

HKEx LISTING DECISION
Cite as HKEx-LD46-1 (Published in July 2005)

Summary	
Names of Parties	<p>Company A – a Main Board listed issuer and a deemed new listing applicant under Listing Rule 8.21C, and together with its subsidiaries upon listing (the “Group”)</p> <p>Parent Group – companies constituting a group of controlling shareholders of Company A and their subsidiaries</p> <p>Target Business – business proposed to be acquired by Company A from the Parent Group</p>
Subject	Whether Company A’s reliance on the Parent Group for certain sales and procurement functions upon the deemed listing rendered Company A unsuitable for listing?
Listing Rules	Listing Rules 8.04; Part A of Appendix 1, Paragraph 27A
Decision	<p>The Exchange, in the first hearing of Company A’s listing application, determined that:</p> <ul style="list-style-type: none"> • given the Group’s current level of reliance on the Parent Group, particularly in respect of the sales function, the reliance issue could not be resolved by disclosure alone; • as such, the Exchange required that Company A should take concrete steps to address the issue of reliance on the Parent Group before Company A’s listing application could proceed. <p>Prior to the second hearing of Company A’s listing application, Company A proposed to incorporate the sales function of the Target Business into the Group. On this basis the Exchange considered that the Group had reduced the level of reliance on the Parent Group to an acceptable level.</p>

SUMMARY OF FACTS

1. Company A entered into an acquisition agreement with the Parent Group to acquire certain target companies held by the Parent Group. These target companies operated a different line of business (the “**Target Business**”) from the existing business of the Group (the “**Existing Business**”). The Existing

Business was operated through a subsidiary of the Group. A part of the share capital of that subsidiary was held by the Parent Group.

2. The Target Business was substantially larger than the Existing Business and the acquisition would result in a change in control. As such the proposed acquisition was treated as a reverse takeover transaction under the applicable Listing Rules and deemed to be a new listing of Company A's Shares.
3. A review of Company A's listing application included a consideration of Company A's independence. The Exchange noted the following issues in the course of its review:

Sales

- a. As the Parent Group adopted a centralised sales function for its subsidiaries, over 95% of the sales of the Target Business and over 75% of the sales of the Existing Business were conducted through the sales network of the Parent Group.

Procurement

- b. Similarly, as the Parent Group adopted a centralised procurement function with respect to sourcing supplies for its subsidiaries, over 90% of the purchase of raw materials of the Target Business was sourced from the Parent Group. The Existing Business sourced a small percentage of raw materials from the Parent Group.
4. In response to the Exchange's concerns, the following submissions of the sponsor were noted:
 - a. Centralisation facilitated the division of responsibility and specialisation and therefore it was mutually beneficial to the Group and the Parent Group and this practice was not uncommon in the market.
 - b. The Group had the expertise, knowledge and resources to carry out its own sales and purchasing for the following reasons :
 - (i) services and raw materials were not unique;
 - (ii) the procurement and sales services provided by the Parent Group were on normal commercial terms and on a non-exclusive basis. The Group presently had the ability and discretion to decide the ultimate suppliers of the goods and services and to sell products to independent parties as and when it saw fit;
 - (iii) the Group presently participated actively in the procurement and sales functions under the Parent Group's central platform. The Group therefore had knowledge of the suppliers and customers; and
 - (iv) the Group had the management expertise to set up its own

purchasing and sales departments or outsource such functions to independent parties. Therefore, these functions could be replicated at similar competitive pricing as in the current model.

- c. The Group had proper internal control within the Group to ensure that all the connected transaction requirements under the Listing Rules would be complied with.
- d. The Parent Group had indicated its willingness to inject the procurement and sales platforms into the Group when the Group's rate of utilisation reached 50% of these platforms.

THE ISSUE RAISED FOR CONSIDERATION

5. Whether Company A's reliance on the Parent Group for certain sales and procurement functions upon the deemed listing rendered Company A unsuitable for listing?

APPLICABLE LISTING RULES OR PRINCIPLES

6. Listing Rule 8.04 requires “[B]oth the issuer and its business, in the opinion of the Exchange, be suitable for listing.”
7. Part A of Appendix 1 of the Listing Rules, paragraph 27A requires a statement explaining how the issuer is satisfied that it is capable of carrying on its business independently of the controlling shareholder (including any close associate¹ thereof) after listing, and particulars of the matters that it relied on in making such statement.
8. When interpreting the requirements under Part A of Appendix 1, Paragraph 27A of the Listing Rules, the Exchange normally requires an applicant to take into account the following:-
 - a. financial independence;
 - b. independent access to sources of supplies/ raw materials for production;
 - c. independence of production/ operation capabilities; and
 - d. independence of access to customers and independent management.

THE ANALYSIS

9. The Exchange ordinarily interprets the requirements in the Listing Rules on reliance as disclosure based. However, where a company's current operating structure is highly dependent on its parent, this could give rise to concerns such as:

¹ Rule amended in July 2014.

- transfer pricing;
 - conflicts of interests between the listed and unlisted parts of the operation and their respective investors;
 - substantial reliance on the protection mechanisms offered by the connected transactions requirements under the Listing Rules; and
 - how performance of the listed part of the company may be independently evaluated.
10. These concerns would be less on reliance, but rather on whether the current structure of listing parts, as opposed to the whole, of an integrated operation would result in significant risks to the company, to the extent that the protection of shareholders' interest would be a concern under applicable provisions of the Listing Rules.
11. Where these concerns could not be addressed, it could translate into a concern regarding whether such reliance on the parent would render the company not suitable for listing. In this respect, the Exchange retains an overall discretion to reject applications on the ground of unsuitability for listing.
12. Applying the above analysis and after considering the submissions of the sponsor, the Exchange had the following findings:
- a. The Exchange did not agree that the Group could easily replicate the functions centralised with the Parent Group, in particular the sales function, in the event that the Group sought to discontinue these functions with the Parent Group for the following reasons:
 - the large size of the central sales function presently performed by the Parent Group, and that the experience of the Group in these procurement and sales processes performed by the Parent Group were not based on contractual arrangements but on goodwill between the Group and the Parent Group;
 - development of independent purchase and sales platforms by the Group after listing might utilise third party systems. This might require obtaining new licences and this concern was not addressed; and
 - the setting of a threshold of 50% utilisation rate by the Parent Group as the trigger point for injecting the sales/ procurement functions in the Group was a pure commercial decision. But before such injection could take place, additional government or other approvals might be required and this concern was not addressed.
 - b. Given the significant reliance that the Group had placed with the Parent Group on the sales and procurement functions, Company A would continue to have a number of significant connected transactions with the

Parent Group. Consequently, heavy burdens would be placed on the effectiveness of the mechanisms for shareholders protection under the Listing Rules, for example on questions involving conflicts of interest, transfer pricing, fair evaluation of performance of the listed part. The effectiveness of these mechanisms remained untested.

- c. Company A had only sought to demonstrate that it had the ability to operate independently of the Parent Group, but did not actually put into place alternative methods of operations before listing.
13. Consequently, the Exchange determined that the current level of reliance on the Parent Group, particularly in respect of the sales function, was such that it could not be addressed by disclosure alone.

THE DECISION

First Hearing

14. Based on the facts and circumstances of the case and the Exchange's analysis of the Listing Rules, the Exchange determined that the level of reliance on the Parent Group, particularly in respect of the sales function, could not be resolved by disclosure alone.
15. The Exchange further determined that Company A should take concrete steps to address the issue of reliance on the Parent Group before the Exchange would consider any further review of Company A's listing application.

Second Hearing

16. At the second hearing of Company A's application, Company A proposed to include the sales function relating to the Target Business in the Group. After such inclusion, the level of reliance by the Target Business on the Parent Group in respect of sales would be reduced from over 95% to approximately 10%, with an overall reliance of the Group on the Parent Group in respect of sales reduced to about 30%.
17. As regards the Existing Business, Company A submitted that it could not include the sales function relating to the Existing Business in the Group at this stage because of regulatory constraints on licensing. However, the Parent Group had undertaken to assist the Group to obtain all the necessary licences that were required to sell its products to third party distributors directly so as to fully address the reliance issue.
18. Based on the above facts, the Exchange considered that the Group had reduced its level of reliance on the Parent Group to an acceptable level.