



CHAPTER 6

Suitability for Listing

As the number of successful initial public offerings (“IPO(s)”) increases every year, The Stock Exchange of Hong Kong Limited (the “**Stock Exchange**”) has rejected more and more cases on the ground of unsuitability for listing in recent years. Listing applicants are advised to conduct in-depth pre-IPO diagnosis at an early stage of their IPO execution to identify issues which may cast doubt on their suitability for listing.

Suitability for listing as one of the listing qualifications

The Hong Kong stock market has prided itself on having very transparent and objective listing qualifications, which help provide certainty to the outcomes of listing applications. The market used to believe that as long as the listing qualifications, in particular the profits/cash flow requirements, management continuity and ownership continuity, are satisfied, the other issues involved in a listing can usually be dealt with by way of disclosure. This expectation is consistent with the general characteristics of the Hong Kong stock market as largely disclosure-based, which means the Stock Exchange will less likely pass judgement on the

commercial viability of a business or company or the commercial aspects of a transaction to be undertaken by a listed issuer.

Rule 8.04 of the Rules Governing the Listing of Securities on the Stock Exchange (the “**Listing Rules**”) and Rule 11.06(1) of the Rules Governing the Listing of Securities on GEM (the “**GEM Listing Rules**”) provide that both the issuer and its business must, in the opinion of the Stock Exchange, be suitable for listing. It is stressed that suitability for listing depends on many factors, and a listing applicant’s compliance with the Listing Rules / GEM Listing Rules may not of itself ensure its suitability for listing, and the Stock Exchange retains discretion to accept or reject applications for listing. Under the Listing Rules / GEM Listing Rules, the only example cited for being unsuitable for listing is where the assets of the proposed listing group consist wholly or substantially of cash and/or short-term investments. There was a time when it is generally believed that, save for the cited example or some other extreme circumstances, the Stock Exchange would unlikely invoke the “imperial sword” of the ground of unsuitability for listing to reject a listing application.

However, in recent years, the Stock Exchange has invoked the ground of unsuitability for listing more frequently and rejected more listing applications. In 2018, the Stock Exchange rejected 24 listing applications, as compared to 3 rejections in 2017.¹ Although there is no bright line test in determining what would render an issuer and its business unsuitable for listing, the Stock Exchange has published a number of listing decisions and guidance letters to illustrate the principles.

Avoiding creation of shells – the seven sins

In recent years, the Stock Exchange has noted that some listing applicants appeared to be listing their companies so that they could sell the listed entities as “listed shells” for another business. There has been a number of listed issuers where

their controlling shareholders either changed or have gradually sold down their interests shortly after the one-year lockup period had expired. The Stock Exchange considers that these shell companies will invite speculative trading activities when identified by potential buyers, which can lead to opportunities for market manipulation, insider trading and unnecessary volatility in the market post-listing, and may enable backdoor listing circumventing regulatory scrutiny. In June 2016, the Stock Exchange published a guidance letter GL68-13A identifying seven characteristics of “listed shells”, which would raise concerns regarding the suitability for such listings and will attract a more focused review by the Stock Exchange. The seven characteristics have been dubbed the “seven sins”.

Seven characteristics	Points to note
1. Small market capitalisation	Listing applicants should compare the market capitalisation of their proposed listings with the market norm.
2. Only marginally meeting the listing eligibility requirements	<p>Under the profits test in the Listing Rules, a Main Board listing applicant should have a profit attributable to shareholders of not less than HK\$20 million in respect of the most recent financial year, and in aggregate not less than HK\$30 million in respect of the two preceding financial years. In addition, since February 2018, Main Board listing applicants need to meet a market capitalisation at the time of the listing of HK\$500 million.² A listing applicant with a net profits marginally over the listing eligibility requirements will unlikely satisfy the market capitalisation requirements because its price to earnings ratio (P/E ratio) is expected to be generally in line with its market comparable.</p> <p>A GEM listing applicant should 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 of at least HK\$30 million in aggregate for the two financial years immediately preceding the issue of the prospectus.³ It is expected to have a market capitalisation of HK\$150 million at the time of the listing.⁴</p> <p>Listing applicants should note that any income or loss generated by activities outside the ordinary and usual course of its business or one-off windfall profits should be disregarded in determining listing eligibility. In addition, the Stock Exchange may disregard the income tainted by material non-compliance incidents.</p>

¹ The figures reflect listing applications that have exhausted all avenues of appeal with the Stock Exchange.

² Rule 8.09(2) of the Listing Rules

³ Rule 11.12A(1) of the GEM Listing Rules

⁴ Rule 11.23(6) of the GEM Listing Rules

3. Involving fund raising disproportionate to listing expenses	Listing applicants should consider if the size of the proposed fund raisings and the proportions of listing expenses to the funds to be raised are appropriate and in line with the market. 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 listing.
4. Involving a pure trading business with a high concentration of customers	Listing applicants should note that a pure trading business is unlikely to be regarded by the Stock Exchange as suitable for listing in Hong Kong. For businesses with a high concentration of customers, the Stock Exchange will take into account the following factors in determining whether the reliance would have impacts on suitability for listing: a. Whether the listing applicant has established relationship or long-term agreement with the customer; ⁵ b. whether the listing applicant's business model can be easily changed to reduce the level of reliance, e.g. by finding substitute customers; c. whether the listing applicant has plans to diversify its business focus to reduce its reliance; d. whether the whole industry landscape is dominated by a few players; e. whether the reliance is mutual and complementary; and f. whether the listing applicant is capable of maintaining its revenue in the future in light of the reliance. ⁶
5. Asset-light businesses where a majority of the assets are liquid and/or current assets	Listing applicants should consider if the asset ratios of their businesses are in line with the nature of the industries in which they operate as well as their market comparable.
6. Involving a superficial delineation of business from the parent company	In pre-IPO reorganisation, it is common for a listing applicant to exclude the business which is not in line with the listing business from the listing group structure. The Stock Exchange may have concerns if there is a superficial delineation of business from the excluded business. In particular, listing applicants should note that excluding a business from the listing group on the grounds that the excluded company has material non-compliance issues or that it is trading at a loss would not be legitimate reasons in the eyes of the regulators.
7. Having little or no external funding at the pre-listing stage	To assess if the listing applicant has genuine funding needs, the Stock Exchange will consider if the listing applicant has a reasonable gearing ratio and any idle cash, the listing applicant's amount of utilised banking facilities and other borrowings and whether the listing applicant has exhausted cheaper financing options.

For a listing applicant which exhibits some of the above characteristics, such listing applicant and its sponsor(s) should provide a robust analysis to substantiate that such listing applicant is suitable for listing, including, among other things, in the following areas:

(i) **Use of proceeds** – The listing applicant should disclose specific uses for proceeds that commensurate with its past and future

business strategy and observed industry trends and explain the commercial rationale for listing.

(ii) **Future objectives and strategies** – A comprehensive analysis should be provided to demonstrate that the listing applicant has a detailed strategic plan for its business operations and growth.

(iii) **Profit and revenue growth** – Where a listing applicant (a) has experienced decreasing or low profit and revenue growth; and/or (b) is expected to record decreasing or low profit and revenue growth after listing, a comprehensive analysis is required to substantiate that the listing applicant's business is sustainable.

(iv) **Potential sunset industries** – If 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 its business is feasible and it has both the ability and resources to modify its business to respond to the changing demands of the market.⁷

The Stock Exchange emphasises that its focus is a qualitative review on the listing applicant's suitability such as whether the listing is consistent with the business strategies of the listing applicant, including the proposed use of proceeds and whether the listing applicant has genuine funding needs.⁸ If the listing applicant is unable to demonstrate the commercial rationale for listing, the Stock Exchange may find that the listing applicant is not suitable for listing, irrespective of the nature and financial standing of the business operated by the listing applicant. In addition, if the Stock Exchange is aware of any specific facts and circumstances which give it a reasonable basis to believe that a listing applicant is likely to invite speculative trading upon listing or to be acquired for its listing status, it may find the listing applicant to be not suitable for listing.⁹

Sustainability of business model

The guidance letter GL68-13 published by the Stock Exchange last updated in March 2019 provides guidance on non-exhaustive factors the Stock Exchange will take into account when assessing whether a listing applicant's business is suitable for listing. One of these factors is sustainability of business model. A business model may be

considered unsuitable due to a combination of factors, such as:

(a) *Deteriorating financial performance*

The Stock Exchange will consider, among other things, (a) how susceptible the listing applicant's financial performance is to changes beyond its control; (b) the underlying causes of the deteriorating financial performance and whether such downward trend is expected to continue, or whether it is the cyclical nature of the industry; and (c) whether the listing applicant had demonstrated that it is able to effectively mitigate its exposure to the relevant risks or to turn around the business.¹⁰

(b) *Material reliance on customer, supplier, limited number of distribution channels and/or controlling shareholder and its close associates (the "Controlling Shareholder Group")*

Material reliance on another party (a "**Relevant Counterparty**") may threaten a listing applicant's business sustainability if it is likely that the relationship with such party may materially adversely change or terminate.¹¹

A listing applicant's material reliance on a Relevant Counterparty 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 prospectus should include:

- (i) the background of the Relevant Counterparty;
- (ii) the business relationship, the nature of reliance and details of the arrangements between the listing applicant and the Relevant Counterparty;
- (iii) basis that the likelihood that the relationship with the Relevant Counterparty will materially adversely change/ terminate is low; or

⁷ Paragraph 3.2 of HKEx Guidance Letter GL68-13A

⁸ Paragraph 4.1 of HKEx Guidance Letter GL68-13A

⁹ Paragraph 4.2 of HKEx Guidance Letter GL68-13A

¹⁰ Paragraph 3.10 of HKEx Guidance Letter GL68-13

¹¹ Paragraph 3.11 of HKEx Guidance Letter GL68-13

⁵ Paragraph 3.12(b) of HKEx Guidance Letter 68-13

⁶ HKEx Listing Decision LD107-1

(iv) basis that the listing applicant is/ will be able to effectively mitigate its exposure to any material adverse changes to or termination of the relationship with the Relevant Counterparty.¹²

(c) Financial assistance from its Controlling Shareholder Group

A listing applicant may receive material financial assistance (e.g. loans from the Controlling Shareholder Group or personal guarantee or other forms of collateral or security given by the Controlling Shareholder securing the listing group's indebtedness) from the Controlling Shareholder Group. The Stock Exchange will presume such financial support will be withdrawn (absent evidence to the contrary) in assessing the sustainability of the listing applicant.¹³

The Stock Exchange will take into account the following non-exhaustive factors to assess whether the listing applicant's business will be sustainable without financial support:

- (i) whether the listing applicant is able to obtain independent financing (e.g. without financial support) on comparable terms; or
- (ii) whether the listing applicant has sufficient liquid assets on hand to meet its financial needs.¹⁴

(d) Material changes that may adversely affect the company's prospect

Concerns on a listing applicant's sustainability of business will also arise if it faces changes which imminently threatens its operations, such as:

- (i) 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

(ii) development of new technology which renders its business obsolete.¹⁵

To address these 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.¹⁶

Whether non-compliance would affect a listing applicant's suitability for listing

Non-compliances that involved fraud, deceit or dishonesty (such as tax evasion or bribery) ("**Integrity Non-compliances**") and material non-compliances with laws and regulations by a listing applicant, its director(s) or controlling shareholder(s) ("**Material Non-compliances**") may render a business unsuitable for listing. With respect to the operational and financial impact of the non-compliances, the Stock Exchange may request the listing applicant to demonstrate that it could still meet the relevant eligibility requirements under the Listing Rules after adjusting its trading record results for the impact of the non-compliances, and that there would not have been any material adverse impact on its business and financial performance had it complied with the relevant rules or regulations and going forward.¹⁷

Category	Implications	Consideration
Integrity Non-compliances	<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, as the case may be.</p> <p>Integrity Non-compliances impugn a culpable director's character and integrity in contravention of the standards required under Main Board Rules 3.08 and 3.09 (GEM Rules 5.01 and 5.02).</p> <p>If a controlling shareholder is culpable for the Integrity Non-compliances, so long as such controlling shareholder 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>	<p>The Stock Exchange will take into account all relevant facts and circumstances (including the underlying reasons for the Integrity Non-compliances and relevant mitigating factors, their operational and financial impact, the culpable person's influence on the listing applicant's operations, internal controls and trading record results, and whether any effective internal control measures have been implemented (and for how long) to avoid re-occurrence of similar Integrity Non-compliances) in determining whether such Integrity Non-compliances would render the listing applicant unsuitable for listing.</p> <p>The Stock Exchange expects the culpable director or controlling shareholder to cease being a director or controlling shareholder of the listing applicant, as the case may be, before listing.</p>
Material Non-compliances	<p>Material Non-compliances that raise concerns regarding the competency of any director who was involved in the Material Non-compliances or was on the board when such non-compliances occurred, leading to issues of his/ her suitability as a director which cannot be addressed by disclosure.</p>	<p>The Stock Exchange expects the listing applicant to have implemented enhanced internal control measures to prevent the recurrence of Material Non-compliances.¹⁸ The Stock Exchange normally expects the Material Non-compliances to be fully rectified before listing.¹⁹</p> <p>Material Non-compliances that involve bill financing from banks and interest rate/loan arbitrage that are not criminal in nature may be addressable by disclosure. The listing applicant will be required to cease all non-compliant bill financing and for a period of at least 12 months before its listing application to demonstrate that its business is sustainable when it is in compliance.²⁰</p>

Rejection cases

Over the years, the Stock Exchange has published a number of listing decisions to disclose the reason for rejecting some listing applications. Here is a summary of some common grounds for rejection.

It should be noted the presence of a single issue may or may not by itself render a listing applicant unsuitable for listing and the Stock Exchange would look at the overall impacts of the issues on the listing applicant to evaluate if it is suitable for listing.

¹² Paragraph 3.15 of HKEx Guidance Letter GL68-13
¹³ Paragraph 3.16 of HKEx Guidance Letter GL68-13
¹⁴ Paragraph 3.17 of HKEx Guidance Letter GL68-13
¹⁵ Paragraph 3.18 of HKEx Guidance Letter GL68-13
¹⁶ Paragraph 3.19 of HKEx Guidance Letter GL68-13
¹⁷ Paragraphs 3.6 and 3.8 of HKEx Guidance Letter GL68-13

¹⁸ Paragraph 3.4 of HKEx Guidance Letter 63-13
¹⁹ Paragraph 3.4(d) of HKEx Guidance Letter 63-13
²⁰ Paragraph 3.7 of HKEx Guidance letter 63-13

Issues	Relevant listing decision(s)
Excessive transactions with closely related parties or connected persons	LD92-1 published in May 2010 (withdrawn in March 2019 and is superseded by GL 68-13 but the principles contained in this listing decision is still of relevance) Company B (rejection case in 2015) in LD100-2016 published in April 2016 Company A (rejection case in 2018) in LD121-2019 published in March 2019
Mining company failing to demonstrate that its principal assets had a clear path to commercial production	Company A (rejection case in 2013) and Company G (rejection case in 2014) in LD92-2015 published in June 2015 Company D (rejection case in 2015) in LD100-2016 published in April 2016
Failure to rectify non-compliance which may affect key licence renewal	Company B (rejection case in 2013) in LD92-2015 published in June 2015
Heavy reliance on controlling shareholders for financial assistance	Company B (rejection case in 2013) in LD92-2015 published in June 2015 Company B (rejection case in 2016) in LD107-2017 published in May 2017
Suitability of director(s), person of substantial interest or controlling shareholder in question	Company B, Company C and Company E (rejection cases in 2013), Company J and Company N (rejection cases in 2014) in LD92-2015 published in June 2015 Company C and Company F (rejection cases in 2015) in LD100-2016 published in April 2016 Company L (rejection case in 2016) in LD107-2017 published in May 2017 Company F, Company N and Company Q (rejection cases in 2018) in LD121-2019 published in March 2019
Failure to meet the financial requirements if (a) one-off income, waived directors' emoluments, waived rental and government grant, (b) income derived from material non-compliances, or (c) fair value gains from investment properties were excluded while notional interest expenses on shareholders' loan was imputed	Company D (rejection case in 2013) and Company N (rejection case in 2014) in LD92-2015 published in June 2015 Company C and Company E (rejection cases in 2015) in LD100-2016 published in April 2016 Company A, Company B, Company E and Company M (rejection cases in 2016) in LD107-2017 published in May 2017 Company I (rejection case in 2018) in LD121-2019 published in March 2019

Unsustainable business model and/or deteriorating financial performance with insufficient basis to believe situation will improve	Company D (rejection case in 2013), Company L, Company N, Company O and Company P (rejection cases in 2014) in LD92-2015 published in June 2015 Company A, Company E and Company G (rejection cases in 2015) in LD100-2016 published in April 2016 Company F, Company H and Company M (rejection cases in 2016) in LD107-2017 published in May 2017 Company B (rejection case in 2017) in LD119-2018 published in March 2018 Company E (rejection case in 2018) in LD121-2019 published in March 2019
Integrity non-compliance (e.g. tax evasion)	Company E (rejection case in 2013) in LD92-2015 published in June 2015
Departure of personnel or material acquisition leading to failure to meet the ownership continuity, management continuity and profit test requirements	Company E (rejection case in 2013) and Company H (rejection case in 2014) in LD92-2015 published in June 2015 Company D (rejection case in 2016) in LD107-2017 published in May 2017 Company C (rejection case in 2017) in LD119-2018 published in March 2018
Reliance on major customer(s), single project or product	Company F (rejection case in 2013) in LD92-2015 published in June 2015 Company I, Company J and Company K (rejection case in 2016) in LD107-2017 published in May 2017
Material or systemic non-compliances casting doubt on the listing applicant's ability to operate in a compliant manner or its business prospects	Company J and Company K (rejection cases in 2014) in LD92-2015 published in June 2015 Company C and Company F (rejection cases in 2015) in LD100-2016 published in April 2016 Company A and Company E (rejection cases in 2016) in LD107-2017 published in May 2017
Lack of title certificate or property ownership certificate to PRC property which is significant to the activities of the listing applicant	Company N and Company O (rejection cases in 2014) in LD92-2015 published in June 2015
Excessive competition with controlling shareholder	Company O (rejection case in 2014) in LD92-2015 published in June 2015
Lack of sponsor independence	Company M (rejection case in 2014) in LD92-2015 published in June 2015 Company V (rejection case in 2018) in LD121-2019 published in March 2019
Operation in high risk jurisdiction with extreme legal and political uncertainties	Company A (rejection case in 2015) in LD100-2016 published in April 2016

Material change of business model during or after the Track Record Period rendering the track record results not representative of future performance	Company B and Company E (rejection cases in 2015) in LD100-2016 published in April 2016 Company G (rejection case in 2016) in LD107-2017 published in May 2017
Significant advances to third parties casting doubt on integrity of director(s)	Company F (rejection case in 2015) in LD100-2016 published in April 2016
Unjustified P/E ratio	Company C (rejection case in 2016) in LD107-2017 published in May 2017 Company D, Company H and Company M (rejection cases in 2018) in LD121-2019 published in March 2019
Controlling shareholder and substantial shareholders previously involved in selling listed shells, casting doubt on whether the shareholders would be committed to nurture the listing applicant in the long run	Company A (rejection case in 2017) in LD119-2018 published in March 2018
Lack of commercial rationale for listing and/or no genuine funding need	Company A (rejection case in 2017) in LD119-2018 published in March 2018 Company B, Company C, Company G, Company H, Company J, Company K, Company L, Company M, Company O, Company P, Company R, Company S, Company W and Company X (rejection cases in 2018) in LD121-2019 published in March 2019
Packaging of different companies to meet the eligibility requirements	Company T (rejection case in 2018) in LD121-2019 published in March 2019

Heightened scrutiny of commercial rationale for listing

It is observed that the Stock Exchange has heightened the scrutiny of commercial rationale for listing in recent years, leading to a notable increase in rejected listing applications in 2018. The Stock Exchange stressed that the rejections were not sector specific. Instead, its primary focus when assessing suitability for listing was on whether the rationale for listing was supported by the listing applicant's expected growth and therefore needs for funding. As part of the Stock Exchange's commitment to maintain market quality, in assessing the suitability for listing for future cases,

it is expected that the Stock Exchange will give more consideration to whether the proposed use of proceeds and funding needs are consistent with the business strategies and future plans of the listing applicants.

Disclaimer

The law and procedure on this subject are very specialised and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

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