



**SECURITIES AND
FUTURES COMMISSION**
證券及期貨事務監察委員會

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

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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 full findings and recommendations in relation to this review are set out in Section 2 of this report. We have identified a number of areas for potential improvement and suggested recommendations for the Exchange to consider. In arriving at our recommendations we have taken into account the Exchange's initiatives and proposals undertaken after the review period.
5. We wish to thank members of the Listing Committee and Listing Department staff for their assistance provided to us in the review process.

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 MOU¹, 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 Rules² 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.

10. Under the Listing MOU, the Exchange agreed that, as the frontline regulator of all listing-related matters, it shall:
 - (a) ensure due and proper observance by listed companies, their directors, controlling shareholders, sponsors, authorized representatives, and any other market users of
 - (i) the Listing Rules; and
 - (ii) any obligations imposed on such persons thereunder;
 - (b) maintain an up-to-date public database of listed company information;
 - (c) maintain a suitable financial statements review program with a view to encouraging high standards of financial disclosure and to detect instances of improper disclosure;
 - (d) maintain an adequate strength of staff in the Listing Department with an adequate level of professionalism and experience to discharge the responsibilities of the Listing Department;
 - (e) maintain proper files, records, and systems of all transactions and other matters proceeded by the Listing Department, the Listing Committee, and the Listing Appeals Committee for the proper regulation of listing-related matters; and
 - (f) develop and maintain adequate procedural guidelines, checklists, and reporting mechanisms for Listing Department staff to assist them in the administration of the Listing Rules and in discharging their respective responsibilities.
11. In March 2004, the Government published its Consultation Conclusions on Proposals to Enhance the Regulation of Listing. Amongst other matters, the Government recommended that we prepare reports on our review of the Exchange's performance of its listing functions and submit these reports to the Financial Secretary before publication.
12. Our review is based on the parameters set out in the SFO, the Listing MOU and the First Addendum to the Listing MOU. This report contains our assessment and, where applicable, our recommendations on matters that should be reviewed or addressed by the Exchange as part of its continuing efforts to discharge its statutory duties under the SFO.

Scope of the 2018 review

13. We conducted a general review of the operational activities, processes and procedures of the Listing Department during 2016 and 2017. In addition, we conducted a more in-depth review of the following areas:
 - (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;
 - (d) the Exchange's policy on listing enforcement; and
 - (e) Hong Kong Exchanges and Clearing Limited's (**HKEX**) report on the operations of the Listing Department in 2016 and 2017.

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 of the operational teams and other senior personnel of the Listing Department; and
 - (j) our discussions with relevant case officers.
15. Our assessment of the Exchange's performance and our views expressed in this report are the result of our on-site inspection or discussions with the Listing Committee members and our continuing interaction with the Exchange under the Listing MOU.
16. We discussed our findings with the Head of Listing and the Chairman of the Listing Committee and their comments on our findings have been incorporated in this report as subsequent comments.
17. This report has been updated to reflect any steps taken by the Exchange after the completion of the review period to address the recommendations in this report.

Section 2

The Exchange's vetting of IPO applications and suitability for listing

Introduction

18. During the relevant period, there was increasing media attention regarding the creation of shell companies through initial listings, particularly on the Growth Enterprise Market (**GEM**) given its lower entry requirements and smaller market capitalization requirements. Ownership of these shell companies often changes hands after listing (see also paragraphs 61 and 62 below). The Department advised us that it had noted the media attention and decided that the shell company issues should be addressed and proposed to issue guidance to the market. The Department discussed the issue with the Listing Committee and as a result of such discussions the IPO Guidance Letter (defined below) was issued.
19. In June 2016, the Exchange published guidance in relation to the suitability for listing of new applicants whose sizes and prospects do not appear to justify the cost or purpose related with a public listing (**IPO Guidance Letter**)³. In these cases, questions may be raised as to the reasons and justification for the applicants' listings which in turn cast doubt on whether they are in fact suitable for listing (see paragraph 22). The Exchange would conduct a more focused review of a listing application when the listing applicant exhibits certain characteristics as discussed in the guidance letter.

Relevant listing rule requirements and guidance

20. Rule 8.04⁴ states that both the issuer and its business must, in the opinion of the Exchange, be suitable for listing.
21. Rule 2.06 states that suitability for listing depends on many factors. Applicants for listing should appreciate that compliance with the Listing Rules may not in itself ensure an applicant's suitability for listing. The Exchange retains the discretion to accept or reject applications and in reaching its decision will pay particular regard to the general principles outlined in rule 2.03 which include, amongst other things, that the applicant is suitable for listing.

IPO Guidance Letter

22. Paragraph 1.4 of the IPO Guidance Letter outlines the characteristics identified by the Exchange as "red flags". The Exchange has observed that companies with "shell-like" features (ie, companies which could potentially have suitability issues) have one or more of the following characteristics⁵:
 - (a) small market capitalization;
 - (b) only marginally meeting the listing eligibility requirements;

³ HKEX-GL68-13A – Guidance on IPO vetting and suitability for listing (June 2016).

⁴ The equivalent GEM rule is rule 11.06.

⁵ These common characteristics were noted in the Exchange's review of all new listings on the Main Board and GEM between 2012 and 2014 where the controlling shareholders either changed or gradually sold down their interests shortly after the regulatory lock-up period following listing.

- (c) involving fundraising disproportionate to listing expenses;
 - (d) involving a pure trading business with a high concentration of customers;
 - (e) being asset-light businesses where a majority of the assets are liquid and/or current assets;
 - (f) involving a superficial delineation of business from the parent whereby the applicant's business is artificially delineated from the parent by geographical area, product mix or different stages of development; and/or
 - (g) having little or no external funding at the pre-listing stage.
23. Where a listing applicant exhibits some of these “shell-like” characteristics, the Exchange would expect the applicant and sponsors to provide a robust analysis to substantiate the applicant's suitability for listing, including, amongst others, in the following areas:
- (a) *Use of proceeds* – the Exchange would expect the applicant to disclose specific uses for proceeds commensurate with the applicant's past and future business strategy and observed industry trends and explain the commercial rationale for listing;
 - (b) *Future objectives and strategies* – the Exchange would expect a comprehensive analysis to be provided to demonstrate that the applicant has a detailed strategic plan for its business operations and growth;
 - (c) *Profit and revenue growth* – where an applicant (i) has experienced decreasing or low profit and revenue growth; and/or (ii) is expected to record decreasing or low profit and revenue growth after listing, a comprehensive analysis is required to substantiate that the applicant's business is sustainable; and
 - (d) *Potential sunset industry* – where an applicant is in a potential sunset industry or in an industry that has declining market prospects, the applicant must be able to demonstrate that it is feasible and it has both the ability and resources to modify its business to respond to the changing demands of the market. The applicant should also demonstrate that the returns from the business justify the cost of listing.
24. The Exchange may also impose additional requirements or conditions or exercise its discretion to reject the applicant's listing on the ground of suitability.

Cases reviewed

25. We reviewed the Exchange's decision-making in relation to potential shell companies when vetting new listing applications to understand its approach in applying the principles in the IPO Guidance Letter.
26. During the relevant period and subsequent to the publication of the IPO Guidance Letter, the Exchange received 446 listing applications. We reviewed the Exchange's case files relating to 28 new listing applications comprising five cases which were presented to the Listing Committee for guidance when the IPO Guidance Letter first came into force and 23 cases which appeared to involve significant potential issues relating to shell companies.

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 Guidance Letter and completes an internal checklist. The checklist forms part of the Listing Department report which is presented to the Listing Committee or the GEM Listing Approval Group⁶ (GLAG) for consideration.
28. If a listing applicant displays some of the “shell-like” characteristics as set out in the IPO Guidance Letter, the case team would make enquiries of the listing applicant and its sponsor in respect of, amongst other things, the applicant's (i) intended use of proceeds, (ii) funding needs and (iii) business strategy and future growth plans.

Listing Committee's application of the IPO Guidance Letter

29. When the IPO Guidance Letter first came into effect, the Listing Department sought guidance from the Listing Committee on the application of the IPO Guidance Letter in relation to five listing applications⁷.
30. In some cases, although the Department and the Listing Committee questioned the applicant's rationale for listing (for example, if the applicant's expansion plan or proposed use of proceeds did not seem to make sense) they found it difficult to challenge the applicant's stated intention for listing⁸. In these instances, the applicant would be required to make enhanced disclosure in the listing document to address those concerns.
31. Set out below is a discussion of the five cases. The Listing Committee's decision in these cases provided guidance to the Department in its vetting of subsequent listing applications and helped to establish consistency in decision-making.

Case 1 (GEM applicant) - an applicant with “shell-like” characteristics

32. The GLAG sought guidance from the Listing Committee as it was concerned that the applicant may be a potential shell company because the applicant's expansion plan was questionable in light of the slowdown in the Hong Kong economy at the time and the applicant's thin net profit margin. The applicant also did not have any apparent need to raise funds and could have used its listing expenses to expand its business rather than incur listing expenses. Its stated reasons for listing also appeared to be boilerplate disclosure.
33. The Listing Committee shared the GLAG's concerns. The Committee noted that the amount of funds expected to be raised by the applicant was small compared to other GEM listings and therefore the listing expenses (which were low in absolute terms) were large in

⁶ GEM rule 3.05 provides that the Listing Department may approve or reject a GEM listing application. For this purpose, the GLAG was established and comprises the Head of Listing and senior staff members of the Listing Department. The GLAG's power is delegated from the GEM Listing Committee and is subject to the oversight of the GEM Listing Committee. In practice the GLAG will seek guidance from the GEM Listing Committee in the event that a particular listing application raises novel or sensitive issues.

⁷ This took place between late June 2016 and early November 2016.

⁸ Extracted from the minutes of the Listing Committee meeting: “The Department had never rejected any listing application pursuant to the [IPO Guidance Letter], so the Department should only reject the most egregious cases to convey a clear message to the market. Further, such an approach would require assessment of intention of the directors and shareholders of a company which would be difficult to prove. It would not be the Department's practice to second guess whether a company's use of proceeds was legitimate.”

comparison. However, the Committee noted that small company size and raising small amounts of capital were characteristics that are unique to the GEM⁹.

34. The Listing Committee also considered that the applicant's operations began in 2006 and therefore the applicant had not been "manufactured" shortly before the listing application was submitted¹⁰. The applicant's business seemed genuine as evidenced by the presence of its premises throughout Hong Kong.
35. The Listing Committee regarded the applicant as a "borderline" case and asked the applicant to demonstrate greater commitment to listing. In response to the Committee's request, the controlling shareholders voluntarily agreed to undertake to the Exchange that they would extend the lock-up period¹¹ for an additional 12 months. The Listing Committee approved the listing application.

Subsequent cases

36. In a number of subsequent IPO cases with similar potential shell characteristics, the applicant volunteered to extend the lock-up period without being requested to do so by the Listing Department or the Listing Committee (see cases 4 and 5 below).
37. In view of the Listing Committee's comments in this case, the Listing Department recommended the Committee to approve the listing of a number of applicants that (i) had a very small market capitalization, or (ii) used a high proportion of the listing proceeds to pay listing expenses (see cases 2 and 4 below).

Case 2 (Main Board applicant) - an applicant with no apparent funding needs

38. The applicant had stable earnings and is a market leader in its industry. It also had high cash balances, readily available banking facilities and strong operating cashflows. The amount of funds to be raised from its listing was modest and the applicant did not have any specific use for the IPO proceeds¹². The Department questioned the applicant's rationale for listing and sought guidance from the Listing Committee.
39. There was only a brief discussion of the Department's concerns at the Listing Committee hearing. The Committee agreed with the Department's view that the applicant did not seem to have any genuine need for fundraising as it was cash-rich. Nevertheless, the Committee considered that it would be too tough an approach to regard an applicant as being unsuitable for listing for this reason alone¹³, and approved the listing application.

⁹ Extracted from the minutes of the Listing Committee meeting: "GEM was established to help small companies, such as the company, with their fund raising requirements. So the fact that the company was small and was not raising a large amount of money were characteristics of the market on which it was listing."

¹⁰ Extracted from the minutes of the Listing Committee meeting: "The company's history of operation dated back to 2006, so it was not manufactured shortly before listing application (usually 18 months or two years before listing application) to be a potential shell."

¹¹ During the lock-up period, the controlling shareholders shall not dispose of their shares in the relevant listed issuer such that they cease to be the controlling shareholders.

¹² The applicant submitted that the net proceeds raised would be used to upgrade its IT management systems, to enhance its capability to undertake large-scale contracts and to recruit more staff.

¹³ Extracted from the minutes of the Listing Committee meeting: "The Company did not seem to have genuine need for fund raising as it had lots of cash. However, to consider a company as unsuitable for listing as it had lots of cash was an approach too tough for the Exchange to adopt."

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 available¹⁴.
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 consider a company as a potential shell. There was a reasonable doubt in this case.”

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" activities¹⁶. 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 there was no record in the minutes that the Committee had discussed the GLAG's concerns.

¹⁶ The controlling shareholder, which is a listed company in Hong Kong, had previously spun-off two companies for separate listings on the Main Board. Shortly after the expiration of the respective 12-month lock-up period under the Listing Rules, the controlling shareholder disposed of its entire interests in the companies. After the spin-off, the two companies conducted a number of major transactions involving acquisitions of businesses in completely different industries. There had also been a number of changes in the composition of the board of directors of these two companies.

business appeared to be sizeable¹⁷. 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 million¹⁸. 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-GL68-13A – Guidance on IPO vetting and suitability for listing).
52. In the updated guidance letter, the Exchange emphasised that the focus of its suitability review is qualitative and is not a "checklist" approach. The Exchange stressed that it would assess a listing applicant's suitability holistically and, in particular, examine whether the stated use of proceeds and funding needs are consistent with its future objectives and strategies and whether the listing applicant has a commercial rationale for listing. Listing applicants that are unable to demonstrate a commercial rationale for listing may not be regarded as suitable for listing.
53. Since the publication of the updated IPO Guidance Letter up to October 2018, the Exchange has rejected nine listing applications on the grounds that the applicant had failed to demonstrate a commercial rationale for listing and did not appear to have genuine funding needs. Five of the rejected listing applications were pending review hearings.

SFC observations

Suitability for listing

54. The Listing Committee recognised the difficulty in applying the concepts of the IPO Guidance Letter (particularly if the "shell-like" characteristics were not overwhelming) as this approach would require an assessment of the intention of the applicant¹⁹. It was

¹⁷ Extracted from the minutes of the Listing Committee meeting: "Although the Company smelt like a potential shell, it did not appear to be a potential shell company under the framework of [the IPO Guidance Letter]. The company also did not seem to be a shell due to its size."

¹⁸ The Listing Department subsequently informed us that the Listing Committee concluded that the applicant was less likely to be a shell as the market capitalisation exceeded the rumoured shell price of \$600 million. We also noted from the minutes of the relevant Listing Committee meeting that there was a comment that, "[H]owever, a listed issuer with substantial net assets of HK\$1.8 billion seemed to be a perfect shell as it was possible to inject new assets or businesses into the issuer without triggering requirements under Chapter 14 of the Rules".

¹⁹ Extracted from the minutes of the Listing Committee meeting: "The Department had never rejected any listing application pursuant to the [IPO Guidance Letter], so the Department should only reject the most egregious cases to convey a clear message to the market. Further, such an approach would require assessment of intention of the

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.
56. We noted that in certain cases, the applicant’s controlling shareholders voluntarily extended their lock-up period to demonstrate greater commitment to listing without being requested to do so by the Exchange (see paragraphs 46 and 50). We question whether this approach provided comfort to the Exchange as to the applicant’s intention for listing. In our view the longer lock-up period could well be an attempt by those involved in shell manufacturing to take advantage of the Exchange’s bright-line approach to achieve their objective to list a shell, and hence might be a red flag. The Department subsequently informed us that the Exchange has not relied solely on the longer lock-up undertaking as an indication that an applicant is not potentially a shell, and the revised IPO Guidance Letter published in April 2018 states that longer lock-up undertakings do not in and of themselves address potential shell company concerns.
57. We noted that the updated IPO Guidance Letter refines the Exchange’s approach in assessing the suitability of listing applicants that exhibit potential shell features. This demonstrates that the Exchange has been seeking to enhance its vetting of listing applicants to curb shell creation and trading activities and ensure the quality of companies that enter our markets. We encourage the Exchange to continue its efforts to maintain the quality and integrity of the Hong Kong market and protect the interests of the investing public.

Record of discussion

58. We noted that in some cases (for example, cases 4 and 5 above), the Department or the GLAG had specific concerns that the applicant may be a potential shell company (see paragraphs 45 and 48) and sought guidance from the Listing Committee. However, there was no record in the case files that the Listing Committee discussed those specific concerns. It is unclear how these concerns were addressed (if at all).
59. We recommend that the Exchange review its practices and procedures to ensure that the concerns raised by the Listing Department or the GLAG are addressed and the reasons for decisions are fully and properly documented (regardless of whether the Committee agrees with or dismisses the concerns raised). At the minimum, the case files and minutes of the Listing Committee meetings should record, with sufficient detail, all significant points

directors and shareholders of a company which would be difficult to prove. It would not be the Department’s practice to second guess whether a company’s use of proceeds was legitimate.”

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 listing²⁰, financial eligibility criteria²¹ and sufficiency of public interest in the business of the issuer²². 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 control²³ 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.

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 applicant²⁵ and the issuer will be required to comply with the requirements applicable to a new listing applicant²⁶.

Guidance on the application of the RTO rules

66. The RTO rules are anti-avoidance provisions to prevent circumvention of the new listing requirements and as such, they involve an application of judgement. In determining whether a transaction is an RTO, the Exchange considers it important to strike a balance between allowing legitimate business activities (such as business combinations and expansions) and the need to maintain market quality (by subjecting RTO transactions to the new listing requirements).
67. In May 2014, the Exchange published guidance on the application of the principle-based test under the RTO rules (**RTO Guidance Letter**)²⁷. Under the principle-based test, the Exchange would take into account six criteria to assess whether an acquisition constitutes an attempt to achieve a listing of the assets to be acquired and a means to circumvent the requirements for new listing. The criteria are:
- (a) the size of the transaction relative to the size of the issuer;
 - (b) the quality of the business to be acquired – whether it can meet the trading record requirements for listings or whether it is unsuitable for listing;
 - (c) the nature and scale of the issuer’s business before the acquisition;
 - (d) any fundamental change in the issuer’s principal business;
 - (e) other events and transactions (historical, proposed or intended) which, together with the acquisition, form a series of arrangements to circumvent the RTO Rules; and
 - (f) any issue of restricted convertible securities to the vendor which would provide it with de facto control of the issuer.
68. A transaction would be treated as an RTO under the principle-based test if the Exchange considers it is an “extreme” case taking into account these six criteria, unless (i) the assets to be acquired can meet the minimum profit requirement under rule 8.05²⁸ and (ii) circumvention of the new listing requirements would not be a material concern, in which case the transaction would be treated as an extreme very substantial acquisition (**Extreme VSA**) and not as an RTO.

²⁵ Rule 14.54.

²⁶ Including: (a) the enlarged group or the assets to be acquired must be able to meet the track record requirements for new applicants under rule 8.05; (b) the enlarged group must meet all other new listing requirements under Chapter 8 of the Listing Rules; (c) the listed issuer must issue a listing document containing all the information required for a new listing application and the information required for a VSA; and (d) the listed issuer must appoint a sponsor which must conduct proper due diligence on the transaction.

²⁷ HKEX-GL78-14 - Guidance on application of the reverse takeover requirements under rule 14.06(6) (GEM Listing Rule 19.06(6)) (May 2014).

²⁸ For GEM companies, the positive cashflow requirement under GEM rule 11.12A.

69. Transactions that the Department considers to be RTOs are not required to be presented to the Listing Committee. Potential Extreme VSAs, on the other hand, are presented to the Listing Committee for its decision as to whether the RTO rules apply. If the Committee considers that the RTO rules apply, the issuer will be treated as if it were a new listing applicant (see paragraph 65). However, if the Committee considers that the RTO rules do not apply to an Extreme VSA, the issuer will instead be required to prepare a transaction circular under an enhanced disclosure and vetting approach, and appoint a financial adviser to conduct due diligence on the acquisition²⁹.

Subsequent developments – market consultation

70. In June 2018, the Exchange launched a market consultation on proposed amendments to the RTO rules to tackle problems related to backdoor listings and shell-related activities (**Backdoor Listing Consultation Paper**)³⁰. The proposals in the consultation paper aimed to enhance the RTO rules to prevent backdoor listings, particularly those involving shell companies and the continuing listing criteria for listed issuers, to deter the manufacturing and maintenance of listed shells. We welcome the Exchange's proposals³¹.
71. The Exchange proposed to (i) codify the six assessment criteria under the principle-based test; (ii) extend the scope of or clarify the application of the criteria; and (iii) impose additional requirements applicable to transactions classified as RTOs and extreme transactions (see paragraphs 95 and 110 below).

The Exchange's review of potential RTOs

72. The Exchange identifies potential RTO cases through (i) post-vetting of announcements relating to transactions below the VSA threshold; (ii) vetting of draft announcements relating to VSAs; and (iii) handling inquiries relating to potential RTOs. In 2016 and 2017 respectively, the Listing Department vetted 60 and 64 draft announcements relating to VSAs, and handled 28 and 32 inquiries relating to potential RTOs. 95 cases (53 in 2016 and 42 in 2017) were discussed at the Listed Issuer Regulation (**LIR**) team's management meetings or daily team meetings (collectively **LIR meetings**), to consider whether they would be regarded as RTOs or Extreme VSAs. Cases that were not discussed at the LIR meetings were considered and decided by the relevant case officers at the case team level.
73. Out of 95 cases, the Department determined that 22 cases (23.1%) were RTOs (12 cases in 2016 and 10 cases in 2017) and seven cases (7.4%) were Extreme VSAs (three cases in 2016 and four cases in 2017).

²⁹ Under the RTO Guidance Letter, the issuer will be required to provide enhanced disclosure about the target and the future business prospects of the issuer, applying the standard of disclosure for listing documents for new listing applicants. The financial adviser is required to provide a declaration to the Exchange in respect of its due diligence on the transaction in the form set out in Attachment 2 of the Guidance Letter.

³⁰ Consultation Paper on Backdoor Listing, Continuing Listing Criteria and Other Rule Amendments (June 2018).

³¹ See SFC press release "SFC endorses Exchange's initiative to tackle backdoor listings" of 29 June 2018 (<https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR74>).

74. Set out below is a summary of the number of potential RTOs vetted by the LIR team:

	2016	2017
Number of VSA announcements vetted	60	64
Number of enquiries received with potential RTO issues	28	32
Total	88	96
Number of potential RTO cases discussed at the LIR meetings (Note 1)	53 (60.2%)	42 (43.8%)
- Determined as RTOs (Note 2)	12 (22.6%)	10 (23.8%)
- Determined as Extreme VSAs (Note 2)	3 (5.7%)	4 (9.5%)
<p><i>Note 1: Percentages are calculated based on the total number of VSA announcements vetted and enquiries received with potential RTO issues in the respective years.</i></p> <p><i>Note 2: Percentages are calculated based on the number of potential RTO cases discussed at the LIR meetings in the respective years.</i></p>		

75. During the relevant period, the Listing Department and the Listing Committee discussed the policy related to backdoor listings and shell activities and the Exchange's approach in reviewing these cases at various Listing Committee policy meetings. The Exchange also published guidance materials on the Committee's decisions relating to the application of the RTO rules, cash companies and sufficiency of operations of issuers.
76. The Exchange informed us that although the RTO assessment criteria have not changed since the issuance of the RTO Guidance Letter, the Exchange noted changes in market practices in structuring RTOs and, accordingly, has taken a more robust approach in recent years in applying the principle-based test when considering whether the RTO rules would apply to proposed transactions. For example, in view of the rising trend of listed issuers attempting to achieve a backdoor listing through multiple smaller transactions to avoid the RTO rules, the Department began to scrutinise a number of major transactions³² (ie, transactions below the VSA threshold) to assess whether they were in fact RTOs (after taking other transactions by the issuer into account).
77. The Exchange has also enhanced its approach to regulating listed issuers that do not appear to possess a sufficient level of operations or assets to warrant their continued listing status under rule 13.24³³.

³² These cases represented more than 10% of potential RTO cases vetted over the period.

³³ In a number of cases, the Exchange determined that listed issuers that have (i) ceased their original business and sought to commence a number of new businesses for the purpose of maintaining the listing status or (ii) disposed of their original businesses and retained minimal operations, have failed to comply with their continuing listing obligations under rule 13.24. (See HKEX-LD99-2016, HKEX-LD98-2016 and HKEX-LD97-2016 (all published in March 2016)).

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 on our on-going monitoring of listed companies³⁴.
79. As part of the process, we reviewed the case files of all 33 cases to understand the Department's experience in assessing each of the six criteria under the principle-based test to identify potential RTOs. We also considered whether the Department's application of the criteria had been consistent with the guidance contained in the RTO Guidance Letter and the anti-avoidance nature of the principle-based test.
80. In reviewing the cases, we were mindful that the RTO rules are principle-based and as such, it is possible for two similar sets of facts to be interpreted differently, depending on the *other* circumstances of the two cases. The assessment of whether a transaction is an RTO should therefore be based on a combination of the criteria and considered in totality.

Fundamental change in the issuer's principal business

Comparison of business sizes

81. The RTO Guidance Letter provides that where an issuer acquires a business that is completely different from its existing business, it is more likely to be viewed as a means to achieve the listing of the target assets. This is more so the case where the target's business is in a specialized industry and the present management does not have the expertise to manage the new business, or where the issuer's existing business is so immaterial that following the acquisition, the issuer would substantially be carrying on only the new business.
82. In determining whether a proposed acquisition would result in a fundamental change in the issuer's business, the Listing Department would usually compare the relative sizes of the new business and the existing business. From our review of the files, we noted that in the majority of the cases reviewed the Department adopted this approach. In five cases, we did not find any record demonstrating that the case team performed this comparison when assessing the "fundamental change in principal business" criterion.
83. We were informed by some case officers that when the issuer's existing business would not be discontinued or become minimal in absolute terms, they did not consider there to be a fundamental change in business, and in such circumstances they did not consider it necessary to assess whether the new business would be substantially larger than the existing business for the purpose of this criterion³⁵.

³⁴ Taking into account indicative factors including: (i) a change in control or de facto change in control; (ii) having conducted significant transactions; and (iii) a change in business. Out of a pool of cases that exhibited some or all of these factors, we selected three companies, two of which were already included in the sample of 32 cases selected for detailed review.

³⁵ For the purpose of assessing another criterion, "the size of the transaction", the percentage ratios would still be calculated (see paragraph 98).

84. For example, in one case, the issuer acquired two new businesses in the same industry (which were different from its original business) within seven months of each other and the aggregate revenue from the two acquisitions was nearly 20 times the revenue of the issuer's original business³⁶. The case team concluded that the acquisitions were a diversification, rather than a fundamental change in principal business, relying on, amongst other factors, the issuer's representation that it would continue its original business (which generated meaningful revenue and had meaningful assets). In the Department's file note under the criterion of fundamental change in principal business, we did not note that any consideration was given to whether the two acquisitions taken together were substantially larger than the original business and thereby potentially resulted in a fundamental change in the issuer's principal business³⁷.

Scope of "existing" businesses

85. In assessing whether a transaction would result in a fundamental change in the principal business, the Department often needs to determine what constitutes an issuer's "existing" business, and whether recently acquired or commenced businesses should be viewed as part of the "existing" business, or part of a series of transactions to list a "new" business. We reviewed the Department's approach in relation to this aspect.
86. In one case, the issuer acquired a new business and developed it into a principal operating segment through several further acquisitions in the same industry. More than two years after the first acquisition, when the issuer proposed a VSA in the same industry, the Department determined that the proposed VSA and the previous transactions formed part of a series of arrangements that would have amounted to a fundamental change in business to circumvent the RTO rule, and regarded the proposed VSA as an RTO.
87. On the other hand, in four cases which similarly involved multiple transactions in new businesses within a relatively short period, the Department staff considered that after the first transaction the new businesses had already become part of the issuer's *existing* business and therefore the later acquisitions were regarded as an expansion of such businesses and not a fundamental change in business³⁸.

³⁶ The asset ratio was 13.4% (when comparing the new e-commerce and finance services business with the existing property development and management business).

³⁷ The Department subsequently explained that the effect of the aggregation of the two acquisitions (including the combined size tests) was discussed in the file note under the "part of a series of arrangements to circumvent the RTO Rules" criterion instead of under the "fundamental change in principal business" criterion.

³⁸ In these cases, in the relevant period the issuers had each acquired or commenced a new business in an industry that was unrelated to its original business. In three out of these four cases, the new business was acquired or commenced after a change in control. About 12 to 20 months later, each of these issuers entered into a larger transaction in the same industry as the smaller business that it had acquired or commenced earlier. Instead of aggregating the two transactions to determine whether (taken together) they would result in a fundamental change in the issuers' principal business, the Department regarded the businesses that were recently acquired or commenced as part of the issuers' "existing" businesses, and considered the later, larger transactions to be an expansion of the issuers' existing businesses. The Department subsequently explained that in these cases, the size tests after aggregating the acquisitions were also taken into account, but the Department considered these cases not "extreme" in making the RTO assessment. However, these considerations were not documented in some cases.

88. In a listing decision issued in June 2017, the Exchange clarified its approach in this area³⁹. In the example given in the listing decision, the issuer asserted that a video gaming business had become one of its principal activities after its first acquisition in this sector, and the proposed second acquisition (in the same industry from a different vendor) was an expansion of that *existing* business. However, the Exchange determined that the two acquisitions constituted a series of acquisitions and should be aggregated, because they were made within a short period and together would lead to a substantial involvement by the issuer in a different *new* business. The Exchange further noted that the acquisitions together with the proposed disposal of the issuer's original business would effect a complete change of the issuers' principal business and formed a series of transactions to list the video gaming businesses. The Exchange pointed out that the rule does not prescribe a fixed time period for aggregating a series of acquisitions for the purpose of the principle-based test, and this assessment is made based on the circumstances of individual cases.

Reliance on issuer's representations

89. From our review of the case files, we noted that in assessing whether there has been a fundamental change in business, the Department has often relied on the issuer's representations that the existing business would be continued⁴⁰.
90. In three cases, when the Department was vetting proposed transactions involving RTO concerns, the issuers represented that their existing businesses would be continued. However, these issuers had already been partially disposing of or scaling-down their original businesses or suffered a deterioration in their financial performance. In each of these cases there had also been a change in control and a change of the board of directors, with all or a majority of the executive directors experienced in the existing business replaced by new executive directors experienced in the new business. Within six to 15 months after the relevant transaction, the issuers proposed to dispose of or further scale down the original businesses. Although the Exchange raised concerns with the issuers in respect of their proposed disposal or further scale-down of the existing businesses, the completed transactions could not retroactively be vetted as RTOs.
91. In one of these cases, within two years of its IPO, the issuer underwent (i) a change in control, (ii) a change in its board of directors with none of the new directors experienced in its existing business, and (iii) a change in name to one that was similar to another company related to the new controlling shareholder. The issuer had also been scaling down its existing business. The issuer acquired from the new controlling shareholder a new business that was different from its existing business; the new business was approximately 70-80% of the existing business in terms of assets and revenue. The issuer disclosed in the transaction circular that it had no intention or plan to dispose, scale-down or terminate

³⁹ HKEX-LD109-2017 (June 2017). The example given in the listing decision involved an issuer that was originally engaged in the food business. Several months after its previous controlling shareholder sold his entire stake in the issuer, the issuer announced an acquisition of a company in the video gaming business from independent third parties. About one year after the completion of the first acquisition, the issuer proposed to acquire another company in the video gaming business, also from independent third parties, and to dispose of its food business to the previous controlling shareholder. Each of the acquisitions would constitute a major acquisition on its own, but would amount to a VSA on an aggregated basis.

⁴⁰ The Department subsequently explained that it would generally make enquiries of the issuer about its intention as regards its existing business. Where subsequent action undertaken by the issuer is found to be contrary to the disclosures made, those cases would represent compliance issues to be dealt with by enforcement action (see the Listing Committee Report 2009 (https://www.hkex.com.hk/-/media/HKEX-Market/Listing/How-We-Regulate/Listing-Committee/Listing-Committee-Report/AnnualRpt_2009dec.pdf)).

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 issuer⁴².

SFC observations

93. The Department generally relies on discussions at internal meetings to provide guidance to staff members on the application of the principle-based test and to communicate the latest development and regulatory responses to staff. Potential RTO cases are usually discussed at the LIR management meetings or daily meetings, and discussion notes (with decisions) are circulated to all LIR staff. Training on the RTO rules is provided to new staff as part of the LIR team's training program. As there are no written guidelines, reliance is placed on the experience and ability of staff members to identify issues and exercise their judgement correctly. We recommend that the Department develop written guidelines on RTOs and provide staff training more regularly on a continuous basis. The guidelines and training should include examples of recent and noteworthy cases where the Department formed the view that the transaction was or was not an RTO based on its assessment of the criteria and the basis for the decision.
94. We noted that, in determining whether a proposed acquisition would result in a fundamental change in the issuer's principal business, the Department staff generally compared the relative sizes of the new business and the existing business. Out of 95 cases reviewed, we found that in five cases, the case officers interpreted the guidance⁴³ in the RTO Guidance Letter for the "fundamental change in principal business" criterion in a restrictive manner and did not compare the relative business sizes as long as the issuer's existing business would not be discontinued or become minimal in absolute terms. We also noted that in four cases where the issuer had recently acquired or commenced a business unrelated to its original business and followed that with a larger acquisition in the same industry, the Exchange considered the business newly commenced or acquired to be part of the issuer's "existing" business, and deemed the latter larger transaction to be an expansion of that "existing" business.
95. To alleviate any misunderstanding in relation to the Exchange's approach in assessing this criterion, in the Backdoor Listing Consultation Paper, the Exchange has reinforced the message that the RTO rules are principle-based and proposed that it may consider that there is a fundamental change in principal business if the issuer's new businesses in aggregate are material in size when compared to its original business. Under the proposal, when making the assessment, the Exchange would compare the size of the new businesses in aggregate with that of the original business at the time of the latest proposed transaction (and "original business" refers to the business the issuer operated before the

⁴¹ The Department staff subsequently explained that they had also taken into consideration the following: (i) the scale of the existing business was sizeable and generated revenue of over \$100 million and (ii) the size of the proposed acquisition was only that of a major transaction.

⁴² The Department was concerned that the proposed further scale-down of the existing business, together with the previous corporate actions and developments, constituted a series of transactions and arrangements in an attempt to achieve a listing of the new business and circumvent the new listing requirements.

⁴³ See paragraph 81.

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 ratios⁴⁴ 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 size⁴⁵ to be an extreme case⁴⁶.
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.

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 commitments⁴⁷ 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 securities⁴⁸ 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 structure. In these cases, the Exchange would consider whether the issuance of the restricted convertible securities is a means to avoid a change of control under the bright-line tests⁴⁹ and whether the vendor effectively “controls” the issuer. Where a proposal does not fall under the bright-line test, it may nevertheless be treated as an RTO under the principle-based test.
108. In our review of the case files, we observed that some Department staff appeared to consider this criterion to be applicable only when there is a change in *de facto* control as a result of an issue of *restricted convertible securities* as specified in the RTO Guidance Letter and not in other circumstances. For example:
- (a) In one case, the issuer proposed to acquire a target and as consideration would issue *new shares* to the vendors representing more than 40%⁵⁰ of the issuer’s issued share capital. The case was ultimately not regarded as an Extreme VSA or an RTO under the principle-based test⁵¹. In the Department’s analysis of the change in de facto control criterion, there was a brief remark that the acquisition did not involve an issuance of restricted convertible securities.
 - (b) In each of two other cases, the issuer proposed to acquire a new business from the new controlling shareholder who acquired control of the issuer within the past 24 months⁵². In its analysis of the change in de facto control criterion, the Department only noted that the acquisition did not involve an issuance of restricted convertible securities but did not consider the fact that there had recently been a change in control and the new controlling shareholder was the vendor.
109. Upon our enquiry as to whether the Department had considered the fact that there had been a change in control in these cases, the Department informed us that, in vetting potential RTOs, it does not take account of a change in control or a change in de facto control as one of the assessment criteria under the principle-based test when there is no issuance of restrictive convertible securities. The Department subsequently informed us that in these cases, it had applied the principle-based test and decided that the transactions were not RTOs.

⁴⁸ Restricted convertible securities are highly dilutive convertible securities with a mechanism to restrict conversion of the securities that would cause the securities holder to hold 30% interest or higher of the underlying shares to avoid triggering a change of control under the Takeovers Code.

⁴⁹ See paragraph 64 above.

⁵⁰ See footnote 23.

⁵¹ The size test (equity capital ratio) was 95% and therefore the case did not fall under the bright-line tests.

⁵² See paragraph 64(b) above. The size test in these cases was 77% and 85%, respectively, so the cases did not fall under the bright-line tests. The Department also considered that, on balance, these cases were not Extreme VSAs or RTOs under the principle-based test.

SFC observations

110. We noted that the RTO Guidance Letter has been interpreted restrictively with respect to the criterion of “change in de facto control arising from issue of restricted convertible securities”. In the Backdoor Listing Consultation Paper, the Exchange proposed to explicitly extend the current criterion of “change in de facto control arising from issue of restricted convertible securities” to include any change in control or de facto control of the issuer, and it would assess whether there is a change in control or de facto control of the issuer that forms part of a series of arrangements to list a new business.

The Exchange’s handling of disclaimer audit opinions

Introduction

111. During the relevant period, there was significant public concern regarding the number of modified and qualified audit reports being issued in respect of listed issuers’ financial statements. According to the Exchange’s statistics (as shown in the table below), the number of listed issuers with modified or qualified audit reports was 119 in 2016 and 113 in 2017, which is significant.

112. Set out below are data compiled by the Exchange for the number of modified or qualified audit reports issued by listed issuers:

	Financial year ended 31 December 2015	Financial year ended 31 December 2016	Financial year ended 31 December 2017
Total number of issuers with 31 December year end	1,412	1,469	1,565
Number of issuers with modified audit reports ⁵³	41 (2.9%)	49 (3.3%)	44 (2.8%)
Number of issuers with qualified audit reports ⁵⁴	53 (3.8%)	70 (4.8%)	69 (4.4%)
<i>Number of issuers with disclaimer opinions</i>	26 (1.8%)	36 (2.5%)	37 (2.4%)
Total number of issuers with modified or qualified audit opinion	94 (6.7%)	119 (8.1%)	113 (7.2%)
<i>Note: Percentages are calculated based on the total number of issuers in the respective years.</i>			

⁵³ Modified reports refer to audit reports which, without qualifying the audit opinion, include matters which are of such importance that it is fundamental to users’ understanding of the financial statements.

⁵⁴ Qualified reports include audit reports with a qualified opinion, an adverse opinion or a disclaimer of opinion. Adverse opinions (which indicate outright disagreement between the auditor and the issuer of the financial numbers) and disclaimers of opinions (which mean the auditor could not form a view on the financial statements) are serious because they indicate that the risk of undetected misstatements could be both material and pervasive.

113. In 2016, there were news reports that the number of modified and qualified audit reports issued by auditors in respect of Hong Kong-listed companies have increased significantly, thereby raising concerns about the financial health of certain listed companies. In the second quarter of 2016, the Exchange conducted a review of 31 December 2015 year end issuers which published their results announcements with qualified audit opinions on or before 31 March 2016⁵⁵ and prepared an internal paper on its findings.
114. The Exchange reviewed a total of 94 issuers' annual results with qualified audit opinions. The Exchange's review provided factual analysis of the qualified opinions, such as an analysis by types of qualified opinions and the nature of the qualifications.
115. The paper concluded by stating that the teams will post-vet the results announcements published by issuers, identify situations where trading suspension concerns may arise, understand the nature of audit qualification, assess its implications for the issuer and consider whether any follow-up action is required. The teams will also consider whether any enforcement action is necessary for possible breaches of the Listing Rules or make referral to the SFC for possible breach of the SFO.

Relevant listing rule requirements

116. Rule 2.03 sets out the general principles which are relevant:
- (a) "...potential investors are given sufficient information to enable them to make a properly informed assessment of an issuer..." (rule 2.03(2)); and
 - (b) "investors and the public are kept fully informed by listed issuers...of material factors which might affect their interests..." (rule 2.03(3)).
117. In addition, paragraph 2 of Appendix 16 requires that each set of financial statements presented in an annual report shall provide a true and fair view of the state of affairs of the listed issuer and of the results of its operations and its cashflows.
118. Paragraph 3 of Appendix 16 provides that if the financial statements do not give a true and fair view of the state of affairs of the listed issuer and of the results of its operations and its cashflows, more detailed and/or additional information must be provided. If a listed issuer is in doubt as to what more detailed and/or additional information should be provided, it should apply to the Exchange for guidance.
119. Rule 13.50 provides that the Exchange will normally require suspension of trading in an issuer's shares if the issuer fails to publish periodic financial information. The suspension will normally remain in force until the issuer publishes an announcement containing the requisite financial information.
120. Rule 3.08 provides that the directors of a listed issuer, both collectively and individually, are expected 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; and that this means every director must, in the performance of his duties as a director:
- (a) act honestly and in good faith in the interests of the company as a whole;

⁵⁵ Being the deadline for the publication of annual results announcements for companies with 31 December 2015 year ends.

- (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.

The Department's vetting of disclaimer audit opinions

121. For the year ended 31 December 2016 and 2017 respectively, 36 and 37 issuers published financial results with a disclaimer audit opinion (**disclaimer cases**).
122. Of the 36 disclaimer cases in 2016, 29 issuers (or 80.6%) had received disclaimer audit opinions for at least two consecutive years; of these, 21 (or 58.3%) had received them for at least three consecutive years. Of the 37 disclaimer cases in 2017, 26 issuers (or 70.3%) had received disclaimer audit opinions for at least two consecutive years; of these, 23 (or 62.2%) had received them for at least three consecutive years.

Review of announcements

123. As a matter of practice, the Department performs a preliminary review of each annual results announcement immediately when it is published on the HKEXnews website to ascertain whether any immediate regulatory action (eg, suspension) is required, followed by a more detailed review.
124. The case team uses a checklist both to conduct its review of the results announcement and to record its findings. When the results announcement reflects a qualified or modified audit opinion, the case team is required to ascertain the events giving rise to the qualification or modification. The vetting checklist states that, where necessary, the case team should follow up with the issuer on the following matters:
- (a) reasons for the qualification or modification of the audit opinion;
 - (b) how the issuer proposes to handle the relevant issues;
 - (c) remedial measures taken or proposed to be taken by the issuer; and
 - (d) the Audit Committee's view (if applicable).
125. The LIR manual⁵⁶ contains limited guidance in relation to the post-vetting of results announcements. For example, the manual provides that when the team completes the checklist, the team should review developments in the issuer group's activities over the reporting period and disclosure in the results announcement and consider whether the issuer has complied with (i) the content requirements for results announcements; (ii) specific requirements of the Listing Rules; and (iii) the general disclosure obligation under rule 13.09.

⁵⁶ The LIR manual for professional staff which sets out processes and procedures in respect of the work of the LIR Team.

126. The vetting checklist does not contain explanatory guidelines for the case teams to decide whether such follow-up action is (or is not) necessary. Instead, the vetting checklist provides examples of situations where a particular follow-up action may be appropriate. To suspend trading of the relevant stock, for example, the vetting checklist provided the following examples:

- (a) where there is material breakdown in internal controls and the published information cannot accurately present the issuer's financial position;
- (b) where there are material breaches of the Listing Rules; and
- (c) where there is insufficient public float.

Follow-up action

127. During the relevant period, the Listing Department's approach to handling disclaimer audit opinions⁵⁷ and its follow-up procedures were as follows⁵⁸:

- (a) *material uncertainty relating to an issuer's ability to continue as a going concern* – the Department considered that most of these cases are disclosure matters. In post-vetting the results announcements in these cases, the Department would ensure that the company had disclosed (i) the basis upon which the issuer considered that its financial statements could be prepared on a going concern basis and (ii) the measures adopted by the issuer to meet its cashflow requirements;
- (b) *accounting irregularities* – the Department would require the issuer to form an independent committee to review the issues, conduct an investigation and take remedial action. Forensic accountants may be required to investigate the issues and address regulatory concerns;
- (c) *internal control deficiencies* – the Department would normally request the issuer to engage an independent adviser to review the internal control system and rectify any weaknesses;
- (d) *limitation of scope* – the Department would require the issuer to provide reasons for, and its proposed plan to address, the issues that gave rise to the auditor's concerns; and
- (e) *concerns with specific line items in the financial statements (eg, recoverability of accounts receivables)* – the Department would ensure that the relevant amounts were quantified by the company and their financial impact was properly disclosed in the financial statements.

⁵⁷ A similar approach is taken in relation to financial results with adverse audit opinions.

⁵⁸ A trading suspension may be required in serious circumstances, for example, if accounting irregularities or possible fraudulent activities are identified or if there has been a significant breakdown in the issuer's internal control, eg, if the books and records are incomplete.

128. Since 2017, the Department has been taking a more vigorous approach to vetting announcements containing financial results with disclaimer audit opinions⁵⁹. In particular:
- (a) the LIR team has put more focus on follow-up actions taken by the relevant issuer to resolve the matters giving rise to the qualifications, including requiring the issuer to propose a plan of action (with detailed timetable) and to disclose the plan in the announcement. Case officers would also follow up to ensure that the issuer's proposed action plan has been observed;
 - (b) where the qualifications involve matters of judgement, the case officers may make follow-up enquiries with the issuer's audit committee on their views and whether the audit committee has reviewed and agreed with the management's position in relation to the areas of judgement;
 - (c) the LIR team has been more robust in referring disclaimer opinion cases to Listing Enforcement to investigate suspected breaches of directors' fiduciary duties under rules 3.08 and 3.09; and
 - (d) guidance has been given to the market through the publication of the Exchange's Annual Report Review Report.

SFC observations

The Department's review of disclaimer cases

129. During the period from 1 January 2016 to 30 June 2018, follow-up action by the Department largely comprised making enquiries with the relevant issuers and ensuring proper and adequate disclosures are made. We noted that, during this period, the LIR team referred 19 cases to the Enforcement team (see paragraph 134). Of the 73 disclaimer cases vetted by the LIR team during the relevant period, none led to the issuance of a warning or cautionary letter to the issuer or its directors despite the fact that 80.6% of the cases in 2016 and 70.3% of the cases in 2017 were repeat cases (see paragraph 122).
130. An auditor issues a disclaimer of opinion on a set of financial statements when the auditor is unable to obtain sufficient appropriate audit evidence on which to base its opinion or, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that it cannot form a view on the financial statements due to the potential interaction of the uncertainties and their possible effect on the financial statements⁶⁰. A disclaimer of opinion is serious because it indicates that the risk of undetected misstatements could be both material and pervasive. This raises fundamental questions about whether the published financial statements can be considered to provide a true and fair view of the financial condition and results of the issuer or otherwise enable investors to make a properly informed assessment as required by rule 2.03 of the Listing Rules.

⁵⁹ As stated in the Exchange's reports on its Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance for 2016 and 2017, the Department reviewed annual reports of issuers with modified audit opinions and qualified opinions (including disclaimer audit opinions) in respect of (a) the disclosures regarding the modified opinions and (b) the issuers' plans to address the audit modifications.

⁶⁰ See paragraphs 9 and 10 of the Hong Kong Standard on Auditing 705 (Revised) - Modifications to the Opinion in the Independent Auditor's Report.

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 paper⁶¹ 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 opinion⁶². 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 duties⁶³ (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 Statements (September 2018).

⁶² Under the delisting rules (rule 6.01A(1)), the Exchange may delist a Main Board issuer if the issuer is unable to remedy the issues giving rise to its suspension and had been suspended continuously for 18 months (or 12 months for a GEM issuer under the equivalent GEM rule 9.14A(1)).

⁶³ In considering whether there has been a breach of directors' fiduciary duties that warrant a referral to Listing Enforcement, the LIR team would take account of, amongst others, the following:

- (a) whether sufficient due diligence had been performed prior to an acquisition of business or assets;
- (b) whether the directors had taken timely and appropriate action to resolve audit issues resulting in the financial statements being disclaimed for a number of years; and
- (c) whether the directors had fulfilled their duty to keep accounting records that were sufficient to show and explain the issuer's financial position with reasonable accuracy and to maintain effective internal control systems.

135. We were informed that the Department is working on a set of criteria to provide guidance to the LIR team on referring disclaimer audit opinion cases to Listing Enforcement.
136. We believe that the tighter approach adopted by the Exchange to regulate listed issuers with disclaimer audit opinions will help to protect market integrity and enhance market quality.

The Exchange's policy on listing enforcement

The Exchange's enforcement objectives and approach

137. The Listing Enforcement team is responsible for investigating possible breaches of the Listing Rules (which may arise from complaints alleging Listing Rule breaches referred by other Listing teams), initiating and conducting disciplinary proceedings before the Listing (Disciplinary) Committee as well as issuing caution and warning letters.
138. The Enforcement Policy Statement⁶⁴ outlines the Exchange's approach to enforcement of the Listing Rules and the criteria for assessing the appropriate level of enforcement action. The Statement provides that the Exchange's enforcement objectives are to deter future breaches, educate the market, influence compliance culture and attitude and enhance corporate governance.
139. According to the Statement, the Exchange would focus its investigative resources on "the most blatant and serious conduct", which tends to be cases where some form of public sanction may be warranted against the parties whose conduct is responsible for the breaches.
140. The Exchange adopts a thematic approach in its enforcement work. In 2016, the Listing Committee endorsed the following seven themes⁶⁵ for the Exchange's enforcement focus:
- (a) director's performance of fiduciary duties;
 - (b) financial reporting – delays, or internal controls and corporate governance issues;
 - (c) delayed trading resumption;
 - (d) failure of issuers and directors to cooperate with the Exchange's investigation;
 - (e) inaccurate, incomplete and/or misleading disclosure in corporate communication;
 - (f) failure to comply with procedural requirements in respect of notifiable/connected transactions; and
 - (g) repeated breaches of the Listing Rules.

⁶⁴ The Enforcement Policy Statement was first published by the Exchange in September 2013 and was updated in February 2017. In discharging its statutory duty, the Exchange would ensure an orderly, informed and fair market for the trading of securities listed on the Exchange.

⁶⁵ When the enforcement themes were first laid down in 2014, the Listing Committee approved five themes. In 2016, the scope of some themes were revised and (i) inaccurate, incomplete and/or misleading disclosure in corporate communication, (ii) failure to comply with procedural requirements in respect of notifiable/connected transactions and (iii) repeated breaches of the Listing Rules were added as new themes.

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 Statement⁶⁶. 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 investigations⁶⁷ 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 the Statement on Principles and Factors in Determining Sanctions and Directions Imposed by the Disciplinary Committee and the Review Committee (**Sanctions Statement**).

⁶⁷ The number represented cases concluded in the year and cases which remained active at year end.

⁶⁸ Comprising: (a) 16 related to directors' performance of their fiduciary duties (2016: 17); (b) five related to inaccurate, incomplete and/or misleading disclosure in corporate communication (2016: one); (c) seven related to failure to comply with procedural requirements in respect of notifiable/connected transactions (2016: seven); (d) one related to repeated breaches of the Listing Rules (2016: none); (e) 10 related to failure of companies and directors to cooperate with the Exchange's investigation (2016: four); (f) none related to delayed trading resumption (2016: one); (g) none related to financial reporting – delays, or internal controls and corporate governance issues (2016: one); and (h) 39 related to two or more of the specified themes (2016: 33).

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 team⁶⁹.
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, having particular regard to the interest of the investing public; (b) the enforcement approach to pursue the most blatant and serious conduct; (c) the criteria for assessing the appropriate level of enforcement action as set out in the Enforcement Policy Statement; and (d) whether the subject of the potential breach falls within the enforcement themes. We were subsequently informed by Listing Enforcement that its manual was updated on 25 April 2018 to include these factors⁷⁰.
147. If a referral is rejected, the relevant team would be informed of Listing Enforcement's decision (and the reasons for its decision) in writing⁷¹. If the referring team disagrees with the decision, it could provide further information for Listing Enforcement's consideration or raise the matter for discussion at the monthly Disciplinary Coordination Meetings⁷².

Initiation of an investigation

148. If Listing Enforcement decides to investigate a possible breach, the case would be assigned to a case officer who would conduct a pre-investigation assessment of the matter to identify the issues, scope and targets for the investigation. Once the pre-investigation assessment is approved by the supervisor of the case and the target investigation completion date is endorsed by the Head of Enforcement, investigation would commence.
149. The progress of investigation is discussed at the Disciplinary Coordination Meeting roughly every three months.

⁶⁹ See paragraphs 154 and 155.

⁷⁰ Note 2 of Listing Enforcement's Operating Manual: "Case Management: Treatment of Referrals and Merger/Split of Cases".

⁷¹ Listing Enforcement informed us that since the third quarter of 2018, it has started to include in such communication more detailed factors that it has taken into account in arriving at the decision to reject a referral.

⁷² Disciplinary Coordination Meetings provide a forum for cross-team discussions of issues which may have implications for any investigation or disciplinary proceedings. These meetings are attended by the Head of Listing, Chief Operating Officer of the Listing Department, Head of Enforcement, Head and Deputy Head of LIR team, Head of Policy and Secretariat Services Unit, Head of Accounting Affairs and all Enforcement professional staff.

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 paper⁷³ 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 factors⁷⁴ 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 disciplinary report and dispatch the report to the Listing (Disciplinary) Committee to commence disciplinary proceedings⁷⁵. If a case is to be disposed of by non-disciplinary action, Listing Enforcement may issue a warning or caution letter to the relevant parties or conclude that no further action is required.
153. The average time for completion of an investigation by Listing Enforcement in 2015, 2016 and 2017 was nine months, 8.2 months and 9.4⁷⁶ months, respectively.

Cases reviewed

154. During the relevant period, Listing Enforcement received 106 referrals from the Department's other operational teams, the majority of which were from the LIR team. Of these 106 referrals, Listing Enforcement rejected 39 cases (37%). The LIR team did not question the decisions of Listing Enforcement or escalate any of the rejected cases to the Disciplinary Coordination Meeting for discussion.

⁷³ The briefing paper sets out an analysis of the rule breaches, the recommended mode of disposal of the matter and the recommended sanctions and/or directions against each of the parties against whom disciplinary action is to be brought for consideration at the Disciplinary Coordination Meeting.

⁷⁴ See paragraph 141.

⁷⁵ Main Board rule 2A.09 and GEM rule 3.10 list the sanctions which can be imposed.

⁷⁶ According to HKEX's published statistics for the year ended 2017, the average time for completion of an investigation was 8.7 months; this was an error which is expected to be rectified in 2018.

155. Set out below are data compiled by the Exchange for the number of referrals received by Listing Enforcement and the number of referrals that were accepted or rejected for investigation in the relevant period⁷⁷:

Referred by:	2016			2017		
	Referral cases received	Accepted for investigation	Rejected	Referral cases received	Accepted for investigation	Rejected
LIR team	54	33	21	50	32	18
IPO Vetting Team	2	2	0	0	0	0
Others	4	2	2	6	3	3
Total	60	37	23	56	35	21

156. We reviewed the case files in relation to all 39 referrals made by the LIR team which were rejected by Listing Enforcement, including the referral memorandum and Listing Enforcement's written decision and reasons for the rejection. Below are our observations in some of these cases.

Failure to obtain shareholders' approval

157. An example cited by Listing Enforcement as serious misconduct⁷⁸ is failure to obtain the requisite shareholders' approval for a transaction. However, from our review of the files, we noted that Listing Enforcement did not take further action in a number of such cases for various reasons, for example, the issuer had a clean compliance record, there were no complaints received, shareholders' approval had subsequently been obtained and the conduct did not appear egregious. In these cases, Listing Enforcement recommended issuing a caution letter to the issuer.

Long suspected breach

158. In one rejected case, the issuer was suspended for six years as it failed to publish its financial results and annual reports as the manager of its key subsidiary would not cooperate in providing the financial records. The case was referred to Listing Enforcement six years after the breach first occurred, after all the issues relating to its suspension were resolved.

159. The Enforcement staff rejected the case as it took the view that (a) the delay in the publication of the financial statements was caused by a commercial dispute between the directors and the manager of the subsidiary and there was not much that the directors could have done to resolve the issue; and (b) it would be difficult to contact the relevant parties and they may have difficulty recollecting the facts of the case due to the lapse of time. It was not apparent from the files that the staff had considered whether the directors

⁷⁷ According to HKEX's 2017 Annual Report (page 38), the number of cases (including complaints) referred by the LIR team to Listing Enforcement for investigation was 35 and 40 in 2016 and 2017, respectively. These include referrals from the LIR team with full documentation and LIR's requests for preliminary discussions with Listing Enforcement which were subsequently accepted for investigation. The data above are provided by Listing Enforcement and represent the total number of referrals or enquiries made by the LIR team regardless of whether they were subsequently accepted for investigation.

⁷⁸ See paragraphs 139 and 146.

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.

Practical difficulties

163. We were informed by the team that one of the practical difficulties encountered by Listing Enforcement in taking enforcement action against directors of listed issuers is that the directors often resign and do not respond to its enquiries. In some cases, Listing Enforcement has not been able to take action against these individuals, except to include their names in the Department's Watch List⁷⁹ for future reference or publish a "Request for Assistance" notice on the HKEX website requesting assistance from the public for information about the individual to aid its enquiries. We noted cases where the Exchange pursued disciplinary action and obtained public sanctions against directors who failed to cooperate in Listing Enforcement's investigations, relying on a provision under the written undertakings by directors to the Exchange pursuant to which documents and notices can be effectively served on them by post or facsimile to the address they last provided.

SFC observations

164. As noted in paragraph 138, the Exchange's list of enforcement objectives focuses on preventing future breaches and influencing and changing the behaviour of issuers and other market players. While preventive measures are important, the Exchange also has a role to play in ensuring that any wrongful conduct is promptly terminated and rectified, and any harm caused to shareholders or the investing public is remedied to the extent possible. Section 21(2) of the SFO requires the Exchange to act in the interest of the public, having

⁷⁹ The Listing Department's Watch List acts as an alert for its staff in respect of individuals whose suitability to act as directors is called into question due to certain past conduct which gives rise to convictions, sanctions, breaches and/or inappropriate acts.

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 period⁸⁰.

165. We understand that the Exchange is conducting a review of the processes and procedures for its enforcement function. The Exchange should try to accelerate this process and examine whether this function can be discharged more effectively. We recommend that the Exchange should also review its enforcement objectives and practices to take into account termination and rectification of wrongful acts and remedies to investors.
166. The decision-making for accepting or rejecting a referral relies on the judgement of the Enforcement staff⁸¹. As noted in paragraph 147, Listing Enforcement's rejection of a referral would be escalated to the monthly Disciplinary Coordination Meeting if the referring team disagrees with the rejection. To strengthen the checks and balances for decisions relating to accepting or rejecting referrals, we recommend that some of these decisions (for example, those involving controversial or difficult issues) should be made by a committee comprising senior management of the Listing Department (for example, at the Disciplinary Coordination Meeting⁸²) or a sub-committee of the Listing Committee. The committee's reasons for rejecting a referral case or not to take further action in relation to a case should be properly documented.
167. As mentioned in paragraph 160, in considering whether to accept a referral case for further investigation, 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. We recommend that Listing Enforcement should, where appropriate (for example, when there are apparent omissions or inconsistencies in the representations or information provided by the issuers), conduct further enquiries to ascertain the facts and circumstances before making a decision. If the facts and circumstances surrounding the case cast doubt on the reliability of the representations or information provided by the issuer, the Enforcement staff should critically consider all relevant information before relying on the representations or information provided.
168. In relation to the case that was rejected due to the lapse of time (see paragraph 158 above), we were informed by the LIR team that its referral practice has since been revised. Going forward, the LIR team intends to refer suspected breaches by long-suspended companies to Listing Enforcement before the issues relating to the suspension are resolved.

⁸⁰ See rule 2A.09(6).

⁸¹ See paragraph 146 above.

⁸² According to Listing Enforcement's operating manual, where the Head of Enforcement considers it appropriate (eg, where novel issues are involved), Listing Enforcement may present a referral to the Disciplinary Coordination Meeting to discuss whether the matter should be investigated and, if so, the scope of the investigation.

169. The number of listed issuers increased by 13.5% from 2015 to 2017⁸³. Over the same period, there was a steady increase in the number of investigations of Listing Rules breaches handled by the Exchange⁸⁴. The number of outstanding investigations also increased from 22 at the end of 2015 to 32 in 2016 before paring down to 28 at the end of 2017. The number of cases pending disposal and disciplinary action tripled from 2015 to 2017. Despite the increase in the number of listed issuers and investigations handled by the Exchange and the complexity of corporate transactions over the same period, we noted that the actual professional headcount of Listing Enforcement remained unchanged at 10; in fact, Listing Enforcement was one person short at the end of 2017⁸⁵. We recommend that the Exchange should assess whether its resources and enforcement capabilities are adequate.

⁸³ The number of the listed issuers increased from 1,866 in 2015 to 2,118 in 2017 representing an increase of 252 (13.5%).

⁸⁴ See paragraphs 142 to 144.

⁸⁵ The budgeted professional headcount approved in 2017 was 11. See paragraph 192.

Our review of HKEX's 2016 and 2017 Annual Reports on the operations of the Listing Department

Overview

170. The following table indicates the level of operational activity reported by the Exchange in its listing regulation for 2013, 2014, 2015, 2016 and 2017⁸⁶.

	2013	2014	2015	2016	2017
Number of listing applications accepted for vetting by the IPO Vetting Team	177	194	217	275	310
Number of listing applications vetted by the IPO Vetting Team ⁸⁷	227	232	256	349	412
Number of applications for which approval was granted in principle	146	148	151	181	216
Number of compliance and monitoring actions handled by the LIR team ⁸⁸	49,103	58,450	71,088	64,932	66,368
Number of investigations handled by the Enforcement Team	69	60	52	71	86
Number of Listing Decisions published	38 ⁸⁹	8	8	11	14
Number of Guidance Letters published	24 ⁹⁰	10	5	5	0
Number of FAQs published	6 series	5 series	1 series	1 series	3 series
Number of other guidance materials published	9	6	3	3	2
Number of listing applications processed by the Structured Products Team ⁹¹	16,212	17,543	17,549	13,771	21,224
- Derivative warrants	7,264	7,560	6,336	4,875	7,989
- Callable bull/bear Contracts (more commonly known as CBBCs)	8,948	9,983	11,213	8,896	13,235

IPOs

171. The number of listing applications accepted for vetting by the Exchange was 310 in 2017, 275 in 2016 and 217 in 2015, representing an increase of 35 (or 12.7%) in 2017 and 58 (or 26.7%) in 2016.

⁸⁶ Source: HKEX 2017 Annual Report, pages 38-39.

⁸⁷ The number comprises new listing applications accepted in the current year (including GEM transfer applications) and listing applications brought forward from the previous year.

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. The average time between the receipt of the application and the issue of the first comment letter in 2017 was 21 business days (2016: 16 business days; 2015: 11 business days). The Exchange explained that the increase in the time taken to issue the first comment letter in 2017 and 2016 was a result of a significant increase in the number of listing applications and the complexities of some cases.
174. The percentage of listing applications presented to the Listing Committee for hearing within 120 days was 31% in 2017 (2016: 53%; 2015: 70%). The number of listing applications approved in principle for listing by the Exchange was 216 in 2017, 181 in 2016 and 151 in 2015, representing an increase of 35 (or 19.3%) in 2017 and an increase of 30 (or 19.9%) in 2016. The increase is in line with the increase in the number of listing applications vetted by the Exchange.
175. In 2017, the IPO Vetting Team did not publish any guidance letter (2016: three; 2015: two) but published two listing decisions⁹² (2016: two; 2015: four).
176. The actual and budgeted numbers of professional staff on the IPO Vetting Team during the relevant period were as follows:

	At 31 December 2015	Change	At 31 December 2016	Change	At 31 December 2017
Actual	47	+ 1 (+ 2.1%)	48	+ 3 (+ 6.3%)	51
Budgeted	49	+ 2 (+ 4.1%)	51	+ 1 (+ 2.0%)	52

⁸⁸ Compliance and monitoring actions include announcements and circulars vetted, share price and trading volume monitoring actions undertaken and complaints handled.

⁸⁹ 13 out of 38 related to Chapter 18 of the Listing Rules (Mineral Companies).

⁹⁰ 10 out of 24 related to rule changes to complement the new sponsor regulations; five out of 24 related to simplification of the listing documents.

⁹¹ The figures referred to new structured products issues and did not include further issues.

⁹² Guidance letter “Placing to connected clients, and existing shareholders or their close associates, under the Rules” (January 2016), “Guide on Producing Simplified Listing Documents Relating to Equity Securities for New Applications” (February 2016), “Guidance on issues related to “controlling shareholder” and related Listing Rules implications” (November 2016).

Listing Decision “To provide guidance on why the Exchange rejected certain listing applications” (April 2016, May 2017), Listing Decision “To provide guidance on why the Exchange returned certain listing applications” (April 2016, May 2017).

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 decrease⁹³ 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 bodies⁹⁴ 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 intention to delist the company under the Listing Rules to three listed issuers in 2017 (2016: one; 2015: four).

181. In terms of turnaround time, the Exchange:

- (a) post-vetted results announcements within five business days of publication in 97% of the cases in 2017 and in 96% of the cases in 2016 (2015: 99%);
- (b) post-vetted other announcements within one business day of publication in 99% of the cases in both 2017 and 2016 (2015: 97%); and
- (c) pre-vetted announcements⁹⁵ within the same day in 96% of the cases in 2017 and in 98% of the cases in 2016 (2015: 96%).

182. In 2017, the LIR team did not issue any guidance letters (2016: two; 2015: three) but issued 12 listing decisions⁹⁶ (2016: nine; 2015: four).

⁹³ In particular, the share price and trading volume monitoring actions undertaken have decreased significantly from 13,757 in 2015 to 6,279 in 2016 and 6,461 in 2017.

⁹⁴ The Securities and Futures Commission, the Financial Reporting Council and other regulatory bodies.

⁹⁵ These primarily comprised announcements made in relation to a very substantial acquisition, very substantial disposal, reverse takeover and cash company, which are required to be pre-vetted by the Exchange under the Listing Rules.

⁹⁶ Guidance letter "Guidance for issuers subject to market commentaries or rumours" (April 2016), "Guidance on bonus issues of shares" (April 2016).

Listing Decision "Whether the Exchange would waive the assured entitlement requirement for Company A's spin-off proposal" (January 2017), Listing Decision "Whether Company A has a sufficient level of operations or assets to meet GEM Rule 17.26" (April 2017), Listing Decision "Whether Company A's proposed acquisition of the Target constituted

183. The Exchange reported that, in 2016 and 2017, it continued its initiative to promote self-compliance by listed issuers with the Listing Rules. This initiative was pursued primarily through issuing guidance materials, holding educational seminars and conferences on Listing Rule issues and publishing reports on its reviews of listed issuers' annual reports and corporate governance practices.
184. The actual and budgeted headcounts for professional staff on the LIR team during the relevant period were as follows:

	At 31 December 2015	Change	At 31 December 2016	Change	At 31 December 2017
Actual	67	+ 5 (+ 7.5%)	72	+ 2 (+ 2.8%)	74
Budgeted	68	+ 6 (+ 8.8%)	74	+ 2 (+2.7%)	76

SFC observations

185. As noted above, the caseload of the IPO Vetting Team increased by 18.1% in 2017 and 36.3% in 2016 (see paragraph 172); while the number of LIR actions handled by the LIR team increased by 2.2% in 2017 following a 8.7% decrease in 2016 (see paragraph 177).
186. Actual headcount for the IPO Vetting Team at the end of 2016 increased by three to 51 at the end of 2017, following a slight increase of one from 47 at the end of 2015. The Exchange advised us that the headcount for the IPO Vetting Team has increased by 19 (or 37.3%) in 2018.
187. Actual headcount for the LIR team increased by five from 2015 to 72 at the end of 2016 and further increased by two to 74 at the end of 2017. In each of 2016 and 2017, actual headcount fell short of the budgeted headcount by two. The Exchange advised us that the headcount for the LIR team has increased by 13 (or 17.6%) in 2018.

a reverse takeover or an extreme VSA" (June 2017), Listing Decision "Whether Company A would be required to aggregate the proposed acquisition with a previous acquisition, and whether these acquisitions would constitute a reverse takeover" (June 2017), Listing Decision "Whether the Exchange would commence the procedures to cancel the listing of Company A whose shares had been suspended for a prolonged period due to insufficient public float" (June 2017), Listing Decision "Whether the Exchange would exercise its power to deem Company B as a connected person of Company A under Main Board Listing Rule 14A.19" (October 2017), Listing Decision "Whether Company A would have sufficient operations or assets under Rule 13.24 after a proposed major disposal" (October 2017), Listing Decision "Whether the Exchange would impose additional requirements under Rule 2.04 on Company A's proposed disposal of its original business" (October 2017), Listing Decision "Whether Company A was no longer suitable for listing" (October 2017), Listing Decision "Whether Company A had a sufficient level of operations or sufficient assets to meet Main Board Rule 13.24" (November 2017), Listing Decision "Whether Company A had a sufficient level of operations or sufficient assets to meet Main Board Rule 13.24" (November 2017), Listing Decision "Whether Company A (excluding its interest in Newco) could meet the new listing requirements of Chapter 8 of the Main Board Rules" (November 2017).

Listing Decision "Whether the Company A (excluding its interest in Newco) could rely on the unrealised fair value gains on investment properties to meet the profit requirement under Rule 8.05(1)(a)" (March 2016), "Whether Company A's proposed subscription of an interest in the Fund would be a reverse takeover" (March 2016), "Whether Company A's proposed acquisition of an interest in the Target from Mr. B would be a reverse takeover" (March 2016), "Whether Company A's proposed acquisition of the Target would be a reverse takeover" (March 2016), "Whether Company A would have sufficient operations or assets under Rule 13.24 after a major disposal" (March 2016), "Whether Company A would have sufficient operations or assets under Rule 13.24 after the disposal" (March 2016), "Whether Company A would have sufficient operations or assets under Rule 13.24 after the disposal" (March 2016), "Whether the Exchange would grant listing approval for the proposed rights issue of Company A" (December 2016), "Whether the Exchange would approve a share subdivision proposed by Company A" (December 2016).

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).