

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

## Cases handled

During the six months ended September 2010, we received 100 listing applications via The Stock Exchange of Hong Kong Ltd (SEHK), including seven applications for transfer to the Main Board by companies listed on the Growth Enterprise Market. We commented on 82 of the listing applications, and deferred commenting on two cases because of serious deficiencies in the initial submissions, which required substantial improvements to be made to the draft listing documents. Our average response time was seven working days<sup>1</sup>.

## Highlights

Areas of concerns during the period under review include:

- Some sponsors failed to identify inaccurate information and significant errors in the initial listing documents and their responses to the regulators.
- Some sponsors failed to demonstrate a basic understanding of the key factors affecting the historical performance of the listing applicants, such as the customer profile and competitive advantages of the applicants.
- The initial draft prospectuses in lapsed or withdrawn cases generally did not contain sufficient disclosure on issues that were fundamental to the listing applications.

## Conduct of sponsors

The Securities and Futures Commission (SFC) noted in a number of cases that the draft listing documents and other supporting materials submitted by the sponsors contained material errors or omissions on the businesses of the listing applicants, including the key factors affecting their financial performance and other issues fundamental to the listing applications. This called into question the competence of the sponsors and whether the sponsors had exercised the level of care expected of them in discharging their professional obligations.

### Inaccurate information submitted

In several cases, the sponsors submitted initial draft listing documents and responses that contained significant errors and obvious inaccuracies. This raised substantial doubt as to whether the sponsors had examined, with professional scepticism, the information given to them by the listing applicants or other parties in the course of their due diligence.

In one case involving a property developer, information in the initial draft prospectus suggested that the unsold units of the listing applicant's only property project had an estimated capital value per square metre that was significantly higher than the actual selling prices of the units already sold. Our enquiries revealed that the estimated capital value of the unsold units was in fact overstated by about three times because

<sup>1</sup> From October 2009 to March 2010, the SFC received 68 listing applications and commented on 60 cases. Please refer to Dual Filing Update Issue No. 3 July 2010 for background statistics.

the value of the units already sold as at the date of valuation had erroneously been included in the valuation. Such an error, if not rectified, would have materially inflated the valuation of the applicant, and ultimately affected the offer price of the applicant's shares. The application was withdrawn shortly after the regulators raised enquiries into a number of other issues identified during the vetting process.

In another case, the sponsor initially submitted that the amount of certain related party transactions recorded by a related party was larger than that recorded by the listing applicant because the related party had converted the relevant transactions into Hong Kong dollars at a higher exchange rate. However, we noted from the information in the same submission that the exchange rate used by the related party was actually lower than that used by the applicant. After repeated enquiries by the regulators, it was found that the difference was due to an error in the preparation of the listing applicant's consolidated financial statements rather than the exchange differences. Consequently the entire income statement for the relevant year in the initial draft prospectus had to be restated at a very late stage of the vetting process.

In both cases, the errors could have been avoided if the sponsors had critically assessed whether the information provided to them was consistent with their knowledge of the applicants' respective business.

### **Poor understanding of key factors affecting performance**

In a number of other cases, the sponsors' responses to the regulators' enquiries suggested that they did not have a basic understanding of the key factors affecting the historical performance of the listing applicants.

In one case, the listing applicant's revenue more than doubled in the latest financial period. A significant portion of the revenue growth was attributable to one customer that was not among the top five customers in previous years. Initially, this customer was said to have been the applicant's customer for six years. However, further enquiries by the regulators revealed that this customer was incorporated only five years ago and it placed its first order with the applicant only about one year ago. The customer, which was initially described as a specialist "solution provider" for the industry, was found to be merely a one-man trading company. It was only after such inconsistencies were brought to the attention to the sponsor that further due diligence was conducted on the profile of this new major customer. It resulted in significant amendment to the disclosure relating to the major customer at a very late stage of the listing process.

In three other cases, the listing applicants enjoyed significantly higher gross profit margins than their industry peers during the track record period. The explanations provided initially were either unspecific or unsubstantiated. Substantial disclosure improvements were made in one case upon our request and the applications were allowed to lapse before the issues were fully addressed in the other two cases.

Factors affecting the historical performance of the listing applicant, such as the applicant's customer profile and competitive advantages, provide important information for investors to properly evaluate the profitability and sustainability of the business of the applicant. It is important that the sponsor conducts sufficient independent due diligence to understand the applicant's business to be satisfied that the explanations provided by the applicant are valid and reasonable and that accurate and complete disclosure is made in the draft listing document. Sponsors should have performed appropriate due diligence before making submissions to the regulators and could not rely on the regulators to verify the accuracy of the information submitted, which would be an indication of sub-standard performance on the sponsors' part.

## **Disclosure deficiencies of fundamental issues in lapsed or withdrawn cases**

During the period under review, several cases were withdrawn or allowed to lapse following the issue of initial comments by the regulators on material disclosure deficiencies concerning issues fundamental to the listing applications. It was unclear from the

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submissions whether the sponsors were aware of these fundamental issues or had properly appraised their implications before submitting the applications.

In one case, the listing applicant was required by law to sell all of its production output to certain designated government-owned entities, except to affiliated entities for their own use. However, the business model of the applicant changed as a result of the corporate restructuring just before the proposed listing such that its major customers would be neither government-owned nor affiliated with the applicant. The application was allowed to lapse before the issue concerning the legality of the applicant's business model could be addressed.

In another case, the listing applicant derived a substantial portion of its revenue during the track record period from the sales of car parking spaces to three individual investors. It was only after our enquiries that the listing applicant disclosed in a draft prospectus that these individuals were given an extended credit term of over two years. Our further enquiries revealed that more than a year after the sales to such individuals, only 10% of these car parking spaces were leased out. After regulators asked for further disclosure of the substance of these significant sales transactions, the application was withdrawn, leaving the issue unaddressed.

In another application, the founder of the listing applicant had been found guilty of bribery purportedly in conducting his personal business in an industry closely related to that of the listing applicant. During the track record period, the applicant made significant amounts of apparently non-business-related advances to third parties. The initial draft prospectus suggested that the founder had been a director and the general manager of the applicant's principal subsidiary until he resigned half-way through the track record period and had his close family members appointed as key management. This raised questions as to whether the applicant had been involved in any criminal activity and whether the current board of the applicant had been acting under the influence of the founder. The application was subsequently withdrawn, after the regulators raised the concerns with the sponsor.

Sponsors are expected to identify issues that are fundamental to the listing application as part of their due diligence and to properly address these issues before submitting listing applications. Failure to do so may result in unnecessary delays in the vetting process or even rejection of the application. Notwithstanding the fact that an application does not proceed to listing because of lapse or withdrawal, if the submissions provided to the regulators in connection with the application contain any false or misleading information in a material particular, and the applicant or the sponsor knows that, or is reckless as to whether, the information is false or misleading in a material particular, the applicant or the sponsor commits an offence under the Securities and Futures Ordinance (SFO)(including section 384). Section 384 of the SFO applies to the applications submitted to and all documents in support of or in connection with applications filed with the SFC or the SEHK by virtue of section 5 of the Securities and Futures (Stock market Listing) Rules.

Providing submissions that contain false or misleading information will also reflect negatively on the fitness and properness of the licensed persons concerned and may, in addition to any action under the SFO (including section 384), lead to disciplinary action under section 194 of the SFO.

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The Dual Filing Update is available under 'Speeches, Publications & Consultations' – 'Publications' of the SFC website at <http://www.sfc.hk>.

Feedback and comments are welcomed and can be sent to [dualfiling@sfc.hk](mailto:dualfiling@sfc.hk).

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