

# The Stock Exchange of Hong Kong Limited

## Practice Note 2

to the Rules Governing the Listing of Securities on GEM  
of The Stock Exchange of Hong Kong Limited  
(the “GEM Listing Rules”)

Issued pursuant to rule 1.07 of the GEM Listing Rules

### **DUE DILIGENCE BY SPONSORS IN RESPECT OF INITIAL LISTING APPLICATIONS**

1. This Practice Note should be read together with Chapter 6A of the GEM Listing Rules and the SFC Sponsor Provisions. Chapter 6A, amongst other things, requires that Sponsors conduct reasonable inquiries (“due diligence”) to enable the Sponsor to make a declaration set out in Appendix 7G under rule 6A.13. The SFC Sponsor Provisions provide a regulatory basis for defining the expected quality of work as a Sponsor.
  - 1A. In undertaking due diligence inquiries a Sponsor must have regard to this Practice Note and the SFC Sponsor Provisions. To the extent that any matters under this Practice Note and the SFC Sponsor Provisions overlaps, the more onerous provisions imposing a higher standard of conduct on Sponsors will prevail.
2. The Sponsor should make such inquiries as may be necessary until the Sponsor can reasonably satisfy itself on the disclosure in the listing document. In undertaking its role a Sponsor should examine with professional scepticism the accuracy and completeness of statements and representations made, or other information given, to it by the new applicant or its directors. An attitude of professional scepticism means making a critical assessment with a questioning mind and being alert to information, including information from experts, that contradicts or brings into question the reliability of these statements, representations and information.
3. This Practice Note sets out the Exchange’s expectations of due diligence Sponsors will typically perform. It is not in any way intended to set out the actual steps that may be appropriate in any particular case. Each new applicant is unique and so will be the due diligence steps necessary for the purpose of its listing application. The scope and extent of appropriate due diligence by a Sponsor may be different from (and in some cases, considerably more extensive than) the more typical examples in this Practice Note. The Sponsor must exercise its judgment as to what investigations or steps are appropriate for a particular new applicant and the extent of each step.
4. The Exchange expects Sponsors to document their due diligence planning and significant deviations from their plans. This includes demonstrating that they have turned their minds to the question of what inquiries are necessary and reasonably practicable in the context and circumstances of the case. The Exchange also expects Sponsors to document the conclusions they reach on the new applicant’s compliance with all the conditions in Chapter 11 of the GEM Listing Rules taking into account the extent to which compliance with those rules has been waived by the Exchange.
5. It may be appropriate for a Sponsor to engage third party professionals to assist it to undertake tasks related to certain due diligence inquiries. For example, assistance in reviewing the circumstances of all current legal proceedings to which the new applicant is a party. In such cases, the Exchange expects the Sponsor to satisfy itself that it is reasonable to rely on information or advice provided by the third party professional. That would include, for example:
  - (a) being satisfied as to the competence of the professional, the scope of work to be undertaken by the professional and the methodology proposed to be used by the professional; and

- (b) being satisfied that the third party professional's report or opinion is consistent with the other information known to the Sponsor about the new applicant, its business and its business plans.
6. The Exchange reminds Sponsors of their other obligations including but not limited to those under the GEM Listing Rules, the SFC Corporate Finance Adviser Code of Conduct, the Code of Conduct and particularly the SFC Sponsor Provisions, the Sponsor Guidelines, the Takeovers Code, the Code on Share Buy-backs, the Securities and Futures Ordinance and all other relevant ordinances, codes, rules and guidelines applicable to Sponsors. Nothing in this Practice Note detracts from or diminishes those obligations.

### **Interpretation of this Practice Note**

7. Unless otherwise stated, all terms used in this Practice Note have the same meanings as in the GEM Listing Rules.
8. All references in this Practice Note to the new applicant's listing document include supporting or supplementary documents, for example, correspondence with the Exchange in relation to the new applicant's initial listing application and relied on by the Exchange in assessing that application.
9. All references in this Practice Note to the new applicant include the new applicant's group of companies.
10. Unless otherwise stated, all references in this Practice Note to directors include executive and non-executive directors.

### **Due diligence**

11. Typical due diligence inquiries in relation to the collective and individual experience, qualifications, competence and integrity of the directors include:
- (a) reviewing written records that demonstrate each director's past performance as a director of the new applicant including participation in board meetings and decision making relating to the management of the new applicant and its business;
  - (b) assessing individually and collectively the financial literacy, corporate governance experience and competence generally of the directors with a view to determining the extent to which the board of the new applicant as a whole has a depth and breadth of financial literacy and understanding of good corporate governance, having regard to any code on corporate governance practices that the Exchange publishes from time to time; and
  - (c) reviewing the financial and regulatory track record of each publicly listed company (this includes companies listed on other exchanges as well as on the Exchange) of which any of the new applicant's directors is or was an executive or non-executive director, for example, by reference to company disclosures, media articles and information about those companies on the website of the relevant stock exchange.
12. Typical due diligence inquiries in relation to the new applicant's compliance with the qualifications for listing include:
- (a) searching the company registry in the new applicant's place of incorporation to confirm that the new applicant is duly established in that place and that the new applicant is in compliance with its memorandum and articles of association or equivalent constitutive documents;

- (b) reviewing material financial information, including:
  - (i) financial statements of the new applicant;
  - (ii) financial statements of all subsidiaries of the new applicant and other companies that are material to the group's financial statements; and
  - (iii) the internal financial records, tax certificates and supporting documents to the tax certificates for the trading record period.

Such review would in most cases include interviewing the new applicant's accounting staff and internal and external auditors and reporting accountants and, where relevant, obtaining comfort from the new applicant's external auditors or reporting accountants based upon agreed procedures; and

- (c) assessing the accuracy and completeness of the information submitted by the new applicant to demonstrate that it satisfies the trading record requirement.

13. Typical due diligence inquiries in respect of each new applicant and the preparation of its listing document and supporting information include:

- (a) assessing the financial information to be published in the listing document including:
  - (i) obtaining written confirmation from the new applicant and its directors that the financial information (other than that already reported upon by a reporting accountant) has been properly extracted from the relevant underlying accounting records; and
  - (ii) being satisfied that the confirmation referred to at paragraph (i) has been given after due and careful inquiry by the new applicant and its directors;
- (b) assessing the new applicant's performance and finances, business plan and any profit forecast or estimate, including an assessment of the reasonableness of budgets, projections and assumptions made when compared with past performance, including historical sales, revenue and investment returns, payment terms with suppliers, costs of financing, long-term liabilities and working capital requirements. This would normally include interviewing the new applicant's senior management and would often involve interviewing the new applicant's major suppliers and customers, creditors and bankers;
- (c) assessing whether there has been any change since the date of the last audited balance sheet included in the listing document that would require disclosure to ensure the listing document is complete and not misleading;
- (d) assessing whether it is reasonable to conclude that the proceeds of the issue will be used as proposed by the new applicant, taking into account the outcome of the Sponsor's assessment of, in particular, the new applicant's existing cash and liquid reserves, projected liabilities, working capital requirements and expenditure controls;
- (e) undertaking a physical inspection of material assets, whether owned or leased, including property, plant, equipment, inventory and biological assets (for example, livestock or crops) used or to be used in connection with the new applicant's business;

Notes:

1. *By physical inspection the Exchange means the Sponsor should visit the site of the asset in order to view the asset and to assess its extent, quality and quantity and the purpose for which it is used.*
2. *Where, in the reasonable opinion of the Sponsor, assessment of an asset, including as to its extent, quality, quantity and use, genuinely cannot be achieved without the use of an expert (for example, in undertaking the physical inspection the Sponsor becomes suspicious that the asset does not exist as to the extent represented or exists but is not used for the purpose claimed) the Sponsor should ensure that the new applicant instructs an appropriately qualified independent expert to conduct all or part of the inspection. In such cases the Sponsor should ensure the expert is required to provide a written report in respect of the inspection.*

- (f) reaching an understanding of the new applicant's production methods;
- (g) reaching an understanding of the manner in which the new applicant manages its business, including as relevant actual or proposed marketing plans, including distribution channels, pricing policies, after-sales service, maintenance and warranties;
- (h) reviewing the business aspects of all contracts material to the new applicant's business;

*Note: By business aspects the Exchange means non-legal aspects.*

- (i) reviewing legal proceedings and other material disputes that are current or recently resolved (for example, resolved in the previous 12 months) and in which the new applicant is involved, and all proceedings or material disputes the new applicant knows to be contemplated and which may involve the new applicant or one of its subsidiaries;
- (j) analysing the business aspects of economic, political or legal conditions that may materially affect the new applicant's business;
- (k) considering the industry and target markets in which the new applicant's business has principally operated and is intended to principally operate, including geographical area, market segment and competition within that area and/or segment (including existing and potential principal competitors and their relative size, aggregate market share and profitability);
- (l) assessing whether there is appropriate documentation in place to confirm that the material assets, whether owned or leased, including property, plant, equipment, inventory and biological assets used or to be used, in connection with the new applicant's business, are appropriately held by the new applicant (for example, reviewing the relevant certificates of title and rights of land use);
- (m) assessing the existence, validity and business aspects of proprietary interests, intellectual property rights, licensing arrangements and other intangible rights of the new applicant;
- (n) reaching an understanding of the technical feasibility of each new product, service or technology developed, being developed or proposed to be developed under the new applicant's business plan that may materially affect the new applicant's business; and

- (o) assessing the stage of development of the new applicant's business and assessing the new applicant's business plan and any forecasts or estimates, including reaching an understanding of the commercial viability of its product(s), service(s) or technology, including an assessment of the risk of obsolescence as well as market controls, regulation and seasonal variation.
14. Typical due diligence inquiries in relation to the expert sections of the listing document include:
- (a) interviewing the expert, reviewing the terms of engagement (having particular regard to the scope of work, whether the scope of work is appropriate to the opinion required to be given and any limitations on the scope of work which might adversely impact on the degree of assurance given by the expert's report, opinion or statement) and reviewing publicly available information about the expert to assess:
    - (i) the expert's qualifications, experience and resources; and
    - (ii) whether the expert is competent to undertake the required work;
  - (b) reviewing the expert sections of the draft listing document to form an opinion as to whether the following are disclosed and commented on appropriately:
    - (i) the factual information on which the expert relies;
    - (ii) the assumptions on which the expert opinion is based; and
    - (iii) the scope of work performed by the expert in arriving at his opinion;
  - (c) verifying factual information for the purpose of making that part of the declaration in rule 6A.13 and Appendix 7G(3);
  - (d) where the Sponsor is aware that the new applicant has made formal or informal representations to an expert in respect of an expert section or in respect of a report made in connection with the listing application, assessing whether the representations are consistent with the Sponsor's knowledge of the new applicant, its business and its business plans;
  - (e) by reference to the Sponsor's knowledge of the new applicant, its business and its business plans assessing whether the assumptions disclosed by the expert as those on which the expert's opinion is based, are fair, reasonable and complete;
  - (f) if the expert's opinion is qualified, assessing whether the qualification is adequately disclosed in the listing document; and
  - (g) where the standard of independence is not set by a relevant professional body, obtaining written confirmation from the expert that it is independent from the new applicant and its directors and controlling shareholder(s), and being satisfied that there is no cause to inquire further about the truth of this confirmation. This would include confirming that the expert does not have a direct or indirect material interest in the securities or assets of the new applicant, its core connected persons, or any close associate of the new applicant beyond that allowed by rule 6A.07.

15. Typical due diligence inquiries in relation to the new applicant's accounting and management systems and in relation to the directors' appreciation of their and the new applicant's obligations include:

- (a) assessing the new applicant's accounting and management systems that are relevant to:
  - (i) the obligations of the new applicant and its directors under the GEM Listing Rules and other legal and regulatory requirements, in particular the financial reporting, disclosure of notifiable and connected transaction and inside information requirements; and
  - (ii) the directors' ability to make a proper assessment of the financial position and prospects of the new applicant and its subsidiaries, both immediately before and after listing.

This assessment should cover the new applicant's compliance manuals, policies and procedures including corporate governance policies and any letters from the reporting accountants to the new applicant commenting on the new applicant's accounting and management systems or other internal controls; and

- (b) interviewing all directors and senior managers with key responsibilities for ensuring compliance with the GEM Listing Rules and other legal and regulatory requirements (including the staff responsible for the accounting and financial reporting function, company secretary and any compliance officers) to assess:
  - (i) their individual and collective experience, qualifications and competence; and
  - (ii) whether they appear to understand relevant obligations under the GEM Listing Rules and other relevant legal and regulatory requirements and the new applicant's policies and procedures in respect of those obligations.

16. To the extent that the Sponsor finds that the new applicant's procedures or its directors and/or key senior managers are inadequate in any material respect on issues referred to at paragraph 15 above, the Sponsor should typically discuss the inadequacies with the new applicant's board of directors and make recommendations to the board regarding appropriate remedial steps. It should also typically ensure that these steps be taken before listing. These steps might include training tailored to the needs of individual directors and senior managers.