

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

Cases handled

Under the dual filing regime, we continue to review disclosure by listing applicants in collaboration with The Stock Exchange of Hong Kong Ltd (SEHK).

During the six months ended March 2010, we received 68 listing applications via SEHK, including three applications by companies listed on the Growth Enterprise Market to transfer to the Main Board.

We raised comments on 60 of these 68 listing applications, and deferred commenting on two others due to the serious deficiencies found in the submissions, which required substantial improvements to be made to the draft listing documents submitted by the listing applicants. 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 applications filed.

Highlights

Areas of concerns during the period under review include:

- Some sponsors failed to properly identify relationships of significant stakeholders to the listing applicants and to explain them.
- Some sponsors gave inadequate and potentially materially inaccurate explanations on the listing applicants' financial performance.
- Some sponsors failed to identify material non-compliance with rules and regulations that may have a potential adverse impact on the operations of the listing applicants.
- Some listing applicants in the mining industry did not provide sufficient disclosure for an informed assessment of the feasibility of their projects.
- Some foreign incorporated listing applicants did not provide comprehensive details of the risks and obligations to which potential investors are subject.

Conduct of sponsors

The SFC raised comments on a large number of issues in the first round of its review in view of the deterioration in the quality of the documents submitted in the initial listing applications. This calls into question the standard of the due diligence performed in the preparation of the listing documents.

Relationship with significant stakeholders

In a number of cases, it appeared that the sponsors failed to disclose material information on the relationship between the listing applicant and significant stakeholders, such as distributors and suppliers.

¹ From April to September 2009, the Securities and Futures Commission (SFC) received 64 listing applications and commented on 53 cases. Please refer to Dual Filing Update Issue No. 2 January 2010 for background statistics.

Such information is important for investors' understanding of the applicant's business.

In one case, the initial draft prospectus provided limited information on the sales of the listing applicant made to certain distributors who were its former employees. Upon our enquiries, it was revealed that the applicant's significant turnover growth during the track record period was mainly attributable to sales conducted through these distributors. The sponsor failed to critically assess how these distributors, who received only a small salary under their former employment with the applicant, were able to finance their initial purchases from the applicant, who required sizeable upfront payments from its distributors. The reason was explained only after repeated requests by the regulators and upon additional due diligence work by the sponsor at a very late stage of the listing process. The lack of professional scepticism by the sponsor in its due diligence led to inefficiencies and unnecessary delay in the listing process.

In another case, the initial draft prospectus suggested that the listing applicant's distributors and their ultimate owners had no relationship with the applicant. Upon the regulators' enquiries, it was revealed that some of the applicant's employees were the shareholders of a majority of these distributors. This raised concerns on the terms of sales made to these distributors and potential conflict of interest on the part of such employees. The disclosures on the applicant's relationship with these distributors were clarified only upon the regulators' further enquiries.

In a similar case, our enquiries revealed that the listing applicant's largest supplier in one of the years during the track record period was controlled by two of the listing applicant's directors at the material time. The draft prospectus failed to properly identify such related party transactions until additional disclosures were made at the request of the regulators.

In another case, the initial draft prospectus omitted material information on the listing applicant's financial obligations under a project with a joint venture partner, which amounted to more than two times the applicant's net assets. The application subsequently was allowed to lapse without addressing in full how the applicant could manage the financial exposure.

Explanations on the financial performance

Explanations on listing applicants' financial performance in draft listing documents are often inadequate and, in some extreme cases, potentially materially inaccurate. In a number of cases, coherent explanations were made only after several rounds of requisitions made by the regulators. A clear picture of the prospects and profitability of the listing applicants is essential for investors to reach an informed investment decision.

In one of the cases, the initial draft prospectus explained that the significant increase in turnover days of trade receivables was due to a seasonal factor. Following repeated enquiries, it was found that the increase was a result of the corporate restructuring undertaken during the track record period and was unrelated to seasonal fluctuations. The draft prospectus and associated submissions were grossly inaccurate. We were unable to further enquire into other disclosure deficiencies of this case as the application was subsequently withdrawn upon the resignation of the reporting accountants and the sponsors.

Identification and assessment of non-compliance with rules and regulations

Compliance with applicable rules and regulations is important for disclosure. Non-compliance may have adverse effect on the applicant and reflects the corporate governance standard of the management. In some circumstances, the sponsor would need to obtain specialist support to ascertain the listing applicant's compliance with special rules and regulations.

In one case, the listing applicant was principally engaged in a highly regulated business. Upon our enquiries, it was revealed that the applicant's fees charged to customers exceeded, and were in breach of, the limits imposed by the relevant regulatory requirements and the excess fee income represented a significant portion of the applicant's profits. The sponsor's due diligence on the applicant's compliance relied solely on the work of the applicant's legal adviser, who had failed to identify the relevant breaches and the potential risks to the applicant. It was not until our enquiries did the applicant take actions to address these breaches.

Where the sponsor lacks the relevant expertise in assessing the listing applicant's compliance with special rules and regulations, to properly discharge its responsibilities, the sponsor would need to consult its own independent advisers and obtain clarification from the competent authorities as appropriate.

One common observation from the above cases is that the sponsors should have been able to identify and correct the deficiencies before filing the listing applications. Sponsors are expected to gain a thorough understanding of the applicant through proper due diligence and to critically assess whether the disclosure in the listing application is sufficient in the circumstances. Failures to exercise professional scepticism and any attempt to avoid full disclosures of material information until requisitions or enquiries by the regulators would only create inefficiencies and unnecessary delays in the listing process. More importantly, it would also reflect negatively on the credibility of the application and the sponsor concerned. Undue reliance on regulators' enquiries in making disclosures may call into question whether sponsors' due diligence has been properly performed, and whether there are possible material non-disclosures that cannot be uncovered by the regulators through their review of the draft listing documents. It is the responsibility of the sponsors and other professional parties, and not the regulators, to ensure that proper due diligence is done in respect of listing applications.

Mining companies

Many mining companies seeking a listing may still be at the stage of exploration and development and have yet been able to generate any revenue. It is of particular importance that they provide sufficient disclosure for investors to assess the feasibility of their projects, including but not limited to, the disclosure of their mining or exploration rights and other requisite regulatory approvals crucial for the mining activities, the construction and financing plan, and the timeframe for commercial production.

In one case, certain key mining assets were located in a jurisdiction where government approval was required for the listing of such assets. The listing applicant failed to obtain such approval. Without such approval, the applicant might lose its key mining assets, and such deficiency may not be able to be addressed by way of disclosure alone. The application was subsequently withdrawn.

In a number of the cases reviewed, the listing applicants' financial conditions depended on the success of their projects but the necessary permits and approvals from the relevant authorities had yet to be obtained. In addition, the applications provided limited information as to how the applicants planned to develop the transportation infrastructure for their production activities and delivery of products to customers. It was only upon our repeated requests that additional disclosures were made for an informed assessment of the applicants' projects.

Whilst it is not unusual for the controlling shareholders to fund the operations of the listing applicant at the start-up stage, the listing applicant is expected to demonstrate how it could sustain its operations after listing without undue reliance on its controlling shareholders. In one of the cases, the mining company would have been unable to continue as a going concern without the continuing financial support of its controlling shareholders. However, the initial draft prospectus failed to disclose prominently its liquidity problem and how the applicant would be able to improve its liquidity position or to meet its financial obligations independently after listing.

In another case, the proposition that the listing applicant would have sufficient cash flow to sustain its operations was based on a cash flow forecast which had assumed that commercial production of its mining projects would commence in the current year when the relevant projects were still at the exploration stage. Unable to meet the relevant listing eligibility criteria, the application was rejected.

Disclosure of investors' obligations when investing in foreign incorporated companies

The SFC noted disclosure deficiencies in various cases where the listing applicant's place of incorporation was recognised as an acceptable jurisdiction only recently.

In these cases, the listing applicants did not provide full details of the obligations to which potential investors may be subjected, some of which may be substantially different from or more stringent than those in Hong Kong. Without such information, investors could be unknowingly exposed to potential consequences of non-compliance as they may not be familiar with the legal or regulatory system in the relevant jurisdiction. Listing applicants from such jurisdictions are reminded to highlight the relevant risks and obligations of shareholders in order to facilitate investors' understanding of their potential obligations and exposure, and how investors may be able to fulfil the obligations. These obligations could cover a wide range of areas, including the disclosure obligation of shareholders' interest and tax payments on capital gains and dividends.

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

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