



# SFC Regulatory Bulletin: Listed Corporations

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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.

## Highlights

- Welcome to the new series
- “Real time” regulation
- SFC staff comments on IPO applications
- SFC inquiries and investigations

## Welcome to the new series

This is the first edition of the *SFC Regulatory Bulletin: Listed Corporations*.

In response to changing market conditions and risks, and to better protect our markets and investors, the SFC is taking steps under the Securities and Futures (Stock Market Listing) Rules (SMLR) and more generally under the Securities and Futures Ordinance (SFO) to intervene in serious cases at an early stage to carry out its statutory objectives under the SFO, including to protect the investing public and to suppress illegal, dishonourable and improper market practices (see sidebar below). These actions complement the SFC’s enforcement work to pursue wrongdoers, seek remediation and deter misconduct (see the [Enforcement Reporter](#) series).

This series of bulletins 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.

We hope that these bulletins are of use to listed corporations, intermediaries, market practitioners and others interested in listing matters. The *Corporate Regulation Newsletter* will be discontinued.

Under section 5 of the SFO, the functions of the SFC include:

- (a) to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
- (b) to secure an appropriate degree of protection for members of the public investing in and holding financial products; and
- (c) to suppress illegal, dishonourable and improper practices in the securities and futures industry.

## “Real time” regulation

### Introduction

The SFC may raise objection to any listing application based on one or more of the grounds set out in section 6(2) of the SMLR (see sidebar on page 3). If and when the SFC forms the view that it is more likely than not, given the known facts and circumstances, that an objection would be raised under section 6 the SMLR, it will promptly issue a “letter of mindedness to object” (LOM) directly to the applicant. The LOM is a letter that sets out substantive concerns of the SFC along with detailed reasons for those concerns. Discussions of the issues raised in an LOM are conducted directly between SFC staff and the relevant applicant and its advisers<sup>1</sup>. If the applicant’s response to an LOM fails to address the SFC’s concerns, the SFC will issue a final decision notice (FDN) under section 6 the SMLR within the time period specified. An FDN is a specified decision under the SFO that is subject to review by the Securities and Futures Appeals Tribunal.

“We are taking steps under the SMLR and the SFO to intervene in serious cases at an early stage.”

Section 8 of the SMLR empowers the SFC to direct the suspension of a listed company’s shares (see sidebar on page 3). Prior to directing a suspension, unless urgent action is required by the circumstances (e.g. to protect investors), the SFC would normally issue a “show cause letter” to the company setting out in detail the concerns behind its mindedness to suspend trading and give the company an opportunity to respond.

<sup>1</sup> This is a departure from the SFC’s historical approach to raising comments on IPO applications. There was an understanding between the SFC and the Exchange that, when the SFC has any comments on a listing application, it would pass them in writing to the Exchange to raise with the applicant and its advisers. This arrangement meant that listing applicants were not afforded the opportunity to discuss the SFC’s comments directly with its staff, and the SFC’s role and focus in vetting listing applications may not be entirely clear to the market. It is appropriate and more efficient for an applicant to be able to communicate directly with SFC staff regarding the SFC’s concerns.

To aid the market’s understanding of the SFC’s approach to performing its functions under section 6 and section 8 of the SMLR, the following are highlights of related actions taken by the SFC in the first six months of 2017.

### IPO Case 1

In one listing application, the SFC was concerned that the applicant had provided false or misleading information regarding its relationship with its largest supplier, which accounted for over 75% of the applicant’s cost of purchases during the track record period. The supplier was described in the application as an independent third party, although it was also disclosed that the applicant and the supplier had various arrangements and connections, including cross-shareholdings.

In response to the SFC’s enquiries, the applicant specifically represented that the supplier had never used the applicant’s trademark (except on the products sold to the applicant and the relevant packaging), and gave other assurances to support its assertion. The SFC, however, found photos showing that the applicant’s trademark was prominently displayed above the name of the supplier at the supplier’s facilities. The SFC issued an LOM due to concerns regarding the veracity of the applicant and the accuracy and completeness of the disclosure of the relationships between the applicant and its largest supplier. The applicant withdrew its listing application on the day it responded to the SFC’s LOM.



## IPO Case 2

In another listing application, the applicant appeared to be highly dependent on its only executive director and a private company controlled by the same director for business and operational support. The applicant acknowledged its past reliance on this executive director for business referrals, but claimed that other key employees were also capable of generating business. It was, however, unable to provide evidence to substantiate this claim.

The private company controlled by the executive director provided office premises, human resources, facilities and other operational support to the applicant. This company was also a primary source of business referrals to the applicant during the track record period. The executive director had contracted to sell the private company after the track record period. The impact of this sale on the applicant's business and operations had yet to be ascertained and

could not have been accounted for in the applicant's results for the track record period.

An LOM was issued because it appeared to the SFC that the applicant's financial information during the track record period might not present a fair and reliable basis for investors' assessment of the applicant after listing. As at the date of this bulletin, the applicant has not responded to the SFC's LOM.

## IPO Case 3

The SFC exercised its power under section 6(2) of the SMLR to object to the listing of the company's shares as it appeared to the SFC that it would not be in the interest of the investing public or in the public interest for the company's shares to be listed. The SFC noted that while the number of public subscribers exceeded the minimum of 100 specified in GEM Listing Rule 11.23, the top 20 shareholders and the top 25 shareholders would respectively hold over 97% and 99% of the company's total issued share

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.

Section 8(1) of the SMLR provides that the SFC may direct the Exchange to suspend trading in a company's shares if it appears to the SFC that:

- (a) any materially false, incomplete or misleading information has been disclosed by the company;
- (b) it is necessary or expedient in the interest of maintaining an orderly and fair market;
- (c) it is in the interest of the investing public or in the public interest, or it is appropriate for the protection of investors generally or for the protection of investors in any listed securities; or
- (d) there has been a failure to comply with conditions imposed by the SFC.



capital upon listing. The extremely high concentration of shareholding of the company casts doubt upon the likelihood of an open market and an orderly and fair market for the company's shares existing upon listing.

#### Post-IPO Case 1

The listed corporation proposed to issue new shares to a small group of subscribers at a price that was significantly discounted from prevailing market price. The placing would result in the subscribers collectively holding around 70% of the enlarged issued capital, effectively resulting in a transfer of control from the existing controlling shareholder. The company planned to use the proceeds from the placing to expand an existing loss-making business.

After several rounds of inquiries by the SFC, the company was unable to provide a reasonable explanation of why the placing (and the transfer of control by the existing controlling shareholder) was being conducted at such a substantial discount. Moreover, there were indications that one or more of the proposed subscribers may be acting as nominees for undisclosed persons. The SFC issued an LOM to the company setting out its concerns regarding the proposed placing. The company subsequently announced that it would not proceed with the proposed placing.

#### Post-IPO Case 2

An SFC investigation revealed that the proceeds from a share placing and a bond placing conducted by the listed corporation were deposited in the personal bank account of one of its executive directors. The company provided bank records to support its explanation that the funds had then been transferred to the company's bank account in Mainland China, and used to pay the company's creditors. However, a separate inquiry by the SFC revealed that the relevant banks did not have any record of these transfers.

The company's stated bank balance in its annual report was materially lower than that shown in the records obtained by the SFC directly from the bank. In view of a possible misappropriation of funds as well as the provision of false and misleading information

by the company, the SFC exercised its powers under Section 8 to direct the suspension of trading in the company's shares.

#### Post-IPO Case 3

The listed corporation completed two highly dilutive fundraisings within a year, and was proposing to engage in a third round of fundraising, although it did not appear to have an urgent need for funding on each occasion. This led the SFC to investigate the affairs of the company. The SFC found that there were undisclosed connections between certain directors of the company and some of the shareholders who voted to approve the fundraising exercises. The directors also appeared to be connected with some of those who subsequently acquired the company's shares from the underwriters in the fundraisings. The SFC was concerned about the accuracy and completeness of the disclosure made by the company in connection with its fundraising, and the impact of another planned fundraising on the company's shareholders and investors. Accordingly, the SFC directed a suspension of trading in the company's shares.

#### Post-IPO Case 4

The SFC exercised its power under section 8(1) of the SMLR to suspend all dealings in the shares of a listed corporation when it appeared that there may not be an open market in the trading of the listed corporation's shares. At the completion of the IPO, the top 25 placees in the IPO received about 15% of issued share capital while the top 25 shareholders of the company (including its controlling shareholders) held around 89% of issued share capital. The share price soared more than five times in the morning session on the first day of listing. The SFC subsequently permitted dealings in the listed corporation's shares to recommence under section 9(3) of the SMLR, after considering representations made by the listed corporation and following its controlling shareholders' placing down of 5% of the listed corporation's issued share capital to various independent placees.

## SFC staff comments on IPO applications

### Introduction

SFC staff would sometimes request for clarification or further information from the listing applicant before determining whether an LOM should be issued. SFC staff maintains a policy of not duplicating comments that have been raised by the Listing Department.

In some of these cases, the applicant would either withdraw its application or allow it to lapse before the SFC determines whether an LOM should be issued. To increase transparency and further aid the market's understanding of the SFC's approach, set out below are highlights of certain IPO applications that either lapsed or were withdrawn between September 2016 and June 2017 following comments made by SFC staff.

“We maintain a policy of not duplicating comments raised by the Listing Department.”

### IPO Case 4

The applicant failed to make sufficient disclosure of the close relationship between it and its former-controlling shareholders during the track record period. In particular, it was unable to provide a reasonable explanation for the disposal of the applicant's business, which had promising prospects, by the former-controlling shareholders. This in turn raised questions regarding the actual beneficial ownership of the applicant. The applicant also failed to provide reasonable analyses and explanations for a significant increase in its revenue during the track record period.

The SFC made inquiries regarding the accuracy and completeness of information contained in the application and the extent of due diligence conducted by the sponsor. As at the date of this bulletin, the applicant has not responded to the SFC's last round of inquiries.

### IPO Case 5

### IPO Case 6

In two cases, the engagement of the reporting accountants was terminated during the preparation of the listing applications, leaving significant audit issues unresolved. In both cases, the applicants eventually submitted listing applications with a different set of sponsors and reporting accountants, but did not satisfactorily address the problematic audit findings identified by their former reporting accountants.

In one of these cases, the applicant had failed to explain to its former reporting accountants certain unusual business practices, including payments from customers made through third-party payers and the cancellation of a machinery purchase despite having made a large prepayment. The SFC raised inquiries regarding the applicant's financial information, which the applicant failed to respond to. As at the date of this bulletin, this listing application has lapsed.

In the second case, the outstanding audit issues raised by the applicant's former reporting accountants included material differences between its Mainland subsidiaries' financial information filed with Mainland authorities and that set out in the subsidiaries' respective Mainland audit reports. Again, the SFC raised inquiries regarding the applicant's financial information, which the applicant failed to satisfactorily address. As at the date of this bulletin, this listing application has lapsed.

### IPO Case 7

The new applicant was party to certain exclusive distribution agreements, which were material to its business. These agreements contained certain pricing restrictions set by the suppliers. In response to inquiries made by the SFC, the applicant disclosed (with the advice of legal counsel) that the pricing restrictions may be in breach of applicable competition legislation, and took steps to remedy the situation. The applicant also failed to disclose details of its previous sales



arrangements with certain related parties. In response to inquiries made by the SFC, the applicant disclosed that certain expenses related to those previous sales arrangements had been excluded from its accountants' reports because of insufficient supporting documentation. This led the SFC to raise further inquiries regarding the state of the applicants' books and records as well as the accuracy of its net profit. The applicant failed to respond to the SFC's last round of inquiries. As at the date of this bulletin, this listing application has lapsed.

#### IPO Case 8

Prior to the track record period, the wholesale operations were run by the controlling shareholders. The SFC's inquiries revealed that

when the wholesale operations were taken up by the new listing applicant at the start of the track record period, sales to two customers were recorded with significantly higher sales value and gross profit margins. In addition, one of these customers ceased operations within two years of its initial purchase from the applicant; while the other customer substantially reduced its purchases from the applicant in the subsequent year. This raised questions regarding the genuineness of the applicant's wholesale operations.

The applicant did not respond to further inquiries by the SFC on its wholesale operations. As at the date of this bulletin, the application has lapsed.

## SFC inquiries and investigations

### Introduction

To inquire into a matter, the SFC may require a listed corporation and other persons to produce any books and records where it appears that one of the grounds set out in section 179(1) exists (see sidebar below). This power complements section 182 of the SFO which confers more general powers on the SFC to conduct an investigation.

A section 179 inquiry by the SFC can be routine in nature. The majority of section 179 inquiries do not lead to further regulatory action against the subject. To aid the market's understanding of the SFC's approach, set out below is an example of a section 179 inquiry conducted during the first six months of 2017 that concluded without further regulatory action being taken by the SFC.

### Post-IPO Case 5

A one-day plunge of over 78% in a listed corporation's share price was followed about four weeks later by an announcement that a broker had disposed of a substantial number of its shares that had been pledged by the controlling shareholder. It was unclear whether the listed corporation had prior notice of the broker's intentions and withheld inside information about the margin calls.

The SFC issued section 179 inquiries and found that two brokers had exercised their margin calls and sold the listed corporation's shares over several days. It was revealed that although the controlling shareholder was notified by the relevant brokers before they made the margin calls, the board of directors had no prior knowledge of the brokers' actions and accordingly did not withhold any inside information.



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.

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