Client alert

Rule changes following consultation on backdoor listings and continuing listing criteria

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Introduction

On 26 July 2019, the Hong Kong Stock Exchange (Exchange) published a paper outlining its conclusions following a consultation on backdoor listings and continuing listing criteria, as well as related amendments to the Exchange's listing rules (Listing Rules), which are due to take effect on 1 October 2019. The paper was accompanied by three guidance letters (GL104-19, GL105-19 and GL106-19) and a frequently asked questions (FAQ No. 057-2019), providing guidance on these changes to the Listing Rules. On the same day, the Securities and Futures Commission (SFC) also published its "Statement on the SFC's approach to backdoor listings and shell activities", analysing the factors that the SFC may consider relevant in determining whether or not to exercise its statutory powers to investigate or require the suspension of trading of a listed issuer.

The changes to the Listing Rules are mainly driven by securities regulators' policy of combatting backdoor listings and shell activities, and include codification of the principles underlying the Listing Rules (as set out in guidance letters published by the Exchange previously) and other amendments that are considered necessary based on the regulators' observation that a range of corporate activities achieved backdoor listing and set up or maintained shell companies over a period of time, to work around the Listing Rules then prevailing.

In this newsletter, we have included only references to the Main Board Listing Rules ("LR"). However corresponding changes have also been made to the GEM Listing Rules.

Summary

Under the revised regime, the Exchange will mainly use a four-pronged approach, which in broad terms involves:

- **Reverse takeover (RTO) rules** (LR 14.06B) to deal with any acquisition, or series of acquisitions over a period of, generally, 36 months (previously, 24 months), that is intended to circumvent the new listing requirements, while allowing 'extreme transactions' as a new class of non-circumventing transactions to allow necessary business growth.
- **Sufficiency of operations and cash company tests** (LR13.24 and LR14.82), which allow the Exchange proactively to address issuers with shell company characteristics.
- A new rule for **large-scale issues of securities** (LR14.06D) to deal with financing for disproportionately large greenfield sites or new, 'home-grown' businesses, to be differentiated from LR7.27B (introduced in 2018), which focused on dilution of the value of shareholders' interests.
- **Restrictions on disposal and distribution in specie** (LR14.06E and LR14.94) to deal with the various means by which issuers may seek to dispose of assets or businesses to facilitate the sale of listed shell companies.
- **General powers under LR2.04** (to impose additional requirements on issuers) and rule 6.01(4) (to direct suspension or cancel listing due to unsuitability for listing) for circumstances or activities that are not specifically caught by the above rules.

The new rules (and related guidance letters) will come into effect on 1 October 2019, with a subsequent transitional period of 12 months applicable to sufficiency of operations and cash company tests for issuers that are able to comply with current requirements. The transitional period does not apply to issuers that become non-compliant after the new rules come into effect.

De facto control

The new rules introduce the concept of 'de facto control' to add to a change of control for the purposes of Hong Kong Takeovers Code (Code Control) in the assessment of RTOs or whether a transaction can be considered an 'extreme transaction'.

Factors relevant in determining whether or not there has been any change in de facto control include:

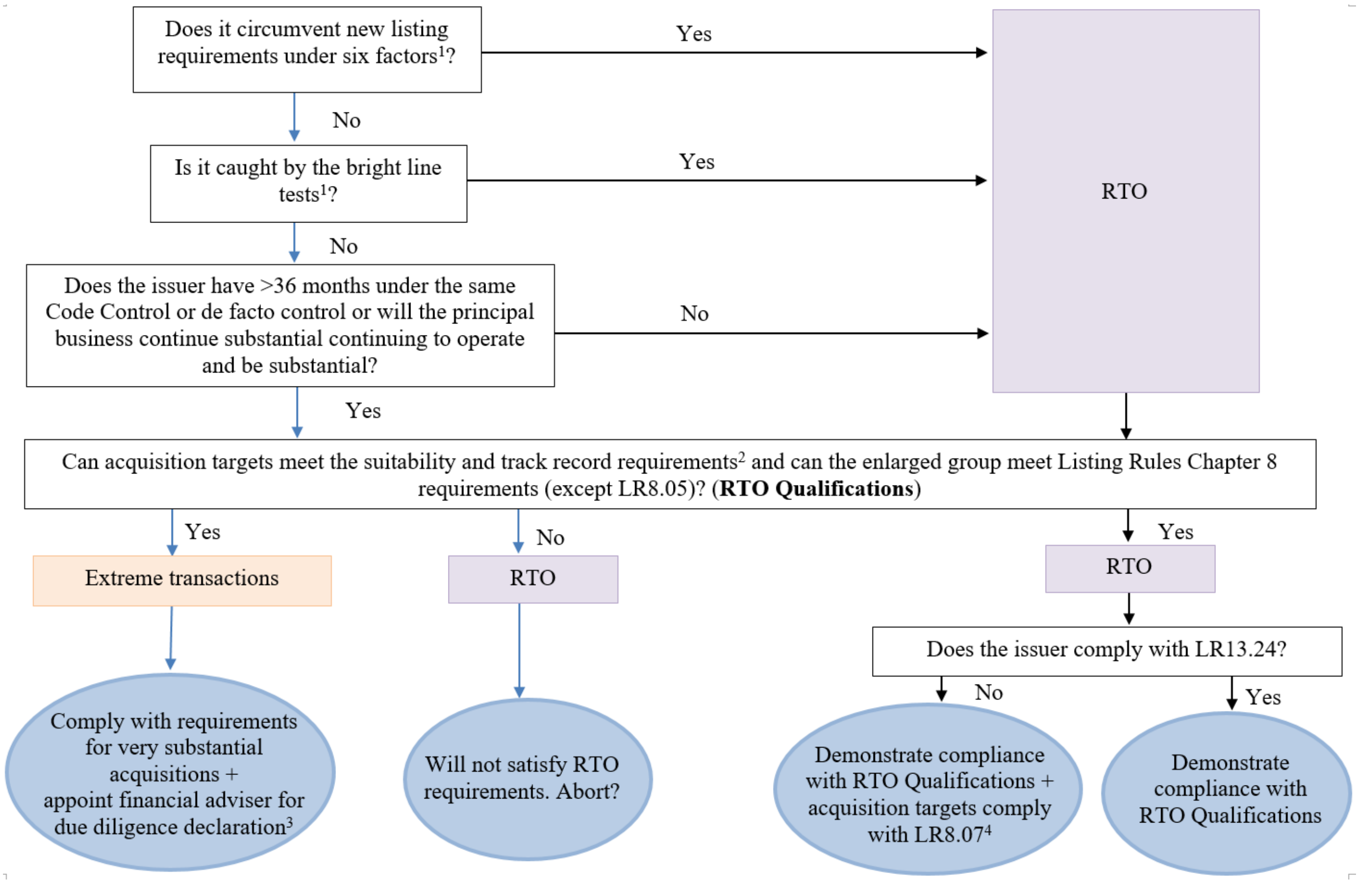
i. whether there has been **any change in the single largest substantial shareholder who is able to exercise effective control over the issuer**, e.g., a substantial change to its board of directors and/or senior management, or to the executive function; and

ii. whether **convertible securities** are issued to a vendor by way of a conversion restriction mechanism to avoid triggering a change in Code Control, thereby **allowing the vendor to effectively control the issuer**.

The introduction of a new substantial (non-controlling) shareholder that is a passive investor does not normally fall within this rule.

RTO rules and extreme transactions

The following diagram is a simplified illustration of how acquisitions (or the last in a series of acquisitions) may be caught by the new rules:



Notes:

1 The **six factors** are a modified version of the six principles based assessment determining whether an acquisition or series of acquisitions constitutes a circumvention of new listing requirements set out in previous guidance letters (see below). The bright line tests are also described further below.

2 The **suitability and track record requirements** means the requirements under LR8.04 and LR8.05 (or LR8.05A and 8.05B).

3 The issuer is required to appoint a financial adviser to conduct due diligence on the acquisition targets and issue the prescribed declaration to the Exchange (akin to an IPO sponsor declaration).

4 The issuer must demonstrate sufficient public interest in the business of the acquisition targets.

The bright line tests

The bright line tests (which involve, in brief, a very substantial acquisition and a change of Code Control as part of the acquisition or, over a period of time, a series of acquisitions) remain the same, except that the 24-month period for a series of acquisitions that enable any person(s) or their associates to acquire Code Control is extended to 36 months.

Arrangements or transactions outside of the 36-month period can be taken into account if there is a clear nexus between the transactions or arrangements or there are specific concerns about circumvention of the RTO rules. Examples given include:

- A transaction proposed shortly after (and likely contemplated within) the end of the 36-month period
- An acquisition of a target business that was previously terminated or downsized because it was treated as an RTO
- An acquisition with an option to make further business acquisitions after the end of the 36-month period

A series of transactions normally refers to acquisitions that **bear some relationship with each other**, for example, acquisitions that are part of a similar line of business, acquisition of interests in the same company or group of companies, or acquisitions of businesses from the same, or a related, party.

To determine if an acquisition or series of acquisitions is substantial, the Exchange would normally compare:

- aggregate financial figures or consideration (at the time of the respective acquisition(s)); against
- the lower of the issuer's latest published financial figures or market capitalisation (i) before the first transaction or (ii) at the time of the last transaction in the series.

Securities transactions will be aggregated if they relate to the same company or group of companies, to the same counterparty, or to companies that are connected or otherwise associated with each other; or if they together lead to substantial involvement in a new business that was not previously a principal business of the issuer.

The general rule and the six factors

The general definition of RTO in LR14.06B remains largely unchanged. It applies to 'acquisition targets', a new term referring to all targets that are part of a series of transactions or arrangements that constitute an attempt to circumvent the new listing requirements.

The Exchange will normally consider the following six factors:

- **the size of transaction(s)** relative to the size of the issuer;
- whether there is a **fundamental change in the issuer's business**;
- **the nature and scale of the issuer's business** prior to the acquisition(s);
- **the quality** of the acquisition targets;
- **a change in Code Control or de facto control**; and
- whether the listing (normally within 36 months) of the acquisition targets constitutes a **series of transactions or arrangements**.

An issuer may be considered to have made a "fundamental change in business" if it acquires a target business that is completely different from, and substantially larger than, its existing business. In these circumstances, the Exchange will compare the size of the acquisition targets (at the time of their respective acquisitions) against the size of the original business (at the time of the last transaction in the series).

The Exchange does not intend to restrict acquisitions that are part of the issuer's business strategy for its existing operations or are consistent with the issuer's size and resources, or to prevent an issuer with an established business from acquiring a company from a completely different area of business to diversify operations and income streams.

The disposal of a business following an acquisition or series of acquisitions may be subject to RTO rules, and sufficiency of operations assessments may be performed in respect of the acquisition targets and the issuer.

Extreme transactions

These are acquisitions or a series of acquisitions that may have the effect of achieving a listing of the acquisition targets, but with the following attributes:

- the issuer can demonstrate to the satisfaction of the Exchange that it has not circumvented the new listing requirements; and

- there has been a long period (of at least 36 months) under the same Code Control or de facto control or the principal business following the transaction will be substantial and will continue operations; and
- the acquisition targets can meet the suitability and track record requirements and the enlarged company meets Listing Rules Chapter 8 requirements (except LR8.05).

An annual revenue or total asset value of HK$1 billion may be indicative of an issuer of substantial size, depending on the issuer's financial position, nature, business operating model and future business plans.

Sufficiency of operations and cash company tests

Issuers must carry out, directly or indirectly, a business with a sufficient level of operations and (as opposed to "or") assets of sufficient value to support its operations, i.e. issuers are non-compliant if they have significant assets but do not have a sufficient level of operations or whose business is not substantial, or is not viable and sustainable.

Proprietary trading and investment in securities are normally excluded except for investment companies listed under Listing Rules Chapter 21 and investment activities carried out by a banking company, insurance company or securities house in the ordinary course of business. Proprietary trading by a securities house that accounts for a significant part of its business does not count. The 'revenue exemption' under LR14.04(1)(g) will exclude securities investments for treasury management purposes. In addition, it should be noted that LD53-2, which sets out the Exchange's position on treasury activities, will be withdrawn.

The **cash company rule** (LR14.82) refers to companies whose assets consist wholly or substantially of cash and/or 'short term investments'(instead of 'short dated securities' under the existing Listing Rules). Short term investments include listed securities or other financial instruments that are readily realisable or convertible into cash, in addition to debt securities that mature in less than one year. The Exchange will normally take into account the value of cash and/or short term investments relative to the issuer's total assets, level of operations, financial position, nature of business and day-to-day cash needs.

The issuer has the burden to prove the sufficiency of its operations. GL106-19 (paragraph 23) sets out the information required from the issuer to demonstrate that it has a substantial business which is viable and sustainable. Issuers should therefore bear these factors in mind when they prepare their Management's Discussion and Analysis as part of their financial reporting.

A business may be considered **not viable or sustainable** if:

- it has a very low level of operating activities and revenue (e.g., revenue is less than corporate expenses);
- the current small scale of its operations is not a result of a **temporary** downturn or reduction or suspension of operations due to its market or business strategy (e.g., long-term losses); or
- it does not have sufficient assets to support an operation capable of generating sufficient revenue and profit to warrant a listing.

A **business of no substance** includes businesses that (a) rely on a limited number of transactions or customers or have a single source of business, (b) have very low barriers to entry, (c) can easily be established and discontinued without significant costs, (d) are asset-light or (e) the basis for generating substantial fees or revenue is unclear or questionable. Small-sized money lenders or indent trading businesses are cited as business types that are more prone to fall within this category.

The sufficiency of operations and/or cash company rules are likely to be invoked:

- As part of regular monitoring of the issuer's financial reporting
- When an issuer's corporate activities involve a disposal or have the effect of discontinuing its principal business (or a material part of it)
- When an issuer establishes or acquires one or more new businesses after disposing of or otherwise substantially scaling down its existing principal business
- In the context of an RTO assessment

Large-scale issues of securities

The restriction applies to issues of new securities (shares and equity derivatives) for cash to acquire and/or develop a new business (that may have started before the equity fund-raising) which the Exchange considers to be part of an attempt at achieving a backdoor listing, e.g., where there has been, or the transaction will result in, a change of Code Control or de facto control of the issuer, and the new business is expected to be substantially larger than the issuer's existing principal business.

To determine whether a proposed issue is likely to fall within this rule, the Exchange will consider whether, after taking into account the proceeds from the issue (including any that are earmarked for specific purposes), less than **50 per cent. of the issuer's assets would consist of cash following the issue**. Prior consultation with the Exchange is recommended before launching an issue that may fall under this rule.

Restrictions on disposal and distribution in specie

The disposal or distribution in specie (or a series of disposals or distributions) of **all or a material part of the existing business** of an issuer is prohibited in connection with a change of Code Control or within 36 months thereafter. An exception is where the remaining business of the issuer or the assets acquired after such change of Code Control can meet the suitability and track record requirements. This may also apply where there is a change of de facto control.

Where the distribution in specie involves assets that would amount to a very substantial disposal (the 75 per cent. test), the following requirements apply:

- **special shareholders' approval** (75 per cent. of permitted votes cast at a shareholders' meeting are in favour of the distribution and less than 10 per cent. of permitted votes are against) is needed, with the controlling shareholder (or, if there is no controlling shareholder, the directors other than the independent non-executive directors (INED) and the chief executive) being required to abstain from voting; and

- reasonable **cash amounts or other liquid alternative** to distributed assets must be offered to the issuer's shareholders (other than non-INED directors, the chief executive and controlling shareholders).

Other rule changes

- An obligation to announce any change in or failure to meet the **profit or performance guarantees provided for notifiable transactions** (LR14.36B and LR14A.63), including the reasons for such change or failure, the fairness of the change, details of any shortfall to any profits or performance target, and the status of any decision with respect to rights to compensation, consideration adjustments and/or put options, together with the board's views, as well as an obligation to disclose the same in the company's annual report.

- An obligation to **disclose all counterparty identities and business activities** (LR14.58 and LR14A.68) instead of limiting disclosure to companies or other entities; and, for connected transactions, a further obligation to disclose the identities and business activities of the ultimate beneficial owners of the counterparty.

- An obligation to **report significant investments** (App. 16, para. 32(4A)) i.e., those that meet the 5 per cent. total assets test, including details of their performance and investment strategy, etc.

- Clarification in FAQ057-2019 that **securities transactions can be aggregated** if they relate to the same company (or group of companies) or counterparty, or to companies that are connected to or associated with each other, or if the transactions together lead to substantial involvement in a new business that was not a principal business of the issuer prior to the transaction.

Key contacts

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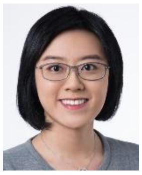

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