

HKEX GUIDANCE LETTER

HKEX-GL68-13 (December 2013) (Updated in June 2015 and March 2019)

Subject	Guidance on suitability for listing for new applicants
Listing Rules	Main Board Rules 2.06, 3.08, 3.09, 8.04 and Chapter 14A GEM Rules 2.09, 5.01, 5.02, 11.06 and Chapter 20
Related Publications	Listing Decision HKEX-LD43-3 (“LD43-3”) Guidance Letter HKEX-GL63-13 – Guidance on disclosure of non-compliance incidents in listing documents (“GL63-13”) Guidance Letter HKEX-GL73-14 – Guidance on pricing policies for continuing connected transactions and their disclosure (“GL73-14”) Guidance Letter HKEX-GL96-18 – Guidance on listed issuer’s suitability for continued listing (“GL96-18”) Guidance Letter HKEX-GL97-18 – Guidance for new applicants in the internet technology sector or that have internet-based business models (“GL97-18”)
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Important note: *This letter does not override the Listing Rules and is not a substitute for advice from qualified professional advisers. If there is any conflict or inconsistency between this letter and the Listing Rules, the Listing Rules prevail. You may consult the Listing Department on a confidential basis for an interpretation of the Listing Rules or this letter.*

1. Purpose

1.1 This letter provides guidance on non-exhaustive factors that the Exchange would take into consideration when assessing whether (i) non-compliances that involve fraud, deceit or dishonesty (such as tax evasion or bribery) (the “**Integrity Non-compliances**”); (ii) material non-compliances¹ by a new applicant, its director(s) or controlling shareholder(s) (the “**Material Non-compliances**”); (iii) uncertainties regarding business sustainability; and (iv) the use of contractual arrangements would affect a new applicant’s suitability for listing under Main Board Rule 8.04 (GEM Rule 11.06). **(Updated in March 2019)**

1.2 **(Deleted in March 2019)**

1.3 **(Deleted in March 2019)**

¹ As defined in GL63-13, these refer to the non-compliance incidents which, individually or in aggregate, have had or are reasonably likely to have in the future, a material financial or operational impact on the new applicant.

2. Relevant Listing Rules (*Deleted in March 2019*²)

3. Guidance

- 3.1 As stated under Main Board Rule 2.06 (GEM Rule 2.09), there is no bright line test in determining what would render an issuer and its business unsuitable for listing. Applicants for listing should appreciate that compliance with Listing Rules may not of itself ensure an applicant's suitability for listing. The following sets out non-exhaustive examples of factors that the Exchange takes into consideration when assessing a new applicant's suitability for listing pursuant to Main Board Rule 8.04 (GEM Rule 11.06). They should not be construed as being definitive and applicable to all cases as we consider all relevant facts and circumstances in each case. New applicants should also refer to the listing decisions and guidance letters published by the Exchange from time to time which explain how the Exchange assesses the suitability requirement in different cases. **(Updated in March 2019)**
- 3.2 In general, the Exchange expects all professional parties and experts named in the listing document to have performed sufficient due diligence to support their views on the relevant matters in relation to the listing application. Where there are red flags identified during the vetting process (e.g. materially inconsistent disclosure or submissions), the Exchange will apply a higher standard of review and expect the sponsors and experts (as the case may be) to provide a higher level of assurance on the relevant matters to ensure the new applicant's compliance with the Listing Rules. **(Added in March 2019)**

Integrity Non-compliances (*Updated in March 2019*)

- 3.3 Integrity Non-compliances will likely render the new applicant, as well as the culpable director, being not suitable for listing or not suitable to be a director of a listed company, as the case may be. 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).
- 3.4 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 new applicant, the new applicant will not be suitable for listing because it would be subject to substantial influence by such controlling shareholder. The assessment of substantial influence will be determined on a case-by-case basis, taking into account non-exhaustive factors such as the controlling shareholder's (i) economic interest in the new applicant; (ii) relationship with the other shareholders, directors and members of senior management of the new applicant; or (iii) involvement in the operation and management of the new applicant's business.
- 3.5 The 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

² This section has been deleted to avoid duplication of the relevant Main Board and GEM Rules. Reference to the relevant Listing Rules is included in the body of the guidance letter.

new 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 new applicant unsuitable for listing. Where Integrity Non-compliances are involved, the Exchange expects the culpable director or controlling shareholder to cease being a director or controlling shareholder of the new applicant, as the case may be, before listing. Such culpable director or controlling shareholder should seek guidance from the Exchange before they become the controlling shareholder or accept the nomination to be a director of a listed issuer. Listed issuers should refer to GL96-18 on suitability issues concerning directors or persons with substantial influence.

- 3.6 With respect to the operational and financial impact of the Integrity Non-compliances, the Exchange may request the new 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 Integrity 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.

Material Non-compliances (Updated in March 2019)

- 3.7 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 may also affect a new applicant's suitability for listing.
- 3.8 With respect to revenue/ profit/ cash flow generated from activities that constitute Material Non-compliances, on a case-by-case basis, the Exchange may request the new 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 such Material 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.

Sustainability of business (Updated in March 2019)

- 3.9 There are many factors that affect a new applicant's sustainability and the Exchange considers the facts and circumstances of each applicant in determining the materiality and the likelihood of the adverse factors. We set out below examples from past cases we have encountered. We emphasize that these examples are non-exhaustive, and may not be applicable to every new applicant.

Deteriorating financial performance

- 3.10 Even if a new applicant meets the relevant eligibility requirements under Main Board Rule 8.05 (GEM Rule 11.12A) at the time of filing, if it recorded deteriorating revenue and profit, and/ or material losses during or after the trading record period, there may be concerns on the sustainability of its business. Factors we consider include:

- (a) how susceptible the new applicant's financial performance is to changes beyond its control (e.g. any small increases in operating costs, such as raw material costs, which cannot be fully passed on to their customers may result in net losses). This is particularly relevant for new applicants that marginally meet the minimum profit requirement under the Main Board Rules (minimum cash flow requirement under GEM Rules), have no-recurring revenue source and a thin profit margin, or have large cash flow mismatch and have not gone through a full collection cycle;
- (b) the underlying causes of the deteriorating financial performance and whether such downward trend is expected to continue (e.g. change in consumer preferences or sunset industries), or whether it is the cyclical nature of the industry; and
- (c) whether the new applicant had demonstrated that it is able to effectively mitigate its exposure to the relevant risks or to turn around the business (e.g. by diversifying its revenue sources, expanding its customer base, or cutting costs).

Material reliance on various parties

3.11 Material reliance on another party (a "**Relevant Counterparty**")³ may threaten a new applicant's business sustainability if it is likely that the relationship with such party may materially adversely change or terminate. Examples of material reliance include:

- (a) high customer or supplier concentration, or both (e.g. captive business model);
- (b) dependence on a limited number of distribution channels, such as through an e-commerce site or social media platform, to market its products (see paragraph 3.13 below for exceptions); or
- (c) dependence on another party, such as the controlling shareholder and its close associates (the "**Controlling Shareholder Group**") for critical functions, such as sales/ distribution/ procurement.

3.12 If a new applicant materially depends on a Relevant Counterparty, we will assess the likelihood that the relationship with the Relevant Counterparty will materially adversely change/ terminate. Some non-exhaustive factors that we consider are:

- (a) whether the Relevant Counterparty is mutually dependent on the new applicant. For example, if the new applicant is (i) the sole supplier of the Relevant Counterparty for a highly bespoke product; or (ii) the sole/ major customer of the Relevant Counterparty, the risk is lower that the Relevant Counterparty will terminate the relationship; or
- (b) whether the new applicant has an established relationship/ long-term agreement with the Relevant Counterparty.

³ If the Relevant Counterparty is a connected person as defined under the Listing Rules, new applicants must comply with the relevant requirements on continuing connected transactions in Chapter 14A of the Main Board Rules (Chapter 20 of GEM Rules) and should also refer to GL73-14 for relevant guidance.

- 3.13 Some Relevant Counterparties dominate the industries in which they operate due to regulatory restrictions, high entry barriers or other factors. As applicants that operates in such industries are unlikely to diversify or reduce its reliance on the Relevant Counterparties (i.e. such reliance is an industry norm), the Exchange will examine whether there are any red flags indicating its relationships with the Relevant Counterparties are likely to be terminated or otherwise materially adversely change, as stated above. New applicants in the internet technology sector or that have internet-based business models should also refer to GL97-18 for further assessment on the nature of reliance on the Relevant Counterparties and other matters for companies in this sector.
- 3.14 A new applicant may be able to demonstrate that despite its material reliance on a Relevant Counterparty, any change in the relationship will not have a material adverse impact on its business because it is/ will be able to effectively mitigate its exposure (e.g. decrease in sales, increase in raw material costs and/ or production time, cost of business disruption). For example, if the Relevant Counterparty is a supplier for raw materials that are readily available or for which there are reasonable substitutes, the new applicant may easily procure such raw materials from a different supplier at a similar price or substitute with another product.
- 3.15 A new 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 new 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, as relevant, include:
- (a) the background of the Relevant Counterparty;
 - (b) the business relationship, the nature of reliance and details of the arrangements between the new applicant and the Relevant Counterparty;
 - (c) basis that the likelihood that the relationship with the Relevant Counterparty will materially adversely change/ terminate is low; or
 - (d) basis that the new 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.

Financial assistance from its Controlling Shareholder Group

- 3.16 A new applicant may receive material financial assistance (e.g. loans, guarantees or other forms of collateral or security) from the Controlling Shareholder Group ("**Financial Support**")⁴. Given the practical difficulty in assessing to what extent the Controlling Shareholder Group's incentive to provide Financial Support will be reduced

⁴ We have come across situations where Financial Support was provided by a director of the new applicant (who is not a controlling shareholder) or an independent third party such as a customer or supplier. However, such situations are not common and therefore, not meaningful as guidance.

after listing, the Exchange will presume such Financial Support will be withdrawn (absent evidence to the contrary) in assessing the sustainability of the new applicant.

3.17 To demonstrate that its business is sustainable without Financial Support, some new applicants in the past have chosen to settle all loans or release all guarantees from the Controlling Shareholder Group at listing. To be clear, settlement of Financial Support is not required. The Exchange has also taken into account the following non-exhaustive factors to assess whether the new applicant's business will be sustainable without Financial Support:

- (a) whether the new applicant is able to obtain independent financing (e.g. without Financial Support) on comparable terms; or
- (b) whether the new applicant has sufficient liquid assets on hand to meet its financial needs.

Material changes that may adversely affect the company's prospect

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

- (a) changes in regulatory requirements which may result in the new 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 renders its business obsolete.

3.19 To address these concerns, the Exchange expects the new applicant to affirmatively demonstrate that such changes are unlikely to materialize or will not affect the sustainability of the new applicant's business.

Substantial reliance by property companies on fair value gains on investment properties

3.20 Fair value gains may be included in profit calculations of a property company for the purposes of satisfying the minimum profit requirement under the Listing Rule 8.05(1)(a) (the "**Profit Test**"). However, if a substantial portion of a new applicant's profit is derived from fair value gains arising from its investment properties, there are concerns on the practical sustainability of such new applicant. For example, in a market downturn, its properties may record fair value losses which may result in the new applicant becoming loss making. As such, the Exchange considers the business of a new applicant in the property business unsustainable and not suitable for listing if it:

- (a) cannot satisfy the Profit Test after excluding unrealised gains of its investment properties; and
- (b) did not have any substantial business during its trading record period (e.g. sales of properties or recurring rental income).

3.21 In all cases that give rise to sustainability concerns, the Exchange will closely scrutinise the new applicant's profit and cash flow forecasts, applicable sensitivity or breakeven analysis, and any inconsistent growth with the industry and/ or peers. We also expect the sponsors to provide details of their due diligence work that satisfy themselves on the reasonableness of the underlying assumptions.

Contractual arrangements (Updated in March 2019)

3.22 A new applicant is only permitted to use contractual arrangements due to foreign ownership restrictions and if the related risks of contractual arrangements are sufficiently mitigated. Otherwise, it may not be suitable for listing. New applicants should refer to LD43-3 for relevant guidance.
