

## Guidance on suitability for listing

### 【Overview】

According to the information published on the website of Hong Kong Exchanges and Clearing Limited (“the Exchange”), almost 50 percent of the Main Board listing applications and near 55 percent of the Growth Enterprise Market (“GEM”) listing applications are lapsed or rejected by the Listing Department during the year 2016.

The Exchange issued a Guidance Letter (HKEx-GL68-13 (December 2013) (Updated June 2015)) (“Guidance Letter”) to provide guidance on the factors that the Exchange would take into consideration when assessing whether an applicant and its business are suitable for listing.

As mentioned in the Guidance Letter, when vetting a listing application, the Listing Department focuses on:

- Eligibility for listing: for example, whether the financial requirements are met; compliance with law, rules and regulations;
- Suitability for listing: for example, whether matters on sustainability of the business; reliance on a parent company; suitability of directors, including potential persons of substantial influence are satisfactorily addressed; and
- Whether there are any material disclosure deficiencies.

Many of these lapsed or rejected applications have common issues. I would like to review one of these issues with questions frequently posed – Undue reliance:

### 【Reliance on customers or suppliers】

***If an applicant only has a single major supplier or customer, is that an issue of being rejected or returned listing application?***

There is no bright line test to determine whether an applicant’s reliance on a single major supplier or customer is an extreme case which impacts on suitability for listing. In assessing a case of reliance on single supplier or customer, the Exchange will take into account:

- (a) The applicant’s ability to find substitute customers
- (b) Whether the applicant’s business model can be easily changed to reduce the level of reliance
- (c) Whether the level of reliance is likely to decrease in the future
- (d) Whether the whole industry landscape is dominated by a few players (e.g. the computer technology industry) making it unlikely for companies in the same line of business as the applicant to break off reliance on a major supplier or customer



- (e) Whether the applicant can demonstrate the reliance is mutual and complementary
- (f) The existence of any long-term contractual arrangements
- (g) Whether the applicant is capable of maintaining its revenue in the future in light of the reliance

Also, when the applicant's major customer is also its supplier (e.g. captive model), the applicant's relationship with this party will be fundamental to its business. If the applicant is unable to demonstrate that it is capable of carrying on its business independently of this party, it will translate into a concern about the suitability.

(Source: HKEx-GL68-13, LD107-1)

### **【Reliance on controlling shareholders】**

The Listing Rules requires a statement explaining how the issuer is satisfied that it is capable of carrying on business independently of the controlling shareholder (including any close associate thereof) after listing, and particulars of the matters that it relied on in making such statement.

When considering independence issues, the Exchange will generally require the company to take into account the following:

- Financial independence;
- Operational independence; and
- Management independence.

Where the degree of dependence is excessive, this may translate into a concern about the suitability for listing.

***Would the Exchange require a listing applicant to repay all outstanding loans due to, and discharge all guarantees provided by, its controlling/substantial shareholders?***

Yes, however it is not a mandatory requirement and accepted other methods:

- (a) Using part of IPO proceeds to repay shareholder loans
- (b) A record of fund raising on stand-alone basis without any credit support from controlling shareholder and a strong financial position may also help
- (c) Where premature release of all parent's guarantees would give rise to early termination liabilities and practical and commercial difficulties, the applicant had obtained confirmations from major banks for credit facilities without guarantee from its parent, and the applicant intended an orderly release of all group guarantees as soon as practicable within 6 months after listing

(Source: HKEx-GL68-13, LD42-1, LD69-1)

***If an applicant relies on its controlling shareholder for sales and procurement functions, is that an issue of being rejected or returned listing application?***

Reliance on controlling shareholder for sales and procurement functions could not be addressed by disclosure alone. The reliance raised concerns such as transfer pricing, conflicts of interests, substantial reliance on the protection mechanisms offered by the connected transactions, and how performance of the listed part of the company may be independently evaluated.

However, reliance on controlling shareholder for supply of raw materials may, in exceptional circumstances e.g. highly regulated industry, be dealt with by disclosure.

The Exchange questioned the suitability of listing in the following case:

A listing applicant and its subsidiaries (“the Group”) had generated substantial revenue from sales to its Parent Company and Parent Company had been the Group’s largest customer, representing over 75% of the Group’s total sales in Year 2, Year 3 and the first six months of Year 4. The group expected future sales to Parent Company to account for more than 50% of the Group’s total sales volume in each of Year 4, Year 5 and Year 6. And the Group had received substantial advances from Parent Company.

(Source: HKEx-GL68-13, LD46-1, LD46-2, LD30-2012)

***If the management of an applicant is the same as that applicant’s controlling shareholder, is that an issue of being rejected or returned listing application?***

The Exchange would consider the level of overlap between the management of the applicant and its controlling shareholder.

Factor to be taken account include the number of common directors, the role of the common directors, daily operation of the applicant, the extent of delineation of the business of the applicant and that of its controlling shareholder, the extent of continuing connected transactions, and the independence of the senior management of the applicant and the controlling shareholder.

(Source: HKEx-LD52-2)

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### About Aoba & Hopkins Group:

The Aoba & Hopkins Group consists of CPA firms and full service consulting firms located in Hong Kong, Guangzhou and Beijing that have been providing quality and efficient professional services to our valued clients aboard and at home since 1989.

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