

A newsletter to help market participants better understand the Dual Filing arrangements

We continue to maintain the quality of disclosure by listing applicants in collaboration with The Stock Exchange of Hong Kong Ltd (SEHK).

During the six months ended September 2009, we received 64 listing applications via SEHK, including three applications by companies listed on the Growth Enterprise Market to transfer to the Main Board.

We found causes to comment on 53 out of those 64 listing applications under the auspices of the dual filing regime. The issues we noticed are highlighted in this edition of the Dual Filing Update. On average, we took seven working days¹ to respond to the cases filed.

Highlights

Issues revealed during the period under review are highlighted as follows:

- Some sponsors failed to conduct careful assessment of business risks before submitting the listing applications.
- Some listing applicants did not explain clearly business performance under certain operating environments, particularly adverse economic conditions, but such information is important for investors to assess a company's management and prospects.
- Some applicants in highly regulated industries did not provide complete and accurate disclosure of relevant legal and regulatory compliance issues in their applications.
- Some sponsors did not exercise due care to ensure that information in the prospectuses was accurate and not misleading.

Understanding potential risks on business viability

For some listing applicants, business risks may potentially result in the suspension, discontinuation or termination of their business. The sponsors should critically assess these risks before submitting the listing applications.

In one case, the listing applicant breached certain regulatory provisions when entering into contracts with its customers which, in the worst case, might render the contracts illegal. The potential result could be the loss of its business licence, the very basis on which the listing was sought. The applicant did not appear to have followed the advice of its legal adviser to mitigate the effects of such breaches. The extent of the deficiencies raised substantial doubts as to whether the sponsors had critically assessed the applicant's business viability, of which disclosure alone might not necessarily be adequate to address the issues. The listing application was allowed to expire, leaving these issues unresolved.

¹ From October 2008 to March 2009, the Securities and Futures Commission (SFC) received 21 listing applications, commented on 11 cases and deferred commenting on four others due to the serious deficiencies found in the submissions, which required substantial improvements to be made by the listing applicants. Please refer to Dual Filing Update Issue No. 1 June 2009 for background statistics.

In another case, a large part of the applicant's business was substantially derived from its connected persons and employees, although the proportion decreased from over 90% to 40% of its profit during the track record period. The reliance on these connected clients was expected to continue after listing. The applicant's ability to obtain third party funding for its business also depended on its ability to generate a sufficient level of revenue, which in turn was substantially derived from the transactions with the connected clients. It was questionable whether the applicant could carry on its business independently.

In addition, some of these connected clients were directors of the applicant. Concerns were raised at the risk that they might override the internal control procedures to facilitate their own transactions or make decisions in favour of themselves at the expense of the interests of the shareholders. Even internal controls and corporate governance measures may not be sufficient to reduce or eliminate these inherent risks. The listing application was formally withdrawn after the regulators raised these concerns with the sponsors.

Inconsistent explanations on impact of the global financial crisis

The global financial crisis in 2008 and the economic downturn adversely affected most business sectors although the SFC noted that some listing applicants had been able to maintain or increase their sales or profits. However, the explanations for business performance in the downturn were in some case either unclear or inconsistent.

In one of the cases reviewed, the listing applicant, a Mainland property developer, claimed that the global financial crisis, uncertain economic prospects, and the tightened credit markets reduced the demand for its properties. However, it actually sold more properties in terms of square meters after the turmoil. In a similar case, the applicant claimed that the downturn in 2008 reduced property prices on the Mainland but the average selling price of its properties continued to increase by more than 20% in the same year.

In another case, the listing applicant attributed the decline in its net profit to the global financial crisis since the second half of 2008. However, its net profit for the second half of 2008 was actually more than double the net profit for the first half.

The listing applicants had failed to explain clearly their financial performance against the economic downturn, which is relevant to investors in assessing their business and management. The applicants only rectified the disclosure at the request of the regulators.

Disclosure of instances of regulatory non-compliance

Listing applicants in highly regulated industries often are exposed to greater risks of regulatory violation. Complete and accurate disclosure of the relevant legal and regulatory compliance issues is particularly important.

The media have widely reported that the Chinese central government has introduced stringent measures against leaving land idle where property developers miss specified development deadlines. In one of the cases reviewed, the listing applicant delayed construction and was in breach of land grant contracts signed with the local regulatory bodies. No analysis of the potential adverse financial and operational impact on its business was provided. Nor was there any basic information relating to the idle land, the amounts invested, any regulatory notices received or any measures taken to address the breach.

In another case, the listing applicant did not obtain the construction permit before commencing construction of a property project and in the worst case could be liable to penalty or forfeiture of the land. However, no disclosure was made relating to the length of the delay, when and whether the construction permit could be obtained, the estimated penalty and the total costs of investment or other information that was important for potential investors to assess the financial and operational impact on the listing applicant.

In some other cases, there were material omissions of major litigation and/or regulatory non-compliances, which were identified by the regulators and subsequently rectified.

In one case, the draft prospectus omitted the applicant's past record of production without valid permits, which had led to the temporary suspension of operations during the track record period. In a similar case, the applicant's various major litigation and regulatory breaches, which had exposed it to penalties and potential disruption of operations, were omitted from the draft prospectus.

Potential investors must have relevant information such as material litigation and regulatory breaches, whether resolved or not, to assess the applicant's business, its management and the effectiveness of its internal controls. Sponsors should ensure the proper disclosure of such information.

Conduct of sponsors

Sponsors are reminded that information disclosed in the listing applications must be accurate and not misleading before submitting the applications. In a number of cases, it appeared that sponsors have failed to exercise due care and skill such that the reliability of statements made in the listing applications was questionable.

In one case, the listing applicant consistently represented to the regulators that the reason why the ownership of a key asset had not been transferred from the parent, but had rather been entrusted to the company, was a prolonged regulatory approval process. However, it was later revealed that the parent's interest in the key asset was, in fact, subject to a lock-up, which prevented the parent from transferring ownership to the applicant in the near future. This rendered the previous reasons submitted by the sponsor for the entrustment arrangement potentially false and misleading. It also raised substantial concerns as to the adequacy of the due diligence performed by the sponsor to understand and verify the rationale behind the arrangement. The disclosure was rectified only after the regulators had persistently challenged the sponsor's representation.

In another case, the listing applicant initially disclosed in the draft prospectus that all three of its executive directors remained as directors of a major subsidiary after its disposal. In fact, only one executive director remained as a director of this company, which was actually managed by the purchaser after the disposal. Had the regulators not enquired into the matter, the statement made could be false or misleading since the prospectus representation would mean that all three executive directors remained involved in the day-to-day management of the major subsidiary after its disposal to a third party.

In a similar case, the listing applicant sold its products to distributors which contributed more than 40% of its total revenue during the track record period. The sponsor failed to perform sufficient due diligence on the number of distributors provided by the listing applicant and the initial disclosure of the number of distributors was revised down by 20% upon enquiry by the regulators.

In another case, the initial draft prospectus failed to disclose the applicant's trading business. When we queried this point, it was revealed that this business segment actually contributed more than 30% of the applicant's total revenue throughout the track record period. As a result, the draft prospectus was substantially revised to rectify the misleading disclosure on the businesses of the applicant.

The quality of disclosure depends on proper understanding and due diligence by sponsors of the businesses of listing applicants. Sponsors have a responsibility to exercise due care and skill and ensure that material information is accurately presented in the prospectuses.

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