

**FACTORS THAT THE STOCK EXCHANGE TAKES INTO CONSIDERATION WHEN ASSESSING A LISTING APPLICANT'S SUITABILITY FOR LISTING**

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**An insight as to the major issues which the Stock Exchange will consider when assessing a listing applicant's suitability for listing.**

**D**uring the vetting process of a listing application, it is crucial for The Stock Exchange of Hong Kong Limited (the "**Stock Exchange**") to strike the right balance between the listing applicant's interests and the regulatory compliance of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "**MB Listing Rules**") and the Rules Governing the Listing of Securities on GEM (the "**GEM Listing Rules**", together with the MB Listing Rules, the "**Listing Rules**"). This article will provide an insight as to the major issues which the Stock Exchange will consider when assessing a listing applicant's suitability for listing.

**(i) Governing rules and regulations**

The guidance letters HKEX-GL68-13, HKEX-GL68-13A and HKEX-GL96-18 published by the Stock Exchange provide guidance on the non-exhaustive factors that the Stock Exchange will consider when assessing the listing applicant's suitability for listing. The factors include but not limited to:

- (a) non-compliances that would involve fraud, deceit or dishonesty (such as tax invasion or bribery) (the "**Integrity Non-compliances**");
- (b) the material non-compliances by a listing applicant, its directors or controlling shareholder(s) (the "**Material Non-compliances**");
- (c) uncertainties regarding business sustainability;
- (d) the use of contractual agreements that would affect a listing applicant's suitability of listing under Rule 8.04 (GEM Rule 11.06); and
- (e) avoidance of creation of shell companies.

The following table provides a brief illustration of the listing process, and the Listing Department of the Stock Exchange will exercise its discretion in considering the suitability of the listing applicant in Step 2:

<b>Step 1 Submitting Listing Application to Listing Document</b>
<b>Step 2 Vetting by the Listing Department</b> <b>Conduct detailed vetting based on eligibility, suitability, sustainability, compliance of rules and sufficient disclosure.</b> <b>For suitability of listing, consideration will include (but not limited to):</b> <ol style="list-style-type: none"> <li style="text-align: center;">1. Non-compliances HKEX GL68-13</li> <li style="text-align: center;">2. Business sustainability HKEX GL68-13</li> <li style="text-align: center;">3. The use of contractual agreements HKEX GL68-13</li> <li style="text-align: center;">4. Avoidance of creation of Shell Companies HKEX GL68-13A</li> </ol>
<b>Step 3 Hearing by the Listing Committee</b>
<b>Step 4 Listing on the Stock Exchange</b>

## (ii) Factors which the Stock Exchange will take into consideration

### (a) Whether non-compliances affect a listing applicant's suitability for listing

As aforesaid, non-compliances that would render a business unsuitable for listing would include Integrity Non-compliances and Material Non-compliances:

<b>Integrity Non-compliances</b>
<p>Integrity Non-compliances will likely render the listing applicant, as well as the culpable director, not suitable for listing or not suitable to be a director of a listed company. In furtherance, Integrity Non-compliances would likely impugn a culpable director's character and integrity in contravention of the standards required under Rules 3.08 and 3.09 of the MB Listing Rules (Rules 5.01 and 5.02 of the GEM Listing Rules). If the controlling shareholder is culpable for the Integrity Non-compliances and has the ability to exert substantial influence over the listing applicant, the listing applicant will not be suitable for listing because it would be subject to substantial influence by such controlling shareholder.</p>
<b>In considering whether there is substantial influence of the controlling shareholder, the following would be considered by the Stock Exchange:</b>
<ol style="list-style-type: none"> <li>1. economic interest in the listing applicant;</li> <li>2. relationship with the other shareholders, directors and members of senior management of the listing applicant; and</li> <li>3. involvement in the operation and management of the listing applicant's business.</li> </ol>
<b>The Stock Exchange, in coming upon an unfettered decision as to whether Integrity Non-Compliances would render a listing applicant unsuitable for listing, will consider all relevant facts and circumstances, including:</b>

1. the underlying reasons for the non-compliances;
2. the relevant mitigating factors;
3. the operational and financial impact of the non-compliances on the listing applicant;
4. the culpable person's influence on the listing applicant's operations; and
5. whether any effective internal control measures have been implemented (and for how long) to avoid re-occurrence of similar Integrity Non-compliances.

The Stock Exchange will also expect the culpable director or controlling shareholder to cease being a director or controlling shareholder of the listing applicant before listing.

### **Material Non-compliances**

The following types of Material Non-compliances may affect the suitability for listing of a listing applicant:

1. if any director was involved in the Material Non-compliances or was on the board when such non-compliances occurred, and such Material Non-compliances raise concerns regarding the competency of such director and leading to issues of his/ her suitability as a director which cannot be addressed by disclosure; or
2. if a listing applicant cannot meet the relevant eligibility requirements under the Listing Rules after adjusting its trading record results for the impact of such Material Non-compliances and that there would have been material adverse impact on its business and financial performance had it complied with the relevant rules or regulations and going forward.

### **(b) Sustainability of Business**

There are various factors that may affect the listing applicant's sustainability and thus impact on its suitability for listing. The followings are examples of factors that the Stock Exchange will examine in evaluating the business sustainability of the listing applicants, with reference to guidance letter HKEX-GL68-13. These factors are non-exhaustive and based on past precedents.

<b>Factors</b>	<b>Implications and disclosure</b>	<b>Stock Exchange's consideration</b>
<b>Deteriorating financial performance</b>	If the listing applicant recorded deteriorating revenue and profit, or material loss during or after the trading period, this will cast doubt on the listing applicant's financial performance and the suitability for listing.	<p>(a) How susceptible the listing applicant's financial performance is to changes beyond its control.</p> <p>(b) The underlying causes of the deteriorating financial performance and whether such downward trend is expected to continue, or whether it is cyclical nature of the industry.</p> <p>(c) Whether the listing applicant had demonstrated that it is able to effectively mitigate its exposure to the</p>

		relevant risks or to turnaround the business.
<p><b>Material reliance on various parties</b></p>	<p>Such various parties may include customer, supplier, distributors and controlling shareholder (including its close associates) (a "Relevant Counterparty").</p> <p>Set out below are examples of material reliance:</p> <ul style="list-style-type: none"> <li>(a) high customer or supplier concentration, or both;</li> <li>(b) dependence on a limited number of distribution channels; or</li> <li>(c) dependence on controlling shareholders or another party for critical functions such as sales, distribution or procurement.</li> </ul> <p>The listing applicant's material reliance on a Relevant Counter-party is a matter of disclosure if, absent red-flags to indicate otherwise, (i) the relationship with the Relevant Counterparty is unlikely to materially adversely change or terminate; or (ii) the listing applicant is/ will be able to effectively mitigate its exposure to any material adverse changes to or termination of its relationship with the Relevant Counterparty. The disclosure in the listing document should also include:</p> <ul style="list-style-type: none"> <li>(a) the background of the Relevant Counterparty;</li> <li>(b) the business relationship, the nature of reliance and details of the arrangements between the listing applicant and the Relevant Counterparty;</li> <li>(c) basis that the likelihood of the relationship with the Relevant Counterparty will materially adversely change/terminate is low; or</li> <li>(d) basis that the listing applicant is/ will be able to effectively mitigate its exposure to any material adverse</li> </ul>	<ul style="list-style-type: none"> <li>(a) Whether the Relevant Counterparty is also mutually dependent on the listing applicant.</li> <li>(b) Whether the listing applicant has an established relationship/ long-term agreement with the Relevant Counterparty.</li> <li>(c) If the Relevant Counterparties dominate the industries and it is unlikely that the listing applicant could reduce its reliance on the Counterparties, the Stock Exchange will also investigate whether there are any red flags indicating that the relationships between the parties would be terminated or materially adversely change.</li> </ul>

	changes to or termination of the relationship with the Relevant Counterparty.	
<b>Financial assistance from its Controlling Shareholder Group</b>	It is quite common that a listing applicant would have received financial assistance (e.g. loans, guarantees and other forms of collateral) (the “ <b>Financial Support</b> ”) from its controlling shareholder (and/or its close associates). However, given that it is particularly difficult in assessing to what extent the controlling shareholders’ incentive to provide the Financial Support will be reduced after listing, the Stock Exchange will presume that such Financial Support will be withdrawn in assessing the sustainability of the listing applicant.	To assess whether the business will be sustainable without Financial Support, the following factors will be considered:  (a) whether the listing applicant can obtain independent financing on comparable terms; or  (b) whether the listing applicant has enough liquid assets on hand to meet its financial needs.
<b>Material changes that may adversely affect the company's prospect</b>	Concerns may arise as to the listing applicant’s sustainability of business if it faces changes which imminently threatens its operations, which include:  (a) changes in regulatory requirements which may result in the listing applicant being unable to continue to operate its business in its current form or at its current profitability level; or  (b) development of new technology which render its business obsolete.	To address the relevant concerns, the Stock Exchange expects the listing applicant to affirmatively demonstrate that such changes are unlikely to materialise or will not affect the sustainability of the listing applicant’s business.
<b>Substantial reliance by property companies on fair value gains on investment properties</b>	Fair value gains may be included in profit calculations of a property company for the purposes of satisfying the minimum profit requirement under the Rule 8.05(1)(a) of the MB Listing Rules (the “ <b>Profit Test</b> ”). Concerns would also arise when a substantial portion of a listing applicant’s profit is derived from fair value gains arising from its investment properties, since this will cast doubt on the practical sustainability of such listing applicant. In furtherance, if there is significant market turndown, the properties would incur fair value losses which render loss making of the listing applicant.	The Stock Exchange, in assessing whether the business of a listing applicant in the property business is unsustainable/not suitable for listing, will consider the following:  (a) the listing applicant’s fair value gains. If the listing applicant’s fair value gains cannot satisfy the Profit Test after excluding unrealized gains of its investment properties ; then it might not be suitable for listing ; and  (b) if the listing applicant did not have any substantial

		<p>business during its trading record period (such as sales of properties and recurring rental income), this would also render the listing applicant's business unsustainable.</p> <p>Apart from the aforementioned factors, the Stock Exchange will also closely monitor the listing applicant's profit and cash flow forecasts, applicable sensitivity or breakeven analysis, and any inconsistent growth with the industry. Sponsors are also expected to provide the due diligence work they had done in order to substantiate their underlying assumptions that the listing applicant is suitable for listing.</p>
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**(c) Contractual arrangements**

The use of contractual arrangements will only be permitted if it is due to foreign ownership restrictions and if the related risks of contractual arrangements are sufficiently mitigated. In case contractual arrangements shall be adopted, listing applicant should refer to listing decision LD43-3 for relevant guidance.

**(d) Avoidance of creation of Shell Companies**

The Stock Exchange had been particularly cautious and skeptical about the fact that some listing applicants will thrive for the listing status for the disguised purpose of creation of "Shell Companies", since the controlling shareholders of these "Shell Companies" would either change or gradually sold their interests shortly after the lock-up period following listing. Such companies may invite speculative trading activities which lead to opportunities for market manipulation, insider trading and unnecessary volatility in the market post-listing. This would potentially trigger back-door listing circumventing all the regulatory scrutiny of the Listing Rules. Guidance Letter GL68-13A sets out the following characteristics which such Shell Companies may have as identified by the Stock Exchange.

Seven characteristics
1. Small market capitalization
2. Only marginal meet the listing eligibility requirements
3. Involve fund raising disproportionate to the listing expenses (i.e., a high proportion of the listing proceeds were used to pay listing expenses)
4. Involve a pure trading business with a high concentration of customers

5. Are asset-light businesses where majority of the assets are liquid and/or current assets
6. Involve a superficial delineation of business from the parent whereby the applicant's business is artificially delineated from the parent by geographical area, product mix or different stage of development
7. Have little or no external funding at the pre-listing stage

The Stock Exchange has made clear that there is no prescribed bright-line test in determining the suitability of listing and each application is facts sensitive. If the listing applicant demonstrates one or more of the above characteristics, the Stock Exchange will expect the applicant and the sponsors to provide a robust analysis in the listing document to substantiate that the listing applicant is suitable for listing, which include, among other things, in the following areas:

<b>Use of Proceeds</b>
The Stock Exchange will expect 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.
<b>Future objectives and strategies</b>
The Stock Exchange will expect a comprehensive analysis to be provided to demonstrate that the listing applicant has a detailed strategic plan for its business operations and growth.
<b>Profit and revenue growth</b>
The Stock Exchange will expect a comprehensive analysis to substantiate that the listing applicant's business is sustainable where the listing applicant (a) has experienced decreasing or low profit and revenue growth (b) is expected to record decreasing or low profit and revenue growth after listing.
<b>Potential sunset industries</b>
If the listing applicant is in a potential sunset industry or in an industry that has declining market prospects, the Stock Exchange will expect the listing applicant to demonstrate that it is feasible and it has both the ability and resources to modify its business to respond to the changing demands of the market.
<b>Cost of living</b>
If a significant portion of the listing proceeds will be applied to listing expenses, the listing applicant should explain how the advantages of listing outweigh the cost of living.

### (iii) Rejection cases

The Stock Exchange had heightened its scrutiny in its assessment of suitability for listing as the number of rejections of listing applications had increased from 8 to 25 from 2017 to 2018, and there were 26 rejected applications in 2019. Beneath is a summary of the factors that the Stock Exchange had contemplated which led to rejections of listing applications on the grounds of suitability for listing as set out in the listing decisions published in 2018 and 2019.

Listing Decisions	Details
<b>HKEX-LD121-2019 (published in March 2019)</b>	Lack of commercial rationale for listing and/ no genuine funding had led to rejection of 15 listing applications, which was the most common reason for rejections of listing applications in 2018. The second most common ground for rejection would be unsupported valuation and suitability of

	director/person of substantial interest or controlling shareholder, which led to three rejections, and the remaining reasons grounds for rejections being packaging, deterioration of financial performance and questionable sustainability of business.
<b>HKEX-LD119-2018 (published in March 2018)</b>	The decision provides guidance as to the rejection of GEM listing applications in 2017. Three rejection cases were mentioned and two of them were being rejected on suitability grounds on a number of factors, including concerns of controlling and substantial shareholders in not committing to nurture the listing group in the long-run, the use of proceeds was not commensurate with the listing applicant's historical and future business strategies and extreme uncertainty on the sustainability of the listing applicant's business.

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