



SFC Regulatory Bulletin: Listed Corporations

Issue No. 2
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This bulletin provides guidance on the manner in which the SFC performs some of its functions under the SMLR and the SFO in relation to listed corporations and other listing matters.

Foreword

"Real-time" regulation continues to be our main theme in tackling corporate misconduct. This second edition of the *SFC Regulatory Bulletin: Listed Corporations* provides an update on how the SFC exercises its power under the Securities and Futures (Stock Market Listing) Rules (SMLR) to fulfil its statutory objective of protecting investors. Case studies demonstrate the close relationship between the use of the SFC's regulatory tools under the SMLR and its enforcement actions against listed corporations and intermediaries (see the *Enforcement Reporter* series).

Case studies

To help the public better understand the SFC's approach to performing its functions under section 6 and section 8 of the SMLR, the following case studies highlight actions taken by the SFC in the nine months ended 31 March 2018.

IPO Case 1

A significant portion of the applicant's revenue was settled by third-party payers other than its customers. While the payers were described as independent third parties, the SFC's enquiries revealed that some of them had relationships or connections with the applicant or its controlling shareholder. For example, amounts recorded as advances to the controlling shareholder were remittances made directly by the applicant to third-party payers. In one case, a third-party payer received an advance from the applicant in the same month it made a payment to the applicant on

behalf of a customer. In addition, the SFC identified other material inconsistencies and omissions regarding third-party payments in the submissions.

The SFC issued a "letter of mindedness to object" (LOM) to the applicant as it had concerns about the accuracy and completeness of the information in the application materials, including whether the sales proceeds received through third-party payers were provided by the applicant's customers and whether the underlying sales were genuine. The applicant did not respond to the SFC's LOM and the application lapsed.



IPO Case 2

The applicant relocated major operations subsequent to the track record period, resulting in a significant change in its cost structure. However, no audited financial information reflecting the applicant's operations following the relocation was available to demonstrate the sustainability of its revenue and profit margins in the new circumstances. The SFC had concerns as to whether the applicant's historical financial information provided a fair and reasonable basis for investors to assess its future prospects and issued an LOM.

After considering the applicant's responses, the SFC exercised its power under section 6(2) of the SMLR to object to the listing of the applicant's shares as it appeared that the application did not contain such particulars and information which was necessary to enable an investor to make an informed assessment of the applicant's activities, assets and liabilities and financial position as well as of the rights attaching to the securities. It also appeared to the SFC that it would not be in the interest of the investing public for the applicant's shares to be listed at that stage.

Section 6(2) of the SMLR provides that the SFC may object to any listing application if it appears to the SFC that:

- (a) the application does not comply with a requirement under section 3 of the SMLR, namely, (i) non-compliance with the Listing Rules except to the extent waived; (ii) non-compliance with applicable law; or (iii) failure to contain such particulars and information which, having regard to the particular nature of the applicant and the securities, is necessary to enable an investor to make an informed assessment of the activities, assets and liabilities and financial position, of the applicant at the time of the application and its profits and losses and of the rights attaching to the securities;
- (b) the application is false or misleading as to a material fact or is false or misleading through the omission of a material fact;
- (c) the applicant has failed to comply with a requirement to supply such further information as the SFC may reasonably require for the performance of its functions under the SMLR or, in purported compliance with the requirement has furnished the SFC with information which is false or misleading in any material particular; or
- (d) it would not be in the interest of the investing public or in the public interest for the securities to be listed.



IPO Case 3

The SFC noted from the applicant's share allotment information that while the total number of shareholders exceeded the minimum of 100 specified in GEM Listing Rule 11.23, the vast majority of the total issued share capital would only be held by a small number of shareholders upon listing. The extremely high shareholding concentration cast doubt on whether there would be an orderly, informed and efficient market for the applicant's securities.

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The SFC issued an LOM to the applicant. Following the SFC's enquiries, the applicant postponed its listing. Subsequently, a wider spread of shareholders was achieved after the applicant relaunched its share offer.

IPO Case 4

Shortly before the end of the track record period, the applicant allocated a significant portion of its working capital, which amounted to more than the applicant's total

turnover in the previous financial year, to a new business segment with completely different risk and reward profiles and liquidity and capital requirements.

Considering this significant change in the applicant's business strategy, the SFC was concerned that the historical financial information presented in the listing document may not be representative of its business going forward. The SFC issued an LOM to the applicant, following which the applicant withdrew its listing application without addressing the SFC's concerns.

Post-IPO case 1

The company proposed to raise funds through a placing under general mandate. It also granted share options to unknown grantees. In aggregate, the placing and the share options represented a substantial portion of the company's enlarged share capital. Moreover, the placing price and the option exercise price were both at a significant discount of more than 80% to the company's net asset value per share. The company had also completed a rights issue in the first half of 2017. There was no indication that the company had an imminent need to raise funds or why it would do so at a price representing a significant discount to the net asset value.



Accordingly, the SFC commenced a section 179 inquiry requesting details about the placing, the share options granted and the use of funds from its earlier rights issue. The share options were subsequently cancelled.

After the SFC issued letters of concern to the company regarding the terms of the proposed placing, the company announced the termination of the placing.

Post-IPO case 2

The company proposed an acquisition through the issuance of convertible bonds as well as a placing of convertible bonds, both with a conversion price discounted

more than 60% to the prevailing market price. If fully exercised, the conversion shares would represent about 57% of the enlarged issued share capital. The SFC was concerned that the acquisition and the placing were part of a series of transactions designed to obtain a listing without going through the usual listing application process. The SFC issued section 179 inquiries in relation to the proposed acquisition and placing.

Through the inquiries, the SFC noted that the acquisition target was loss-making and had yet to commence operations. It appeared that the company did not have an imminent need for funds to justify the

Section 179(1) of the SFO provides that the SFC may require the production of any books and records where it appears to the SFC that there are circumstances suggesting:

- (a) the business of the corporation has been conducted (i) to defraud creditors, (ii) for any fraudulent or unlawful purpose; or (iii) in a manner oppressive to its shareholders;
- (b) the corporation was formed for any fraudulent or unlawful purpose;
- (c) persons involved in the corporation's listing have engaged, in relation to such process, in defalcation, fraud, misfeasance or other misconduct;
- (d) persons who managed the corporation have engaged in defalcation, fraud, misfeasance or other misconduct towards it or its shareholders; or
- (e) shareholders of the corporation have not been given all the information with respect to its affairs that they might reasonably expect.



placing and could not explain why it was placing the convertible bonds at a deep discount or why it did not attempt to obtain cheaper financing options. Furthermore, there was no reasonable explanation for the projected growth of the acquisition target and no independent valuation was sought.

In light of the above, the SFC issued a letter of concern regarding the terms of the proposed acquisition and placing. The company subsequently announced the lapse of the acquisition and the termination of the placing.

Post-IPO case 3

The company proposed a rights issue and an issuance of convertible notes which would have an aggregate dilution impact of more than 50%. The subscription price of the rights issue and conversion price of the convertible notes both represented a substantial discount to the prevailing market price. In addition, the company had conducted two highly dilutive fund raisings since 2015.

The SFC issued a letter of concern to the issuer and the company subsequently restructured the proposed transactions in light of the SFC's concerns. Under the new proposal, no convertible bonds were

issued. The dilution impact on minority shareholders was significantly reduced and the subscription price of the new rights issue represented a more reasonable discount to the prevailing market price as compared to the original proposal.

Post-IPO case 4

The company had acquired a minority equity interest in a broker and later announced the proposed acquisition of the remaining interest.

The SFC issued section 179 inquiries and found that the broker's recorded net profit was mainly attributable to non-recurring items and its key customers were subsidiaries or parties associated with the seller. In addition, the SFC also found that the company had recently granted options to a small number of individuals, all of whom had exercised their options via loans provided by the seller. The SFC was concerned that the series of transactions was pre-arranged to justify an artificially high valuation for the broker.

As such, the SFC issued an LOM setting out its concerns about the impact of the proposed acquisition on the company's public shareholders. Subsequently, the company announced that the acquisition had terminated.



Post-IPO case 5

The SFC issued section 179 inquiries to the company in relation to a settlement deed under which the company proposed to satisfy an outstanding loan through the issuance of new shares and convertible bonds. The issue price and conversion price were both deeply discounted compared to the prevailing market price. If converted in full, the new shares and convertible bonds would together represent 35% of the enlarged share capital. Their combined value was also much higher than the company's outstanding debt.

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The SFC was concerned that the terms of the settlement deed might be prejudicial to the interests of the company's shareholders. Accordingly, the SFC issued a letter of concern and the company subsequently announced the lapse of the settlement deed and proposed to seek alternative funding to repay the outstanding debt.

Post-IPO case 6

The company proposed to issue unlisted warrants at a discount over approximately 14% of the company's enlarged share capital, but failed to provide a reasonable explanation for raising capital at such a deep discount. Moreover, the board did not obtain an independent valuation of the warrants to be issued.

The SFC was concerned that the directors might not have obtained sufficient information to determine whether the issue price for the warrants was fair and reasonable and in the interest of the company's shareholders. The SFC issued a letter of concern and the company subsequently announced that the warrant subscription had been terminated.

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