

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

## Cases handled

During the six months ended March 2011, we received 101 listing applications via The Stock Exchange of Hong Kong Ltd (SEHK), including 10 applications for transfer to the Main Board by companies listed on the Growth Enterprise Market. We commented on 78 of the listing applications, and deferred commenting on seven cases because of fundamental issues or 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 exercise reasonable judgment in assessing the legality of apparently questionable business practices of the listing applicants.
- Some sponsors failed to critically evaluate the implications of actual or potential loss of major revenue sources on the sustainability of the listing applicants' businesses.
- Some initial draft listing documents showed material disclosure deficiencies in relation to significant changes in the cost structures of the listing applicants.

## Conduct of sponsors

During the period under review, the Securities and Futures Commission (SFC) noted in a number of cases that the sponsors failed to address issues that were fundamental to the listing applications. This cast substantial doubt as to whether the sponsors had properly discharged their professional obligations in understanding the applicants' businesses and addressing the fundamental issues before submitting the listing applications.

### Legality of business

In a few cases, the applicants' core businesses involved certain apparently questionable practices, the legality of which is crucial to the viability of the applicants' businesses. However, the initial submissions suggested that the sponsors had not properly ascertained the legality of these practices or appraised their implications on the applicants' businesses.

In one case, the listing applicant operated an online trading platform for virtual items of third party-operated websites. The user agreements of the website operators generally prohibited trading of virtual items and using their proprietary software for commercial purposes. As part of its trading services, the applicant downloaded and used the relevant third party-developed software to transfer the virtual items on behalf of its customers with full knowledge that this may violate the user agreements, with which it had agreed to

<sup>1</sup> From April to September 2010, the SFC received 100 listing applications and commented on 82 cases. Please refer to Dual Filing Update Issue No. 4 January 2011 for background statistics.

comply before the download. This mode of operation exposed the applicant to potential claims from the website operators, and raised questions as to why the applicant's management would find it appropriate to enter into agreements that it had intended to breach and take on the associated legal risks. It was not until over a year into the vetting process and after the regulators' repeated enquiries that the applicant changed its mode of operation in an attempt to minimise its legal exposure arising from such blatant breach of the user agreements. The application was subsequently allowed to lapse, before we were able to enquire further about the legality of the revised mode of operation.

In another case involving a property developer, the listing applicant only developed one property project during the track record period, ie, a commodity trade centre complex with residential apartments and office premises. However, the parcel of land on which the property complex was constructed was permitted to be used for warehouse and storage only. As the applicant has already sold and leased out part of the complex, it might be subject to potential claims by the purchasers and the tenants. Despite repeated enquiries by the regulators, the draft listing document still failed to demonstrate that the actual use of the property was consistent with the permitted use for the land parcel and to explain the possible consequences of the apparent breach of the terms of the relevant land use rights. The application was allowed to lapse before the issue concerning the legality of the applicant's business was satisfactorily addressed.

It is important that sponsors identify all material risks associated with the listing applications and ensure that the risks are properly addressed or disclosed before submitting the listing applications. Illegal or dubious business practices could lead to legal claims, regulatory actions and even business cessation. Sponsors are expected to exercise reasonable judgment in appraising the legality of any questionable business practices, rather than simply relying on management representations.

### **Actual or potential loss of major revenue sources**

In some other cases, the major revenue sources of the listing applicants were either discontinued shortly before submission of the listing applications or subject to significant risk of imminent discontinuation. However, the sponsors failed to demonstrate that the actual or potential loss of the major revenue sources would not have a material adverse effect on the applicants' businesses.

In one case, the listing applicant derived all of its revenue from the subleasing and management of three leased properties during the track record period. The revenue and profit from these properties continued to decrease because a property that contributed a substantial portion of the applicant's revenue was being demolished in phases until it was completely demolished towards the end of the track record period. The applicant would have operated at a loss in the latest financial year if it had not recognised a gain on the revaluation of a recently completed property. It was unclear whether the applicant met the basic financial tests under the Listing Rules. The application was allowed to lapse after the regulators raised the concerns with the sponsors.

In another case, the listing applicant was one of the many value-added service providers of a major telecommunications operator. The applicant's business relied solely on the mobile platform operated by the telecommunications operator under a co-operation agreement that was due to expire soon after the expected listing date. Shortly before the end of the track record period, the telecommunications operator initiated a substantial reduction in the percentage of fees shared by the applicant because the telecommunications operator was said to have decided to take a more active role in the provision of that service. Despite repeated enquiries by the regulators, the sponsors failed to provide sufficient facts to demonstrate that the co-operation agreement would likely be renewed on similar or reasonable terms or, if the agreement were not renewed, the applicant would still be able to continue its business without an operating platform. The application was subsequently allowed to lapse, leaving these issues unresolved.

Loss of major revenue sources can be detrimental to the business of a listing applicant. In assessing whether an applicant will continue to have sufficient operations after listing, the sponsor should conduct a balanced and objective assessment of the pertinent factors, such as the applicant's fundamentals, the relative bargaining powers of the applicant and its business partners and the industry environment.

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## Disclosure deficiencies regarding significant changes in cost structure

In a number of cases, the initial draft listing documents showed material deficiencies in the disclosure of significant changes in the cost structures of the listing applicants, which were rectified only upon the regulators' enquiries.

In one case, the initial draft listing document disclosed prominently the significant historical profits of the assets to be acquired from a related party of the listing applicant and highlighted the potential increase in operational scale as a result of the acquisition. However, the draft listing document did not highlight the fact that the historical high profitability of the assets to be acquired was largely attributable to the low cost of supplies sourced from the vendor at rates that the listing applicant would not be able to enjoy. Our enquiries revealed that the gross profit margin would be reduced by half if the cost of supplies were to be adjusted to market price. The disclosure of the historical profitability of the assets to be acquired was clarified only upon the regulators' further enquiries.

In another case, the key raw material of the listing applicant was originally supplied at cost by a single supplier that was originally owned by a related party. Shortly before submission of the listing application, the supplier was disposed of to an independent third party, which led to a change in the pricing mechanism of the raw material sold to the applicant. The initial draft listing document only disclosed in general terms that the price of the raw material would be changed to third-party price subject to discounts to be provided after negotiations. The draft listing document failed to properly explain the impact of the change in pricing mechanism on the applicant's cost structure going forward until additional disclosure was made at the request of the regulators.

It is essential that the listing document contains sufficient information to enable investors to make an informed assessment of the applicant's business, prospects and risks. In the event that there are or will be substantial changes to the revenue model or cost structure of the listing applicant, the listing document should highlight the changes, analyse their implications on the applicant's operations and financial performance and explain the bases adopted. A mere inclusion of a risk warning that the historical financial information may not be indicative of the applicant's future profitability falls far short of providing investors with the necessary information.

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

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