Report on the Securities and Futures Commission's review of the Exchange's performance in its regulation of listing matters

December 2018

Contents

Introduction

1. This report summarises the key findings and recommendations of the Securities and Futures Commission's (**SFC**) 2018 review regarding the performance of The Stock Exchange of Hong Kong Limited (**Exchange**) in its regulation of listing matters during 2016 and 2017.

2. For this report, we reviewed the operational activities, processes and procedures of the Listing Department during 2016 and 2017. In addition, we conducted a more in-depth review of a number of areas by examining relevant case files of the Exchange to understand how their processes and procedures operate in practice. As part of our review, we interviewed the Chairman and Deputy Chairmen of the Listing Committee to obtain their views of the Listing Department's performance.

3. The scope of our review is set out in Section 1 of this report. The key areas reviewed were:

   (a) the Exchange's vetting of IPO applications and suitability for listing;

   (b) the Exchange's work in regulating reverse takeover transactions;

   (c) the Exchange's work in handling disclaimer audit opinions; and

   (d) the Exchange's policy on listing enforcement.

4. Our

Section 1

Purpose of our review

6. The SFC has a statutory duty under section 5(1)(b) of the SFO to supervise, monitor and regulate the activities carried on by the Exchange. Under the Listing MOU[1], it was agreed that the SFC would conduct periodic audits or reviews of the Exchange's performance in its regulation of listing-related matters as a means to discharge its statutory function to supervise and monitor the Exchange.

7. The First Addendum to the Listing MOU dated 9 March 2018 provides that in conducting these periodic audits or reviews the SFC will focus on:

   (a) whether the Exchange, in carrying out its listing regulatory function, has discharged and is discharging its duties under the SFO; this will include assessing its work in developing, administering and implementing its Listing Rules[2] as well as the monitoring and enforcement of compliance with those rules;

   (b) the adequacy of the Exchange's systems, processes, procedures and resources for performing its listing function; and

   (c) the effective management of conflicts of interest within the Exchange as a regulator and as part of a for-profit organisation, including the supervisory functions performed by the Listing Committee.

8. Section 21 of the SFO imposes certain obligations upon the Exchange, as a recognized exchange company, including to ensure, so far as reasonably practicable, an orderly, informed and fair market. In discharging this duty, the Exchange is obliged to:

   (a) act in the interest of the public, having particular regard to the interest of the investing public; and

   (b) ensure that the interest of the public prevails where it conflicts with the interest of the recognized exchange company.

9. Section 21 also requires the Exchange to provide and maintain, amongst other things:

   (a) adequate and properly equipped premises;

   (b) competent personnel; and

   (c) automated systems with adequate capacity, facilities to meet contingencies or emergencies, security arrangements and technical support,

   for the conduct of its business.

[1] The Memorandum of Understanding between the Exchange and the SFC dated 28 January 2003 (**Listing MOU**).

[2] Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited.

How we conducted the assessment

14. In conducting our assessment, we considered:

(a) relevant internal documents, written policies, procedures and processes of the Listing Department's operational teams;

(b) sample cases, including the relevant operational teams' internal reports and case files;

(c) information we received from the Listing Department in the ordinary course of our dealings with it, including its monthly reports to us, internal reports and case data;

(d) HKEX's 2016 and 2017 annual reports, the Listing Committee Report for 2016 and 2017, "Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance" – Reports 2016 and 2017, and "Financial Statements Review Programme" – Reports 2016 and 2017;

(e) the Exchange's published disciplinary procedures, listing decisions, rejection letters, guidance letters and other related documents on the HKEX website;

(f) minutes of meetings of the Listing Committee and the Boards of Directors of the Exchange and HKEX and other relevant internal documents relating to the activities of the Listing Committee and the Listing Department;

(g) relevant internal documents submitted to the Listing Committee by the Listing Department in relation to the activities of the Listing Department;

(h) our discussions with the Chairman and Deputy Chairmen of the Listing Committee;

(i) our discussions with the Head of Listing, the heads

Listing Department's review of listing applications

27. When the Exchange receives a listing application, the IPO case team considers the application in the first instance with reference to the characteristics set out in the IPO

Subsequent cases

40. In a few subsequent cases involving applicants which had high cash balances and available funds which exceeded the proposed amount to be raised in the IPO, the Department recommended the Listing Committee to approve the listing applications. The Department would require the applicant concerned to make detailed disclosure of its proposed use of proceeds in the listing document to establish its funding needs.

Case 3 (GEM applicant) - an applicant with "shell-like" characteristics and a history of shell activities

41. The GLAG sought the Listing Committee's view as it considered the applicant to be a potential shell company due to the following reasons:

    (a) the applicant's controlling shareholder had a history of establishing and disposing of companies in the same industry. As the applicant's controlling shareholder had previously listed a similar business and sold the company shortly after the expiry of the shareholders' lock-up period, the Department questioned the shareholder's commitment to the business; and

    (b) the applicant failed to demonstrate the business need for its expansion plan. The applicant also did not appear to have any immediate funding needs as it had sufficient capital and internal resources to pursue its expansion plan. The Department considered that the intended use of proceeds was not in line with its historical and future business strategy.

42. The Committee members' views were mixed. Some Committee members considered that the Exchange should not regard a company as a potential shell if there was reasonable doubt as to whether the company is in fact a shell based on the information available[14].

43. Other Committee members did not find the applicant's stated use of proceeds plausible as they considered that, instead of seeking a listing, the applicant could have obtained a bank loan to fund its expansion plan. The Committee noted that given the nature of its business and low market capitalization, the applicant could easily be sold off (as a shell) after listing. Taking into account the applicant's characteristics and its controlling shareholder's history of establishing and disposing of companies in the same industry, the Listing Committee decided that the applicant was not suitable for listing and rejected the application.

Subsequent cases

44. We noted that in a subsequent case (see case 5 below), the Department sought the Committee's view in respect of another listing application where the applicant's controlling shareholders also had a history of shell-related activities. In that case, the Committee resolved that the Department should continue to vet the Company's listing application without giving reasons why the previous shell-related activities of the controlling shareholder were not an issue in assessing the suitability of the applicant. The listing application was later approved by the Committee.

[14] Extracted from the minutes of the Listing Committee meeting: *"The Exchange should vet IPO cases based on the principle of presumption of innocence instead of guilt. If there was a reasonable doubt, the Exchange should not*

Case 4 (GEM applicant) – an applicant whose use of proceeds was not in line with its business strategy

45. The GLAG sought guidance from the Listing Committee as it was concerned that the applicant may be a potential shell company because the applicant intended to use a significant portion of the IPO proceeds to purchase an office for conducting seminars and showroom purposes when during the track record period, the applicant did not purchase any property for its own business use and its rental expenses were immaterial. The applicant's listing expenses were to be funded by investment proceeds from the company's pre-IPO investors and the GLAG questioned the pre-IPO investors' rationale for investing in the applicant.

46. At the Listing Committee meeting, the Listing Committee focused its deliberations on the applicant's negative growth in both revenue and net profit (which was one of the factors where robust analysis is required (see paragraph 3.2 of the IPO Guidance Letter))[15]. It concluded that its concerns could be addressed by disclosure, asked the applicant to enhance the disclosure in the "Industry Overview" and "Regulatory Overview" sections of the prospectus and approved the listing application. We noted that, before the Listing Committee hearing, the applicant's controlling shareholders voluntarily extended their lock-up period by an additional 12 months without being requested to do so by the Listing Department.

Subsequent cases

47. In view of the Listing Committee's comments in this case, the Department would not regard applicants that propose to use their IPO proceeds to fund acquisitions as potential shell companies if they can demonstrate that the proposed acquisitions are comparable to those of their peers and properly disclosed in the listing document.

Case 5 (Main Board applicant) – an applicant with a history of "shell-like" activities

48. The applicant was a spin-off from an existing listed company. Although the applicant did not display any of the characteristics listed in the IPO Guidance Letter, its controlling shareholder had a history of "shell-like" activities[16]. The Department sought guidance from the Listing Committee.

49. The Listing Committee commented that although the applicant smelt like a potential shell, it did not appear to be a potential shell company under the IPO Guidance Letter and its

[15] Extracted from the minutes of the Listing Committee meeting: *"The principal issue raised by the GLAG was whether the Company was a potential shell company pursuant to the [IPO Guidance Letter]. The GLAG's concerns and the sponsor's further submission were set out in section III of the Department's report. The Department sought the Committee's view on whether the Company was likely to be a shell company, which might render the Company unsuitable for listing under GEM Rule 11.06. The Department invited comments from Committee members."* However

business appeared to be sizeable[17]. The Listing Department subsequently informed us that the Listing Committee noted from the Department's report that the applicant would have a market capitalisation of $1.8 billion to $2.2 billion, which was significantly higher than that of recent Main Board shells of approximately $700 million[18]. The Listing Committee then requested the applicant to repeat the disclosure of its controlling shareholder's previous disposals in other companies shortly after their respective listings on the Exchange (which had been included in the summary section of the listing document) under a separate heading.

50. The minutes of the Listing Committee meeting made no mention of whether the controlling shareholder's previous history of "shell-like" activities was taken into account when considering the suitability of the applicant, nor why the applicant did not appear to be a potential shell company under the IPO Guidance Letter, and the listing application was approved. We noted that, before the Listing Committee hearing, the applicant's controlling shareholders voluntarily extended their lock-up period by an additional 24 months without being requested to do so by the Listing Department.

Subsequent developments – updated guidance

51. In April 2018, the Exchange published an updated IPO Guidance Letter (HKEX w 054

recorded in the minutes of the Listing Committee meeting for one of the cases reviewed (case 3 above) that, unless it can be determined beyond reasonable doubt that an applicant is a shell, that applicant should be allowed to list. To address its concerns in "borderline" cases, the Exchange has required the applicant to make enhanced disclosures in the listing document, for example, by requiring the applicant to disclose the intended use of proceeds and explain whether this is in line with the applicant's past and future business strategy.

55. In vetting the suitability of a listing applicant, the Exchange is required under the Listing Rules to form an opinion as to whether an applicant and its business is suitable for listing. Requiring proof beyond reasonable doubt that an applicant is unsuitable for listing before rejecting its application is inconsistent with the Listing Rules. The Department subsequently informed us that the Listing Committee did not apply this standard in case 3; it had looked at all the facts in totality (including funding needs, whether the expansion plan could be substantiated, that there would be no growth in business after the proposed expansion, etc.) and then made a judgement in the context of that case

discussed at its meetings and the Committee's consideration of the concerns raised by the Department, the GLAG and the Listing Committee and how they are addressed.

The Exchange's work in regulating reverse takeover transactions

Introduction

60. Under the Listing Rules, a reverse takeover (**RTO**) transaction is treated as if it were a new listing and is subject to the procedures and requirements for new listing applications as set out in Chapters 8 and 9 of the Listing Rules (see paragraph 65).

61. Backdoor listings involve transactions and arrangements that are deliberately structured to achieve a listing of assets while circumventing the requirements applicable to a new listing applicant, including initial listing criteria under the Listing Rules, such as suitability for listing[20], financial eligibility criteria[21] and sufficiency of public interest in the business of the issuer[22]. If these transactions are not regarded as RTOs, the listed issuer would avoid the relevant disclosure and due diligence obligations and the regulatory vetting process.

62. In recent years, there has been widespread media coverage on the problems associated with backdoor listings and shell activities. It has been reported that the demand for shell companies to facilitate backdoor listings has led to a significant increase in the value of these companies as some market participants are prepared to pay a substantial premium to acquire a listed shell in order to achieve a backdoor listing of an unlisted business or assets.

Relevant Listing Rule requirements

63. Rule 14.06(6) defines an RTO as an acquisition or a series of acquisitions by a listed issuer which, in the opinion of the Exchange, constitutes, or is part of a transaction or arrangement or series of transactions or arrangements which constitute an attempt to achieve a listing of the assets to be acquired and a means to circumvent the requirements for new applicants. This is a principle-based test.

64. Separately, rules 14.06(6)(a) and (b) set out the bright-line tests which apply to two specific forms of RTOs involving a change of control[23] of the issuer. They are:

    (a) an acquisition or a series of acquisitions of assets by a listed issuer constituting a very substantial acquisition (**VSA**)[24] where there is, or which will result in, a change in control (as defined in the Takeovers Code) of the issuer; or

    (b) an acquisition or a series of acquisitions of assets, which individually or together constitute a VSA, from the incoming controlling shareholder within 24 months after the change in control.

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[20] Rule 8.04.

[21] Rule 8.05.

[22] Rule 8.07.

[23] Under the Codes on Takeovers and Mergers and Share Buy-backs (**Takeovers Code**) "control" is defined as a holding of 30% or more of the voting rights of a company. RTOs may also include transactions involving an injection of assets into an issuer to achieve a listing of assets which do not involve a change of control of the issuer.

[24] Rule 14.08 provides that a transaction is regarded as a VSA if any of the percentage ratios (ie, assets ratio, consideration ratio, profits ratio, revenue ratio or equity capital ratio) is 100% or more.

65. If a transaction is regarded as an RTO under the Listing Rules, the Exchange will treat the issuer as if it were a new listing applicant[25] and the issuer will be required to comply with the requirements applicable to a new listing applicant[26].

Guidance on the application of the RTO rules

66. The RTO rules are anti-avoidance provisions to prevent circumvention of the new listing

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Cases reviewed

78. We reviewed the meeting notes for all 95 potential RTO cases which were discussed at the LIR meetings. Of these, we selected 32 cases which involved more unusual or complicated issues when applying the principle-based test for more detailed review. We also selected one other case for detailed review based

84.

its existing business. While the Department noted that the issuer had been downsizing its existing business, the Department was of the view that there was no fundamental change of principal business because the existing business *was still generating revenue*[41].

92. Subsequently, in the first interim report issued by the issuer following completion of the acquisition, the new business recorded revenue and assets that were about 130% and 520%, respectively, of those of the existing business. Around that time, the issuer proposed to further scale down its existing business, at which point the Department issued a letter of concern to the issuer[42].

SFC observations

93. The Department generally

first transaction or event in the series). The consultation paper also provided guidance on how to compare the sizes of the new businesses and the original business and examples to illustrate the proposal.

96. We understand that in the course of vetting a proposed transaction, the Department may at times require the issuer to provide representations or confirmations. In situations such as the three cases noted in paragraph 90, we highlight the importance of critically assessing whether the representations provided could be relied upon, taking into consideration known facts and circumstances which may indicate otherwise. If in the course of considering such representations, there are strong reasons to suggest that the representations cannot be relied upon, the Department should make further follow-up enquiries and critically assess all relevant information before relying on the representations provided.

97. We noted a number of cases where there were no detailed records of how the Department assessed certain criteria under the principle-based test in considering whether a transaction was an RTO. It is recommended that the Department staff should maintain a more detailed written record of the reasons for its assessment and conclusions in its files.

Assessment of the size of the transaction

98. The Listing Rules provide guidance on how the percentage ratios[44] should be calculated to assess whether a transaction should be regarded as a very substantial transaction or otherwise.

99. The RTO Guidance Letter clarifies that there is no absolute threshold in determining whether the size of a transaction is extreme. In assessing the impact of an acquisition on an issuer, the Exchange would take into account the nature and scale of the issuer's existing business and whether the acquisition would result in a fundamental change in the issuer's business. In March 2016, the Exchange issued a listing decision where, having considered the facts of that case, it considered a transaction that was below the VSA size[45] to be an extreme case[46].

100. We understand from our interview of the case officers that, in assessing the size test, they would come to a conclusion after taking into account all the size ratios, and would not conclude that a case is extreme just because one particular ratio is large.

What size is "extreme"?

101. In reviewing the Department's case files, we noted that in some cases, a size between 100% and 110%, or between 110% and 150% was considered "significant" under the size criterion. However, there were some cases where, even after disregarding the highest, potentially anomalous ratio, the remaining highest ratio in each case was in the range of 200% to over 400%, but was nonetheless considered by the Department not to be extreme. We could not find any record in the case files of the reasons why the sizes of these transactions were not considered extreme. The Department's response to our inquiry was that there is no bright-line test to determine "extreme" in terms of size.

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[44] Namely asset ratio, consideration ratio, profits ratio, revenue ratio and equity capital ratio (see rules 14.07 to 14.21 of the Listing Rules).

[45] See footnote 24.

[46] HKEX-LD95-2016.

Calculation of percentage ratios

102. As part of their review of draft announcements or inquiries, the LIR case teams would review the percentage ratio calculations submitted by the issuers to determine the size of transactions.

103. In reviewing the Department's case files, we noted one case which involved the payment of the consideration for an acquisition of a target in stages where the calculation of the consideration ratio did not take into account all such payments. Details of the case are as follows:

    (a) the issuer first granted a loan to a borrower (with the shares of the borrower pledged as collateral), who used the loan proceeds to pay an *initial* instalment of the consideration for an acquisition of certain debts of and over 50% equity interest in a target;

    (b) as the loan went into default, the issuer enforced the collateral taking sole control of the borrower and assuming the obligation to pay the *remaining* portion of the consideration to complete the acquisition of the target;

    (c) when the Department was vetting the circular, it became apparent that the issuer also assumed the borrower's various commitments to acquire certain debts of the target, provide working capital to the target and pay various fees incurred by the target.

104. In this case, when considering whether the acquisition of the target constituted an RTO by the *issuer*, we noted from our review of the files that the LIR case team accepted a calculation of the consideration ratio submitted by the issuer based solely on the *remaining* acquisition consideration to be paid. There was no record demonstrating that the case team had revised the size test calculation or required the issuer to re-submit an updated size test calculation to take into account the initial loan granted to the borrower (which was paid as an initial instalment for the acquisition) or the other commitments[47] assumed by the issuer.

105. The Department subsequently explained that (i) the initial loan granted to the borrower was taken into account and documented in the file, although the revised size test was not documented and (ii) at the circular stage, the other commitments were identified and considered by the case team; however the assessment was not documented in the files. Because the revised size ratio (99%) at the circular stage (including various commitments) would still be slightly below the VSA level and the assessment of the other criteria under the principle-based test did not change, the case team concluded that the transaction was not an RTO and the case was not resubmitted for discussion at the LIR management meeting.

SFC observations

106. When assessing whether the size of a transaction is extreme, we recommend that the Department maintain a more detailed record of the reasons for its conclusions. We also recommend that in a case like the one described in paragraph 103, the Department should critically consider information (eg, the ratio calculation) submitted by the issuer and request updated information when appropriate. If after the initial RTO assessment is made

[47] Rule 14.15(4) provides that, when calculating the consideration ratio, if the issuer may pay or receive consideration *in the future*, the consideration is the maximum total consideration payable or receivable under the agreement.

(normally at the enquiry or announcement stage) new information surfaces that may affect that initial assessment, the Department should reassess whether the proposed transaction(s) amount to a RTO in view of the newly-available information and maintain a detailed written record of the re-assessment.

Change in control or de facto control

107. The RTO Guidance Letter provides that, in determining whether a transaction is an RTO, the Exchange would consider whether there is any issue of restricted convertible securities[48] to the vendor which would provide it with de facto control of the issuer. The Exchange noted that some cases involving an issue of restricted convertible securities lacked a business rationale for adopting such a structurean i

SFC observations

110. We noted that the RTO Guidance Letter has been interpreted restri

(b) act for proper purpose;

(c) be answerable to the issuer for the application or misapplication of its assets;

(d) avoid actual and potential conflicts of interest and duty;

(e) disclose fully and fairly his interests in contracts with the issuer; and

(f) apply such degree of skill, care and diligence as may reasonably be expected of a person of his knowledge and experience and holding his office within the issuer.

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126. The vetting

128. Since 2017, the Department has been taking a more vigorous approach to vetting announcements containing financial results with disclaimer audit opinions[59]. In particular:

(a) the LIR team has

131. The Department considers that the current Listing Rules permit an issuer to publish disclaimed financial statements. The Department takes the view that trading in the issuer's stock can continue on an informed basis as long as appropriate disclosure has been made regarding the disclaimer opinion (see paragraph 118).

132. We were informed that, since 2017, the Department has been more robust in taking follow-up action in relation to disclaimer cases and in considering whether there had been any breach of directors' fiduciary duties under rule 3.08 of the Listing Rules in those cases which would warrant enforcement action.

Subsequent development

133. The Exchange reconsidered its approach in respect of disclaimer opinions and published a consultation paper[61] on 28 September 2018 with a proposal to require a trading suspension where an issuer has published a preliminary annual results announcement and its auditor has issued, or has indicated that it will issue, a disclaimer or adverse opinion on the financial statements. Once suspended, trading in companies whose financial statements have been disclaimed by the auditor may only resume when the issuer has addressed the issues giving rise to the disclaimer or adverse opinion[62]. If adopted, the Exchange's proposal will eliminate trading on the basis of disclaimed audit opinions.

Cases referred to Listing Enforcement

134. From 1 January 2016 to 30 June 2018, the LIR team referred 19 cases to the Enforcement team relating to the issues underlying the disclaimer opinions including:

(a) breach of directors' fiduciary duties[63] (rules 3.08 and 3.09);

(b) delay in publication of annual results or annual reports within the prescribed time (rules 13.46 and 13.49);

(c) failure to comply with announcement and/or reporting and shareholders' approval requirements in respect of notifiable transactions or connected transactions (certain rules under Chapters 14 and 14A);

(d) suitability for listing (rule 6.01);

(e) non-disclosure of previous public sanctions made against directors by regulatory authorities (rule 13.51); and

(f) accuracy of information provided in financial statements (rule 2.13).

[61] Consultation Paper on Proposal Relating to Listed Issuers with Disclaimer or Adverse Audit Opinion on Financial

135. We were informed that the Department

141. The decision as to the level of regulatory response and whether disciplinary action is appropriate will be guided by a non-exhaustive list of factors set out in the Enforcement Policy Statement[66]. In July 2017, the Exchange published the first edition of the Enforcement Newsletter with a view to enhancing transparency of the Exchange's enforcement practice and work and achieving its objectives in enforcing the Listing Rules.

Investigation and enforcement

142. The Exchange reported that it handled 86 investigations[67] in 2017 and 71 investigations in 2016 (52 in 2015), representing an increase of 15 (21.1%) in 2017 and 19 (36.5%) in 2016. Of the 86 investigations handled in 2017 (2016: 71), 78 or 91% (2016: 64 or 90%) related to one or more of the seven specified enforcement themes (see paragraph 140)[68].

143. The Exchange completed nine disciplinary cases in 2017, eight in 2016 and six in 2015. All these disciplinary cases were concluded with public sanctions being imposed by the Exchange. Apart from disciplinary action, the Exchange issued nine warning or cautionary letters in 2017, 15 in 2016 and five in 2015. The Exchange closed 11 investigations by way of "no further action" in 2017, compared with eight in 2016 and 10 in 2015.

144. Set out below is a summary of the number of investigations handled by the Exchange and the enforcement outcomes from 2013 to 2017:

	Investigations*	**Warning/Caution letters issued**	**Cases closed by way of "no further action"**	**Disciplinary cases**
2013	69	16	8	8
2014	60	14	12	6
2015	52	5	10	6
2016	71	15	8	8
2017	86	9	11	9

* The number represented cases concluded in the year and cases which remained active at year end. The number of outstanding investigations at the end of 2017 was 28, compared to 32 at the end of 2016 and 22 at the end of 2015. The number of cases pending disposal or disciplinary action at the end of 2017 was 29, compared to eight in 2016 and nine in 2015.

[66] The factors are: (a) the nature and seriousness of the possible breach; (b) the circumstances and manner in which the conduct giving rise to the possible breach was committed; (c) the conduct of directors and senior management; (d) the market impact and prejudice to investors as a result of the possible breach; (e) any personal benefit accruing to the parties responsible for the possible breaches and its magnitude; (f) the post-breach conduct of the relevant parties; (g) whether adequate and effective internal controls are implemented and maintained; (h) whether the possible breach reveals serious or systemic weaknesses or failings in the issuer's procedures; (i) the level of cooperation during the investigation; (j) the compliance history of the issuer and its directors; and (k) any other mitigating or aggravating factors as outlined in t

Listing Enforcement's procedures for handling referrals

Review of case referrals

145. Listing Enforcement's work comes from a number of sources, including referrals from other operational teams within the Department. In 2016 and 2017, substantially all the referrals received by Listing Enforcement were made by the LIR team[69].

146. We were informed that the Head and the Vice Presidents of Listing Enforcement would discuss the referrals at the weekly case referral meetings and decide whether the referral cases would be accepted for investigation. We noted that, during the relevant period, Listing Enforcement's own operating manual did not set out any guidelines or explanation of the factors to be considered in assessing referrals. We were informed by Listing Enforcement that the decision as to whether to commence investigation would be made by reference to (a) the Exchange's statutory duty to act in the interest of the public

Decision on the mode of disposal of an investigation

150. At the conclusion of an investigation, a decision would be taken as to what, if any, disciplinary action is required. The case officer would prepare a briefing paper[73] and the matter would be discussed at the Disciplinary Coordination Meeting. After discussion at the Disciplinary Coordination Meeting, the Head of Listing would decide on the mode of disposal of the investigation.

151. The case officer would make recommendations as to the mode of disposal of the matter by reference to the factors[74] set out in the Enforcement Policy Statement and the Exchange's duty to act in the interest of the public, and as to the sanctions or directions to be imposed on each of the parties against whom disciplinary action is to be brought by reference to the principles and factors in the Sanctions Statement.

152. If a case is to be disposed of by way of disciplinary action, Listing Enforcement would prepare a

had been diligent in performing their fiduciary duties (including the duty to keep proper books and records).

Reliance on information provided by the issuer

160. We were informed by Listing Enforcement that in arriving at its decision to accept or reject a case, Listing Enforcement generally relies on information provided by the issuer and/or the referring team and would not make further enquiries unless there are reasons to doubt the information provided.

161. In one case involving an acquisition of a target by an issuer, the consideration for the acquisition was determined by reference to a valuation of the target obtained by the issuer. The valuation was calculated based on a projection of the cashflow of the target's principal business. However, within 12 months after the acquisition was made, the issuer fully impaired goodwill and impaired a significant portion of intangible assets arising from the acquisition because the business was terminated due to unsatisfactory operating results and decreasing market demand.

162. Although the LIR team expressed concerns that the directors might have failed to exercise due care and diligence in entering into the transaction, the Enforcement staff took into account the matters set out in the issuer's submissions which included the fact that the directors had obtained a valuation to support the consideration for the acquisition and had engaged lawyers to perform other due diligence work, and decided not to pursue the case. From our review of the files, although the target's principal business was terminated very soon after the target was acquired, we noted that the Enforcement staff had relied on the submissions made by the issuer through its lawyers and considered there was no reason to doubt the valuation report or the due diligence conducted by the directors.

regard to the interest of the investing public. The Listing Rules provide for a number of potential remedies that are designed to protect investors and the market, eg, the Listing Committee may require the issuer to rectify a breach or take other remedial action within a stipulated period[80].

165.

169. The number of listed issuers increased by 13.5% from 2015 to 2017[83]. Over the same period, there was a steady increase in the number of investigations of Listing Rules breaches handled by the Exchange[84] T L 56.656.7

172. The number of listing applications vetted by the Exchange was 412 in 2017, 349 in 2016 and 256 in 2015, representing an increase of 63 (or 18.1%) in 2017 compared to an increase of 93 (or 36.3%) in 2016. The number of applications vetted comprises applications accepted for vetting in the current year and “in-progress” applications brought forward from the previous year. The difference between the number of applications vetted and the number of applications accepted represents the number of cases brought forward from the previous year, which is affected by different factors including the number of applications received, the complexity of the cases and when the applications were received.

173.

Listed issuer regulation

177. The number of LIR actions handled by the Exchange was 66,368 in 2017, 64,932 in 2016 and 71,088 in 2015, representing an increase of 1,436 (or 2.2%) in 2017 and a decrease of 6,156 (or 8.7%) in 2016. The decrease[93] in LIR actions handled from 2015 to 2017 is out of line with the increase in the number of listed issuers across the years (2017: 2,118; 2016: 1,973; 2015: 1,866). The following is a breakdown of the announcements handled by the LIR team in 2015, 2016 and 2017.

	Post-vetted	% of Total	Pre-vetted	% of Total	Total
2015	54,512	99.68%	176	0.32	54,688
2016	55,793	99.73	153	0.27	55,946
2017	57,376	99.79	122	0.21	57,498

178. In 2017, remedial follow-up action by the issuer was required in 1,426 (or 2.5%) of the post-vetted cases (2016: 1,232 or 2.2%, 2015: 1,037 or 1.9%).

179. The LIR team referred 40 cases to Listing Enforcement in 2017, representing a slight increase from 35 referral cases in 2016 (2015: 26). Referrals to external regulatory bodies[94] have significantly increased from nine cases in 2016 to 37 cases in 2017 but both years saw a decrease from 2015 (47 referrals).

180. For long-suspended companies, the Exchange issued a notice of its ls(2015:easneed finiJ -0.00.6 b (v

188. Over the same periods:

(a) the processing time for listing applications increased substantially between 2015 to 2016 and further increased in 2017 (see paragraph 173); and

(b) the proportion of other announcements vetted within one business day increased slightly in 2017 and 2016, and the proportion of post-vetting results announcements vetted within five business days fell slightly in 2016 and 2017 (see paragraph 181).

189. We note that the documented performance measures reported by the operational teams related to the length of time taken to process cases and the efficiency of the teams. We stress the importance of having qualitative performance measures to ensure that the Department staff do not prioritise the turnaround time for cases over other aspects of their work (eg, the depth or scope of their case review, accuracy and success in spotting issues). The Exchange advised that a memorandum from the Head of Listing was issued in June 2018 reminding its staff to focus on the proper discharge of the Exchange's regulatory duties when setting performance objectives.

190. We also noted that the IPO Vetting Team issued a total of three guidance letters and four listing decisions during the relevant period (see paragraph 175); while the LIR team issued a total of two guidance letters and 21 listing decisions (see paragraph 182). A number of professional advisers have in the past commented that the volume of guidance materials (for example, guidance letters, listing decisions, FAQs and interpretative letters) has become very large and should be consolidated. We noted that neither the IPO Vetting Team nor the LIR team codified any existing listing guidance during the relevant period. In 2018, the Exchange began the exercise of codifying existing listing guidance.

Investigation and enforcement

191. The relevant details have been included in the section entitled "The Exchange's policy on listing enforcement".

192. The actual and budgeted headcounts for professional staff in Listing Enforcement during the relevant period were as follows:

	At 31 December 2015	Change	At 31 December 2016	Change	At 31 December 2017
Actual	10	Nil	10	Nil	10
Budgeted	10	Nil	10	+1 (10%)	11

Debts and derivatives

193. The total number of derivative warrants and CBBCs listing applications processed by the Debts and Derivatives Team in 2017 (21,224) increased by 54.1% from 2016 (13,771), which saw a decrease of 21.5% from 2015 (17,549).