New rules to combat backdoor listings will take effect in October 2019

On 26 July 2019, The Stock Exchange of Hong Kong Limited (Exchange) announced conclusions on its consultation paper published last June regarding backdoor listing, continuing listing criteria and other Listing Rule amendments (see our previous client alert on the consultation proposals), as part of its initiatives to address concerns over backdoor listings and “shell” activities.

The Exchange decided to implement the consultation proposals, with modifications.

The Listing Rule amendments will take effect on 1 October 2019.

The key Listing Rule changes are summarised below.

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<thead>
<tr>
<th>Current position</th>
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<tr>
<td><strong>A. Rule amendments relating to backdoor listing</strong></td>
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<tr>
<td><strong>1. Modifying the definition of “reverse takeover” (RTO)</strong></td>
<td>To codify the six assessment factors under the principle based test in Guidance Letter GL78-14, with the following modifications made to the last two factors:</td>
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<td>(a) Principle based test</td>
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<td>RTO is defined under the Listing Rules as an acquisition (or series of acquisitions) which constitute, in the opinion of the Exchange, 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”.</td>
<td><strong>Change in control or de facto control</strong></td>
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<td>In May 2014, the Exchange published Guidance Letter GL78-14 which provides guidance on its application of the RTO rules. In particular, it sets out the following six assessment criteria that the Exchange would take into account in considering whether the “principle based test” applies:</td>
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<td>• transaction size</td>
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<td>• quality of the business to be acquired</td>
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<td>• nature and scale of the issuer's business</td>
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<td>• any fundamental change in the issuer's principal business</td>
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<td>• <strong>issue of restricted convertible securities</strong></td>
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<td>• <strong>series of transactions and/or arrangements to circumvent the RTO rules</strong></td>
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<td>In assessing whether there has been a change in control or de facto control of the issuer, the Exchange will consider (i) any change in the controlling shareholder of the issuer; or (ii) any change in the single largest substantial shareholder who is able to exercise effective control over the issuer, as indicated by factors such as a substantial change to its board of directors and/or senior management.</td>
<td><strong>Series of transactions and/or arrangements</strong></td>
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<td>The amended rule provides that these transactions or arrangements may include changes in control/de facto control, acquisitions and/or disposals that take place in a reasonable proximity to each other (which normally refers to a period of <strong>36 months</strong> or less) or are otherwise related.</td>
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(b) Bright line tests

The current Listing Rules set out two specific forms of RTOs:

(a) an acquisition or a series of acquisitions of assets constituting a very substantial acquisition where there is or which will result in a change in control (as defined in the Takeovers Code); or

(b) very substantial acquisition(s) of assets (individually or in aggregate) from the new controlling shareholder and its associates within **24 months** following a change in control (as defined in the Takeovers Code).

To extend the aggregation period from 24 months to **36 months**.

(c) Disposal restriction

To complement the bright line tests, the Listing Rules restrict an issuer from disposing of its existing business within **24 months** after a change in control, unless the asset injection(s) from the new controlling shareholder and his associates and any assets acquired during the period leading to and after the change in control would meet the requirements for a new listing application.

To modify the bright line tests to restrict disposals (or distributions in specie) of all or a **material** part of the issuer’s business proposed at the time of or within **36 months** after a change in control of the issuer, unless the remaining group, or the assets acquired from the person or group of persons gaining such control or his/their associates and any other assets acquired by the listed issuer after such change in control, can meet the track record requirements.

The Exchange may also apply the restriction to disposals (or distributions in specie) at the time of or within 36 months after a change in de facto control (as set out in the principle based test) of the issuer.

(d) Backdoor listings through large scale issue of securities

In December 2015, the Exchange issued Guidance Letter GL84-15 explaining the circumstances under which the Exchange would apply the cash company rules to disallow large scale issues of securities where the funds raised would be used to start a greenfield operation which, in the opinion of the Exchange, is a means to circumvent the new listing requirements and to achieve a listing of that greenfield operation.

To codify Guidance Letter GL84-15 to disallow backdoor listing through large scale issue of securities for cash, where there is, or will result in, a change in control or de facto control of the issuer, and the proceeds will be applied to acquire and/or develop new business that is expected to be substantially larger than the issuer’s existing principal business.

2. Codifying the “extreme very substantial acquisition” requirements with modifications

Guidance Letter GL78-14 provides that a transaction which falls outside the bright line tests but which is considered to be “extreme” by the Exchange with reference to six assessment criteria mentioned in section A1(a) above would be treated as an “**extreme very substantial acquisition**” (but not a RTO) where the issuer can demonstrate that the target business meets the eligibility and suitability for new listing requirements and that circumvention of the new listing requirements would

To codify the “**extreme very substantial acquisition**” requirements in Guidance Letter GL78-14 and rename this category of transactions as “**extreme transactions**”.

To impose additional eligibility criteria on the issuer that may use this transaction category: (a) the issuer must operate a **principal business of substantial size**; or (b) the issuer must have been under the control or de facto control of the same person(s) for a long period (normally not less than 36 months) and the transaction will not result in a change in
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<td>not be a material concern.</td>
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### 3. Imposing additional requirements applicable to RTOs and “extreme transactions”

Under the current Listing Rules, the Exchange will treat a listed issuer proposing a RTO as if it were a new listing applicant.

The enlarged group or the acquisition targets must be able to meet the track record requirements and the enlarged group must be able to meet all the other basic listing conditions. This requirement also applies to extreme very substantial acquisitions currently.

To require the acquisition targets in a RTO or extreme transaction to meet the requirements of Rule 8.04 (i.e. suitability for listing) and Rule 8.05 (or Rule 8.05A or 8.05B) (i.e. track record requirements), and the enlarged group to meet all the new listing requirements in Chapter 8 of the Listing Rules except Rule 8.05.

Where the RTO is proposed by an issuer that fails to meet the requirements under Rule 13.24 (which requires an issuer to have sufficient operations and assets of sufficient value to warrant its continued listing), the acquisition targets must also meet the requirement of Rule 8.07 (i.e. requirement to have sufficient public interest).

The current Listing Rules require an issuer proposing a RTO to comply with the procedures and requirements for new listing applications, including documentary requirements such as accountants’ reports and pro forma financial information. For RTO involving a series of acquisitions, some of which may have taken place over a few years, the current Listing Rules do not provide guidance on how the track record of the acquisitions would be determined and the financial information to be presented.

To clarify that, for extreme transactions and RTOs that involve a series of transactions and/or arrangements, the track record period for the completed acquisition(s) and the latest proposed transaction in the series would be referenced to the latest proposed transaction and covers the three financial years immediately prior to the issue of the circular for that transaction.

To require issuers to submit financial information of the acquisition targets based on accountants’ reports or audited financial information to the Exchange to demonstrate compliance with Rule 8.05.

### B. Rule amendments relating to continuing listing criteria

#### 1. Sufficiency of operations

The current Listing Rules requires that an issuer must carry out a sufficient level of operations or have tangible assets of sufficient value and/or intangible assets for which a sufficient potential value can be demonstrated to the Exchange to warrant the continued listing of the issuer’s securities.

To require an issuer to carry out a business with a sufficient level of operations and to have assets of sufficient value to support its operations to warrant its continued listing.

Proprietary securities trading and/or investment activities by an issuer’s group (other than a Chapter 21 company) are normally excluded when considering whether the issuer can meet this requirement (except for those carried out by a member of the issuer’s group that is a banking company, an insurance company, or a securities house that is mainly engaged in regulated activities under the Securities and Futures Ordinance (SFO)).

#### 2. Cash companies

Under the current Listing Rules, where for any reason the assets of a listed issuer consist wholly or substantially of cash or short-dated securities, it will not be regarded as suitable for listing. Short-dated

To extend the definition of “short-dated securities” to cover investments that are easily convertible into cash and rename it as “short-term investments”.

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<td>securities mean securities such as bonds, bills or notes that have less than one year to maturity. The cash company rules do not apply to a Chapter 21 company or an issuer solely or mainly engaged in the securities brokerage business.</td>
<td>To confine the exemption to cash and short-term investments held by members of an issuer’s group that are <strong>banking companies, insurance companies or securities houses</strong>, but this exemption will not apply to an issuer that operates a securities house where the Exchange has concerns that the issuer is holding cash and short-term investments through the member to circumvent the cash company rules.</td>
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3. **Transitional arrangements**

| | A transitional period of **12 months** from the effective date of the Listing Rule amendments (i.e. 1 October 2019) will apply to listed issuers that do not comply with the amended Listing Rules relating to sufficiency of operations or cash companies strictly as a result of the Listing Rule amendments. |

C. **Other Rule amendments**

1. **Securities transactions**

| Transactions that are of a revenue nature in the issuer’s ordinary and usual course of business are fully exempt from the notifiable transaction requirements under the current Listing Rules (revenue exemption). In recent years, some issuers have reported securities trading / investment as one of their principal business activities and claimed revenue exemption for their securities trading activities. | To confine the revenue exemption from the notifiable transaction requirements for purchases and sales of securities to cases where they are conducted by **banking companies, insurance companies and securities houses** that are mainly engaged in regulated activities under the SFO. |

The current Listing Rules require issuers to disclose in annual reports **significant investments** held, their performance during the financial year, and future prospects.

2. **Significant distribution in specie of unlisted assets**

<p>| As set out in Listing Decision LD75-4, the Exchange requires issuers who intend to conduct significant distributions in specie of unlisted assets (which amounts to a very substantial disposal) to obtain prior approval of the distribution from independent shareholders in a general meeting. The approval should be given by at least 75% of the votes attaching to any class of listed securities held by holders voting either in person or by proxy at the meeting, and the number of votes cast against the resolution must not be more than 10% of the votes attaching to any class of listed securities held by holders permitted to vote in person or by proxy at | To codify Listing Decision LD75-4 to impose additional requirements where an issuer proposes a significant distribution in specie of unlisted assets comparable to requirements for a withdrawal of listing. |</p>
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<td>the meeting. Further, the issuers’ shareholders (other than the directors (excluding independent non-executive directors), chief executive and controlling shareholders) should be offered a reasonable cash alternative or other reasonable alternative for the distributed assets.</td>
<td>To require (i) disclosure on the outcome of any guarantee on the financial performance of an acquisition target that is subject to the notifiable or connected transaction requirements (irrespective of whether the guaranteed financial performance is met) in the next annual report; and (ii) disclosure by way of an announcement if (a) there is any subsequent change to the terms of the guarantee; or (b) the actual financial performance of the target acquired fails to meet the guarantee.</td>
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3. **Other matters relating to notifiable or connected transactions**

The current Listing Rules set out the information required to be disclosed in an announcement and the next annual report in relation to any financial performance guarantee given by a connected person where the actual financial performance fails to meet the guarantee.

Where an independent party provides a financial performance guarantee, the current rules do not provide any specific disclosure requirements in this regard, but the Exchange has recommended in a report on its review of annual report disclosures that as a matter of accountability and transparency, issuers should follow the disclosure requirements even where the counterparty is independent, and should make these disclosures in all circumstances involving financial performance guarantees (including where the financial performance guaranteed was met).

The current Listing Rules require issuers to disclose in notifiable transaction and connected transaction announcements a general description of the principal business activities of the parties to the transaction (if the counterparty is a company or entity).

For connected transactions, the current Listing Rules require issuers to disclose the identity and activities of the parties to the transaction and of their ultimate beneficial owners in the circulars.

Under the current Listing Rules, issuers are required to classify the size of a notifiable or connected transaction using five percentage ratios, which are generally based on the latest published financial positions of the issuers, which may not reflect the current financial position of the issuer in some cases, e.g., where the issuer made a material disposal shortly before an acquisition.

To require (i) disclosure on the identities of the parties to a transaction in the announcements and circulars of notifiable transactions; and (ii) disclosure on the identities and activities of the parties to the transaction and of their ultimate beneficial owners in the announcements of connected transactions.

To make it clear that where any calculation of the percentage ratios produces an anomalous result or is inappropriate to the sphere of activity of the listed issuer, the Exchange (or the issuer) may apply an alternative size test that it considers appropriate to assess the materiality of a transaction under Chapter 14 or 14A.
To provide clarifications and guidance on the application of the amended Listing Rules, the Exchange also published:

- Guidance on application of the reverse takeover rules (HKEX-GL104-19);
- Guidance on large scale issues of securities (HKEX-GL105-19);
- Guidance on sufficiency of operations (HKEX-GL106-19); and
- A frequently asked question on the notifiable transaction requirements relating to securities transactions (FAQ Number 057-2019).

On the same day, the Securities and Futures Commission (SFC) also issued a statement explaining its general approach to utilising its statutory powers under the Securities and Futures (Stock Market Listing) Rules (SMLR) and the SFO to tackle backdoor listings and shell activities.

The SFC stated that in deciding whether to exercise its powers of investigation under the SFO or its powers under the SMLR in cases involving backdoor listings and shell activities, the SFC will have regard to the facts and circumstances of each case including whether there are any red flags (i) indicating a possible scheme designed to mislead regulators and/or the investing public or to circumvent applicable rules or (ii) suggesting that other forms of serious misconduct have been or will be committed. Set out below are some non-exhaustive factors that the SFC considers are likely to be relevant:

- Whether there are any red flags indicating concealed arrangements or understandings (such as one involving a change in control or a change in de facto control) between the parties involved, including the directors, shareholders, intermediaries and advisers;
- Whether the listed company or the listing applicant has disclosed the true nature or extent of its business, affairs and plans;
- Whether there are any fundamental issues relating to the new assets or businesses being or to be injected that would lead to concerns as to whether these assets or businesses should be allowed to be listed and have access to public investors' capital;
- Whether there are any concerns that the directors might not have fulfilled their fiduciary duties and acted in the interests of the shareholders as a whole; and
- Whether sufficient due diligence has been conducted on the assets or businesses acquired, and whether the scope of due diligence is appropriate.

Want to know more?

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