to E) and five GEM listing applicants (Companies G to K). Each applicant had several deficiencies in its disclosure of different areas of the business in the prospectus/listing document and was therefore deemed unsuccessful and returned by the Exchange. The following summarises the reasons given for returning applications during the period from January 2012 to November 2012. Subsequently, all but two applicants re-filed listing applications within 3 to 119 days after the Exchange returned their previous application, providing the missing information and documents. The re-filed applications were accepted for review.

## Neglecting The Guidelines Outlined In Guidance Letter HKEx-GL27-12

The Exchange published [Guidance Letter HKEx-GL27-12](http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/iporq/Documents/gl27-12.pdf) (**Guidance Letter**) ([see archive](gl27-12.pdf)) on 12 January 2012 providing guidance on disclosure in the “Summary and Highlights” section of listing documents. The Guidance Letter was specifically crafted to ensure that the ‘Summary’ section is written in a concise and comprehensible manner which allows investors to decide whether they might be interested in the offer and thus, wish to read the rest of the listing document. However, more than half of the eleven companies that are the subject of the Listing Decision did not follow the guidance given in HKEx-GL-27-12. Failings identified by the Listing Decision can be summarised as follows:

* One summary section lacked sufficient information to provide investors with a concise overview of the company’s operation model and highlights of significant matters (Company A);
* The summary section in relation to Company F had several disclosure deficiencies including failure to include:
  + a detailed discussion of Company F’s fair value gains of the investment properties and realized gain on disposal of an investment property holding subsidiary, their contribution to the profit of Company F and relevant sensitivity analysis;
  + breakdown of the Company F’s revenue distribution and key operating data during the track record period, with commentary on material fluctuations;
  + historical non-compliances;
  + identities, background and relationships with major customers and suppliers; and
  + an update on the recent development of Company F’s operations and financial performance in accordance with the Guidance Letter.
* The summary section for Company I, a distributor of certain products, lacked sufficient information to provide investors with a concise overview of the company’s operation model and highlights of significant matters. Examples of material information missing included description of the usage of the company’s main products, the classification of distributors, how the company determined pricing of its products with its suppliers and distributors, price control under PRC regulations and legal proceedings against the company.
* Company J neglected to highlight matters which could have a significant adverse impact on its operation and financial position in the foreseeable future in the “Summary” and other relevant sections as required under the Guidance Letter. An example given was that there was no discussion regarding the potential significant decrease in revenue resulting from the recent reorganization and massive lay-off plan of one of the company’s top five customers and the anticipated substantial decline in profit.

## Business Model

The Guidance Letter includes a checklist of information that might be included in the Summary and Highlights section (at Attachment 1 to the Guidance Letter), with suggestions on what to disclose and how to disclose it. In relation to business model, the purpose of disclosure is to:

* Provide information concerning the listing applicant’s business (i.e. the applicant’s current principal business activities (including any change in the business focus during the track record period), and how they generate revenue);
* Provide information on major stakeholders (since the applicant’s business may be significantly influenced by its stakeholders and their relationship with the listing applicant);
* Provide information on market positions within the industry (to help investors assess the competitive landscape of the listing applicant’s business environment); and
* Provide a summary of the applicant’s competitive strengths and business strategies.

The Listing Decision identifies several deficiencies in the prospectus disclosure of the business models of Companies A, F and G.

### Company A

Company A was a provider of maintenance works. Criticisms were that:

* prospectus disclosure lacked clarity as to whether Company A acted as a main contractor or a sub-contractor in projects completed during the track record period and in future projects;
* for the service segment, there was no information on whether Company A acquired service projects through bidding or negotiation and on how it carried out its services (e.g. whether special government approval and traffic arrangements were required);
* for the equipment segment, there was no detail on whether Company A participated in tender bidding.

### Company F

Company F was engaged in the property business. The disclosure of its business model and future plans provided inadequate information regarding: (i) details of the properties held by the Company; and (ii) in respect of properties acquired by the Company, details of the tendering process and the decision making process and the measures to monitor the Company’s leasing business, occupancy rates, rental yield and liquidity and financial positions.

### Company G

Company G’s disclosure of its principal businesses was unclear and the delineation between the different segments was vague. In particular, it was unclear when and how revenue was derived and recognised for each business segment. The Exchange also questioned whether the agent customers served as the Group’s distributors or end-customers.

## Future Plans And Business Strategies

There were a number of deficiencies in the disclosures of future plans and business strategies. In the case of Company D, a mining company, the prospectus failed to provide any information on the company’s business model after commencing commercial production. Company A failed to disclose sufficient justification for the 100% increase in production capacity and its expansion plan given that its existing geographic coverage in the relevant country already appeared to be extensive. In the case of Company I, there was inadequate information on the company’s plan to expand its distribution network by obtaining new exclusive distribution rights for new products. It was also unclear why the company, as a product distributor, needed to enhance the development of products through alliance or partnership despite being engaged only in distribution, and not research and development. In the case of Company F, the Exchange considered that the disclosure failed to properly address how the company’s development plan would affect its business risk profile and highlight the associated risks and impact in the “Summary” and “Risk Factors” sections. The prospectus also failed to properly disclose how the company’s strategy of developing residential projects aligned with its policy, the commercial rationale for this strategy and how the company planned to achieve it.

## Disclosure Of Financial Position

In the case of Company A, the Exchange considered that the discussion of the company’s trade and bills receivables was too general. In particular, there was no meaningful explanation on (i) why Company A accumulated significant amounts of trade and bills receivables given that it required advanced deposits from new customers and did not generally grant credit to new customers; (ii) circumstances giving rise to the increasing amount of impairment of trade receivables during the track record period; (iii) underlying reasons for delays in settlement from certain customers and (iv) delay in settlement of certain payments for raw materials and subcontracting costs and the significant increase in trade payables aged over 1 year.

Company F, which was engaged in property businesses, had negative operating cash flow and net current liabilities. Its prospectus disclosure was criticized for not providing more meaningful discussion on the company’s tight liquidity position and how it would improve its liquidity position and finance its purchase of land/ properties.

In the case of Company K, there was insufficient information regarding: (i) its business rationale to raise significant bank borrowings to acquire numerous properties from the controlling shareholders shortly before submitting the listing application; and (ii) the year-on-year fluctuation on financial statement items and financial ratios.

## Listing Rule Contravention

In the case of Company B, the audited financial information included in the prospectus covered each of the three financial years ended 31 December 2011 and the company therefore failed to meet the requirement of Main Board Listing Rule 8.06 which requires that the latest financial period reported on by the reporting accountants must not have ended no more than six months before the listing document. The company had also failed to provide the confirmation required under paragraph 4.6 of Guidance Letter HK HKEx-GL-09 for the Exchange to accept early filing.

Company D’s disclosures did not fully comply with the requirement under Rule 8.10(1)(a) to include reasons for the exclusion of the excluded business, size of such business and how such business may compete with Company D’s business. On the other hand, Company H breached GEM Listing Rule 12.22(13) by not submitting the anticipated final draft of the sponsor’s letter on working capital sufficiency.

## Suitability Of The Directors/Key Management Staff

In the case of Company B, the PRC legal opinion revealed that its controlling shareholder and executive director was implicated in two bribery convictions that might have implications for his suitability as a director. These issues were not however brought to the attention of the Exchange in the documents submitted with the listing application form (e.g. under paragraph 27 of Checklist I.B. - confirmation that there are no other material issues which could detrimentally affect the suitability of listing) and the sponsor did not comment on the suitability of the individual to be appointed as director.

The biographies of the directors and senior management of Company D, which was a mining company, appeared to demonstrate that they lacked experience in operating mining businesses in overseas countries.

Similarly, the sponsor of Company G did not provide views on the character and competency to operate a listed company of the company’s executive director and non-executive director. Both served in another company criticized for human rights abuses, ignoring indigenous people’s human rights, perpetrating political corruption and neglecting the environment in relation to the company’s forestry logging activities.

## Distributorships

In the case of Company I, a distributor, there was insufficient information on the relationship between different types of distributor customers and measures to address the potential conflicts of interests. The company’s degree of control over its distributors with respect to compliance with the national pricing policy, sales and avoidance of cannibalization and the competition between different types of distributors were unclear.

The Listing Decision noted that information should have been included to address the issue of independence of distributors in accordance with the Exchange’s Guidance Letter HKEx-GL36-12. An explanation should have been given on what value-added services the company provided to its distributor customers to sustain its level of gross profit margin which was particularly high when compared to its peers.

## Regulatory Overview And Non-Compliance

The prospectus for Company F contained insufficient disclosure on the relevant rules and regulations applicable to the company’s business and operations. The disclosures on non-compliance incidents were also unclear and insufficient and the rectification measures and internal controls were not specific and could not be aligned with the incidents of non-compliance.

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