

## HKEx LISTING DECISION

HKEx-LD19-2011 (September 2011) (Updated in September and October 2013)

Summary	
<b>Party</b>	Company A – a Main Board listing applicant seeking a listing on the Exchange
<b>Issue</b>	How Company A’s material non-compliant financing would affect its listing
<b>Listing Rules</b>	Rules 3.08, 3.09 and 8.04
<b>Decision</b>	The Exchange delayed Company A’s application for 12 months from the date it ceased its material non-compliant activities to demonstrate that it would be financially sound and could operate without reliance on the non-compliant financing arrangements. The prospectus must include the audited financial statements of that 12 month period to enable that, investors fully appraise its performance without reliance on the non-compliant activities.

### FACTS

1. Company A was a manufacturer operating in the Mainland.
2. During the track record period, Company A had allied with several suppliers to obtain bill financing from banks by issuing invoices to these suppliers which were not backed up by underlying trades as required by the relevant laws applicable to banks in the Mainland (**Non-compliant Bill Financing Arrangements**). The purpose of these arrangements was to obtain financing at lower interest rates.
3. The opinion of Company A’s legal adviser was that there were no express provisions in the relevant laws, rules and regulations in the Mainland imposing administrative or criminal liability on enterprises regarding these Non-compliant Bill Financing Arrangements.
4. Company A’s Non-compliant Bill Financing Arrangements were significant during the track record period compared with its cash, bank borrowings and operating cash flow.
5. Company A ceased the Non-compliant Bill Financing Arrangements and repaid the non-compliant loans shortly before it filed its listing application. It enhanced its internal controls to avoid future non-compliance. It obtained confirmations from the governmental authorities and the relevant branches of the respective commercial banks that no punitive or legal actions would be taken against it or its senior management. The sponsors confirmed that the confirmations were obtained from the competent governmental authorities and banks.

6. After ceasing the Non-compliant Bill Financing Arrangements, Company A experienced declining liquidity. It recorded negative operating cash flow compared to positive operating cash flow throughout the track record period. The directors explained that the negative operating cash flow was due to seasonal factors rather than the discontinuation of the Non-compliant Bill Financing Arrangements.
7. The controlling shareholders agreed to provide an indemnity to Company A in respect of all possible losses incurred by it in relation to the Non-compliant Bill Financing Arrangements.

## **APPLICABLE RULES, REGULATIONS AND PRINCIPLES**

8. Under Rule 3.08, the Exchange expects the directors, both collectively and individually, to fulfil fiduciary duties and duties of skill, care and diligence to a standard at least commensurate with the standard established by Hong Kong law.
9. Rule 3.09 requires that every director of a listed issuer must satisfy the Exchange that he has the character, experience and integrity and is able to demonstrate a standard of competence commensurate with his position as a director of a listed issuer.
10. Rule 8.04 requires that both the issuer and its business must, in the opinion of the Exchange, be suitable for listing.

## **ANALYSIS**

### *Factors to consider*

11. The Exchange considered that the Non-compliant Bill Financing Arrangements raised concerns about suitability of the financing, the ability of Company A to operate without reliance on such financing and the director's actions.
12. In determining the impact of the non-compliances on its listing, the Exchange considered the following factors:
  - a. the nature, the extent and the seriousness of the breaches, for example whether the breaches involved dishonesty, or newly established laws and regulations which may be subject to different interpretations by legal professionals.
  - b. the reasons for the breaches: whether the breaches were intentional or due to recklessness or negligence;
  - c. the impact of the breaches on the issuer's operations;
  - d. the rectification measures adopted;
  - e. the precautionary measures put in place to avoid future breaches; and
  - f. whether the issuer's business and financial performance could be sustained without reliance on the Non-compliant Bill Financing Arrangements.

### *Precedent cases*

13. In precedent cases, the Exchange had requested the listing applicant in each case to demonstrate for a reasonable period (not longer than 12 months) that it would be

financially sound and could operate without reliance on the non-compliant bill financing arrangements.

## CONCLUSION

14. In line with the precedent cases, the Exchange requested Company A to demonstrate effective internal control to avoid future non-compliance. In response, Company A agreed to enhance its internal controls to include:
  - a. engaging an independent consultant with the relevant expertise to assess the overall internal control system and implementation of the relevant recommendations such as revised approval procedures, staff training, etc.;
  - b. engaging an independent professional adviser for not less than 12 months from listing to (i) conduct periodic reviews and assessments of the group's internal control measures; and (ii) report to the board of directors and the audit committee (consisting of four Independent Non-Executive Directors) the results of its reviews and assessments;
  - c. quarterly internal reviews by the internal audit department; and
  - d. disclosing in the first annual report after listing any Non-compliant Bill Financing Arrangements identified during the internal and external reviews.
  
15. To enable investors to fully appraise Company A's performance without reliance on the Non-compliant Bill Financing Arrangements and to demonstrate it would operate for a reasonable period of time in a fully compliant manner, the Exchange decided that:
  - a. notwithstanding the confirmations referred to in paragraph 5 and the indemnity given by the controlling shareholder in paragraph 7, Company A's listing application would be delayed for 12 months from the date it ceased all Non-compliant Bill Financing Arrangements;
  - b. Company A must audit its financial results during this 12-month period and the financial results cannot be qualified. The prospectus must include those audited results and disclose the independent consultant's reviews and conclusions<sup>1</sup> on its internal control measures (*Updated in September 2013*); and
  - c. listing approval would be conditional on Company A's independent consultant not having major negative findings about its internal control system at the end of the period.

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<sup>1</sup> In the event the internal control consultant is the reporting accountants or another accounting firm, the relevant guidelines and practices of the accounting profession position an internal controls review as private advice to the directors of the applicant (and if they are party to the engagement, the sponsors). Accordingly, in such circumstances the name of the reporting accountants or other accounting firm and details of their work and findings may be prevented from being quoted or referenced in the listing document. One circumstance in which internal controls work may be referenced in the listing document is where it is practicable for the applicant and the sponsor to additionally and separately engage the reporting accountants or other accounting firm to also perform an assurance engagement in relation to internal controls.

## **SUBSEQUENT DEVELOPMENT** (*Paragraphs 16 to 17 added in October 2013*)

16. It has also been noted that some Mainland companies obtain overseas loans under domestic guarantee to benefit from interest rate differentials and potential foreign exchange gain. Similar to Non-compliant Bill Financing Arrangements, some of these overseas loans under domestic guarantee are not backed up by genuine underlying transactions<sup>2</sup> (**Non-compliant Overseas Loans Arrangements**) and are material to applicants in terms of gains from interest rate arbitrage or foreign exchange.
17. Applicants with material Non-compliant Overseas Loans Arrangements should disclose the arrangements in their prospectuses. They should demonstrate that they have effective internal controls to avoid recurrence of the non-compliances and that they could operate for a reasonable period of time in a fully compliant manner in line with paragraphs 14 and 15. They should also disclose the amount of gains from interest rate arbitrage and foreign exchange. The Exchange will take into account the factors set out in paragraphs 11 and 12 in considering these applications.

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<sup>2</sup> An example is that a Mainland company places a renminbi deposit with a Mainland bank. The company then obtains a renminbi-denominated letter of credit from the bank, ostensibly to pay for a shipment of goods from its Hong Kong subsidiary (which is not a genuine transaction). The Hong Kong subsidiary then takes the letter of credit to a Hong Kong bank and uses it as collateral to obtain a U.S. dollar loan at a much lower interest rate than those available on the Mainland.