

# SEHK's Consultation Conclusions/SFC and SEHK's Joint Statement

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## **(A) Hong Kong Stock Exchange's consultation conclusions on Main Board Profit Requirement and (B) Joint Statement on IPO-related Misconduct by Securities and Futures Commission and Hong Kong Stock Exchange**

On 20 May 2021, The Stock Exchange of Hong Kong Limited (**SEHK**) published the conclusions on the Main Board Profit Requirement with respect to its consultation paper published on 27 November 2020. On the same day, the Securities and Futures Commission (**SFC**) and SEHK issued a joint statement (**Joint Statement**) in relation to certain regulatory issues noted in recent listings and their approach in tackling such issues.

### **(A) Conclusion on Main Board Profit Requirement**

After considering the feedback from a broad range of respondents that were representatives of all stakeholders in the Hong Kong capital market, SEHK decided not to proceed with the proposed double or even triple the annual profit requirements as set out in its consultation paper. Instead, SEHK has modified its proposal and will adopt the following approach:

- (a) a 60% increase in the profit requirement resulting in an aggregate profit threshold of HK\$80 million with a profit spread of 56%:44% (**Modified Profit Increase**), effective from 1 January 2022; and
- (b) SEHK will be prepared to grant a relief from the modified profit spread on case-specific circumstances to provide flexibility.

#### *Modified Profit Increase*

Under the Modified Profit Increase, the minimum amount of profit attributable to shareholders for a Main Board listing applicant is (a) HK\$35 million for the most recent financial year; and (b) HK\$45 million in aggregate for the two preceding financial years of a three-year trading record period, resulting in an aggregate profit threshold of HK\$80 million. The amended profit spread from 60%:40% to 56%:44% and hence a minimum profit of HK\$35 million for the most recent financial year of the trading record period will result in an implied historical P/E ratio of 14 times, which is in line with the average P/E ratio of the Hang Seng Index between 1994 and 2020, at the time of listing of a listing applicant, significantly lower than 25 times as seen in some IPOs recently and, particularly, since 2018.

The Modified Profit Increase will be effective from 1 January 2022. Any Main Board listing applications (including renewals of previously submitted applications or GEM Transfer applications) submitted on or after 1 January 2022 will be assessed under the Modified Profit Increase. A listing applicant will not be permitted to withdraw its listing application before it lapses and resubmit the listing application shortly thereafter before the effective date of the Modified Profit Increase such that the listing application will be assessed for a longer period of time in accordance with the current profit requirement.

#### *Relief from the Profit Spread*

SEHK will be prepared to grant relief from the profit spread on case-specific circumstances rather than through a set of fixed conditions, provided that the listing applicant meets an

increased aggregate profit threshold of HK\$80 million. In this respect, SEHK will ordinarily, among other things: (a) evaluate the listing applicant's business nature and the underlying reasons for its inability to meet the profit spread (e.g. growth stage companies and companies whose businesses have been severely affected by the COVID-19 pandemic and current economic downturn); and (b) impose conditions where appropriate, including disclosure of the listing applicant's profit forecast in its listing document.

### *Way Forward and Potential Impact*

In considering an application for a waiver for the relief from the revised profit spread under the Modified Profit Increase, SEHK will critically assess the need to include a profit forecast in the listing document to enable investors to make an informed decision on the position and prospects of an issuer and it may make enquiries on how the issuer's IPO price was determined with reference to the book-building process.

SEHK and the SFC will continue to monitor the situation after the implementation of the Modified Profit Increase and may revisit the Profit Requirement at a later time if circumstances warrant a review.

The Modified Profit Increase would indubitably affect companies at an early development stage and small or mid-sized companies seeking a Main Board listing on SEHK. Such companies would however still be able to access the capital market by pursuing a listing on GEM of SEHK, the listing requirements of which do not include any minimum profit during the track record period. Only sizeable companies which are able to demonstrate a more robust financial performance will be eligible for seeking a listing on Main Board, allowing the SEHK to reinforce its objectives to distinguish Main Board and GEM issuers.

Notwithstanding the satisfaction of the higher entry level of the Modified Profit Increase, SEHK and SFC will continue to critically review listing applicants with relatively high historical P/E ratios, particularly by comparison against those of their listed peers. To deter any possible over-valuation of a listing applicant through inflation of its profit forecast, SEHK and SFC will continue to critically evaluate the reasonableness of the applicant's valuations and, where applicable, require the disclosure of the profit forecast in an applicant's listing document.

Potential applicants seeking or contemplating seeking a Main Board listing should critically assess the potential impacts of the Modified Profit Increase on their eligibility for listing as well as their proposed listing timetable.

## **(B) Joint Statement on IPO-related Misconduct**

### *Regulators' observations and concerns*

SFC and SEHK are concerned with certain suspected arrangements in IPOs which artificially satisfy the initial listing requirements or facilitate market manipulation of the shares at a later date, which undermine the development of an open, orderly and fair capital market in Hong Kong.

The regulators have observed an increasing number of suspected "ramp-and-dump" schemes in recent IPOs whereby fraudsters used different means to "ramp" up the share price of a listed company and then induce unwary investors to purchase the shares that the fraudsters "dump" at an artificially high price. In certain IPOs, shares were apparently allocated in the placing tranche to controlled placees which were seemingly financed in part by funds from the unusually high underwriting commissions or other listing expenses paid

under the IPOs. Shares were also allocated to controlled places in the placing tranche to artificially satisfy the initial listing requirements under the Listing Rules (such as sufficient investor interest, minimum market capitalisation and adequate shareholders spread), creating a false market for the shares, or corner the shares for market manipulation after listing. In the absence of such arrangements, some listing applicants may not satisfy certain initial listing requirements and/or the IPO issue price and valuation may be substantially lower than what were stated in the listing prospectus. In some cases, the share price dropped substantially on the first trading day to a level which more closely reflected the true market value of the company.

In light of the concerns identified in the Joint Statement, where a listing application displays one or more of the following features, the SFC and SEHK will make enquiries to ascertain whether there is sufficient investor interest in the company and adequate spread of shareholders to enable an open, fair and orderly market for the securities after listing:

- (i) The applicant's market capitalisation barely meets the minimum threshold under the Listing Rules.
- (ii) Very high P/E ratio taking into account the applicant's fundamentals (including its profit forecast) and the valuations of its peers.
- (iii) Unusually high underwriting or placing commissions or other listing expenses.
- (iv) Shareholding is highly concentrated in a limited number of shareholders, particularly where the value of public float is small and the minimum threshold for shareholders spread is barely met.

The above is however a non-exhaustive list of features which the SFC and SEHK would consider in their review. The regulators may identify other features which entail their heightened scrutiny.

#### *Regulatory Action*

SEHK may exercise the discretion to reject a listing application if questions raised regarding the share placement and price discovery process are not satisfactorily addressed, or the basic conditions of listing under the Listing Rules are not met, including sufficient public interest, an open market in the shares and an adequate spread of shareholders. The SFC may also object to the listing application on the ground that the listing application does not comply with the Listing Rules, or on public interest grounds.

The SFC and SEHK not only have the discretion and power to object to a new listing, the regulators are empowered to investigate and take appropriate action against the parties involved under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong SAR), the Securities and Futures (Stock Market Listing) Rules (Chapter 571V of the Laws of Hong Kong SAR) and the Listing Rules. In addition to SEHK's regulations of listed issuers based on the Listing Rules, the SFC has statutory powers, including its investigation powers, in relation to issuers, directors, major shareholders and intermediaries suspected of being involved in market misconduct. The SFC may also direct SEHK to suspend trading in any securities listed on SEHK. There will be an enhanced focus on the supervision of intermediaries involved in bookbuilding and placing activities in IPOs as part of SFC's regulatory framework with a view to identifying malpractices and misconduct.

#### *Potential Impact*

Listing applicants should be mindful that the SFC and SEHK may request a listing applicant to provide evidence to demonstrate that it satisfies the Listing Rules requirements, including there is a genuine investor demand and the reasonableness of its valuations having regard to those of its listed peers, during the IPO vetting process and to justify any unusual features in an IPO. Listing applicants should be prepared to explain to the regulators should their IPO exhibit any such problematic features, such as to demonstrate that the IPO price has been or will be determined through a robust and transparent price discovery exercise.