The Listing Rules' requirements for Reverse Takeovers of Hong Kong Listed Companies

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Content

1 THE 10 MOST IMPORTANT THINGS TO KNOW ABOUT REVERSE TAKEOVERS (RTOs) OF HK LISTED COMPANIES

i. What is a Reverse Takeover?

An RTO is broadly defined as an acquisition (or series of acquisitions) of assets by a listed issuer which, in the opinion of the Exchange, attempts to achieve a listing of the acquired assets and a means to circumvent the Listing Rules' requirements for a new listing applicant.[1] This is a **principle based test**.

ii. Is there a specific definition of Reverse Takeover?

No. The Listing Rules only set out the bright line tests for two specific types of RTOs which are transactions involving a change in control (i.e. 30%) of a listed issuer and a very substantial acquisition ("**VSA**") (i.e. acquisition(s) where any percentage ratio is 100% or more) from the incoming controlling shareholder at the time of the change in control or within the following 24 months.[2] A VSA which falls within the bright line tests constitutes an RTO and will require the listed issuer to follow the procedures for a new listing applicant.

iii. Are there any other circumstances that can give rise to an RTO?

Yes. The two examples above are <u>not</u> exhaustive, and if a transaction falls outside the bright line tests (e.g. where there is no change of control), the Exchange will apply the principle based test to assess whether the acquisition constitutes an attempt to list the assets to be acquired and circumvent the requirements for new listings.[3] Hence, a listed issuer's disposal of its existing business and acquisition of a totally new business may be regarded as an RTO even if there is no change in control.[4]

iv. What are the consequences of entering a VSA within the bright line tests?

Where the VSA falls within either of the bright line tests in Listing Rule 14.06(a) and (b) (GEM Rule 19.06(a) and (b)), the transaction will be treated as an RTO and the Exchange will treat the listed issuer proposing the RTO as a new listing applicant irrespective of whether the assets acquired meet the requirements for a new listing. The Exchange will only grant a waiver if it considers that circumvention of the new listing requirements is not a material concern: this is more likely to be the case where the VSA involves an acquisition closely related to the issuer's principal business (e.g. a business expansion). Waivers are unlikely to be granted where the issuer is a listed shell.

Where a waiver is granted, the Exchange generally insists on an

[1] Rule 14.06(6) of the Main Board Listing Rules and Rule 19.06(6) of the GEM Listing Rules.

[2] Paragraphs (a) and (b) of Rules 14.06(6) and 19.06(6) of the Main Board and GEM Rules, respectively.

[3] Exchange Guidance Letter HKEx-GL78-14 at paragraph 7.

[4] See the Exchange's Listing Decision 75-1 of October 2009.

enhanced level of disclosure in the circular to shareholders where the acquisition is very material to the issuer or will result in a fundamental change in the issuer's business. This approach set out in the Listing Committee's 2009 Report brings the Exchange's standards for VSA circulars closer to that required for IPO prospectuses.

v. What are the consequences of an RTO being treated as a new listing application?

Where the Exchange treats the listed issuer proposing an RTO as a new listing applicant:

(a) the enlarged group or the assets to be acquired must be able to meet the financial criteria for a new listing;[5]

(b) the enlarged group must meet all other basic listing conditions;

(c) the listed issuer must issue a listing document containing virtually all the information required for a new listing applicant and the information required for a VSA;

(d) an initial listing fee is payable;

(e) the listed issuer must appoint a sponsor which must conduct due diligence;

(f) the new listing must be approved by the Exchange's Listing Committee (or its Listing Division where the issuer is listed on GEM); and

(g) the RTO must be conditional on shareholders' approval in general meeting.

vi. What are the consequences of a VSA outside the bright line tests?

Where there is no change in control, the Exchange will treat a VSA which attempts to list the assets acquired and circumvent the new listing requirements as an RTO only if it considers the VSA to be an "**extreme case**".[6]

The Exchange considers the following factors in determining whether a VSA is an extreme case:

- the size of the acquisition relative to the size of the issuer;

- the quality of the acquired business – whether it can meet the trading record requirements for a new listing, or whether it is unsuitable for listing (e.g. an early stage mineral exploration company);

[5] As set out in Main Board Rule 8.05 and GEM Rule 11.12(A).

[6] Exchange Guidance Letter HKEx-GL78-14 at paragraph 7.

- the nature and scale of the issuer's business before the acquisition (a key question is whether it is a listed shell);

- any fundamental alteration to the issuer's principal business (e.g. the existing business would be discontinued or very immaterial to the enlarged group's operations post acquisition);

- any other events and transactions (past, proposed or intended) which, together with the acquisition, form a series of arrangements to circumvent the RTO Rules (e.g. a disposal of the issuer's original business simultaneously with a very substantial acquisition); and

- any issue to the vendor of Restricted Convertible Securities which would provide it with de facto control of the issuer. Restricted Convertible Securities are highly dilutive convertible securities with a conversion restriction mechanism (e.g. restriction from conversion that would cause the securities holder to hold 30% interest or higher) which avoids triggering a change of control under the Code on Takeovers and Mergers.[7]

The Exchange will not apply the RTO Rules to a VSA within the principle based test which it does **not** consider to be extreme. The Exchange may nevertheless require the issuer to prepare a transaction circular under an enhanced disclosure and vetting approach.[8]

vii. How does the Exchange Treat a VSA which is an extreme case?

Where the Exchange considers a VSA to be an "extreme case" by reference to the criteria set out in paragraph (vi) above, it will treat it as an extreme very substantial acquisition ("**extreme VSA**"[9]**)** where:

- the assets to be acquired can meet the minimum profit requirement under Rule 8.05 (the positive cash flow requirement under GEM Rule 11.12A); and

- circumvention of the new listing requirements is not a material concern.[10]

Extreme VSAs are presented to the Listing Committee for its decision. Transactions which are not extreme VSAs (i.e. because the assets to be acquired cannot meet the requirements for new listings) will be treated as RTOs and will not be able to proceed since the new listing requirements are not satisfied.

If the Listing Committee determines that the RTO Rules apply to an

[7] Exchange Guidance Letter HKEx-GL78-14 at paragraph 7.

[8] Ibid. at paragraph 30.

[9] The term "extreme VSA" has the same meaning as the term "borderline case" which was used in the discussions about reverse takeovers in the 2009, 2010 and 2013 Listing Committee Annual Reports.

[10] Exchange Guidance Letter HKEx-GL78-14 at paragraph 8.

extreme VSA, the issuer will be treated as a new listing applicant and will be subject to the listing requirements for new applicants (see paragraph (v) above).

If the Listing Committee determines that the RTO Rules will not apply to an extreme VSA, the issuer will 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 acquisition.[11]

The transaction also needs to follow the requirements for VSAs under Chapter 14 (GEM Chapter 19) including the requirement for shareholders' approval.

The Exchange has said that acquisitions of new businesses or assets are more likely to be treated as new listings since enhanced disclosure is likely to be of limited use given that there will be little in the way of track record or operating history.

viii. Can the RTO Rules be circumvented by deferring disposal of the existing business until after the asset injection to the listed issuer following a change of control, thus avoiding the asset injection's classification as a VSA?

No, the Listing Rules provide that a listed issuer cannot dispose of an existing business within 24 months of a change of control if: (a) there has been an injection of assets from the new controlling shareholder; and (b) taking into account the disposal(s), the asset injection (or series of injections) from the new controlling shareholder before and after the change in control would have resulted in a VSA, unless the assets acquired after the change of control can meet the requirements for a new listing.[12] If not, the transaction will be treated as an application for a new listing.[13]

ix. What are the RTO Rules' implications for a listed issuer proposing an RTO of mineral or petroleum assets?

A listed issuer which acquires mineral or petroleum assets in a VSA or RTO will become a "Mineral Company" for the purposes of the Listing Rules.[14] If the transaction is treated as an RTO which is subject to the requirements for a new listing, the assets acquired or enlarged group must meet the additional criteria for listing new applicant Mineral Companies set out in Chapters 18 and 18A of the Main Board and GEM Rules, respectively, in addition to the basic listing conditions.

[11] Exchange Guidance Letter HKEx-GL78-14 at paragraph 9. W here the acquisition in involves natural resources and a competent person's report and valuation report are prepared under Chapter 18 of the Rules (Chapter 18A of the GEM Rules), the Listing Committee may not apply additional due diligence requirements.

[12] See Main Board Rules 14.92 and 14.93 and GEM Rules 19.92 and 19.93 and the Listing Committee's 2008 Annual Report.

[13] See also the Exchange's Listing Decision LD7-2011.

[14] Main Board Rule 18.11 and GEM Rule 18A.11.

x. What are the Takeovers Code implications of an RTO?

An offer to acquire 30% or more of the voting rights of a Hong Kong listed company will trigger the obligation under Rule 26 of the Takeovers Code to make a general offer to all shareholders of the target company on the same terms in the absence of a waiver from the SFC Executive. Rule 25 further prohibits an offeror and its associates from offering favourable conditions to one or more shareholders which are not available to all the other shareholders.

2 INTRODUCTION: RTOS VS. IPOS

Historically, reverse takeovers ("**RTOs**") have been used as an alternative means of achieving a stock exchange listing. In a typical reverse takeover, a company (the "**Acquiree**") will identify a target listed company. The listed company will then acquire the equity interests in the Acquiree or another company or other assets of the Acquiree and will issue shares (ordinary or preference shares) and/or convertible bonds in consideration, which results in the Acquiree obtaining a controlling stake in the listed company. The fact that no significant regulatory review was required (and there was no prospectus requirement) meant that the timeframe for completion of an RTO was considerably shorter than that for an IPO. In addition, RTOs are not subject to the vagaries of the market, as is an IPO, and the new owners of the listed company will generally suffer less share dilution and thus have greater control. Costs can also be saved due to the lack of an underwriter. It will be much easier for the company acquiring the listed company to raise capital, as investors will have a clearly defined exit strategy through the public market.

Some of the drawbacks to RTOs are that their speed and eventual value are sometimes overestimated, and they are sometimes completed without enough regard for the uninvolved shareholders.

In many countries RTOs still offer an alternative route to listing status, although there have been moves recently, notably in the United States (U.S.) and China, to tighten the regulation of RTOs following a number of accounting scandals involving Chinese companies that listed by this route. In the U.S. and Canada, reverse takeovers had been encouraged in the past, especially for small and micro-cap companies who were unlikely to be able to afford the underwriter necessary for an IPO. In the U.S., for example, it is possible to trade shares in listed shells – the investment objective being presumably to achieve a gain when there is an RTO of the shell. However, problems can arise when RTOs are under-regulated. Singapore had several high-profile reverse takeovers fall through due to concerns over profit guarantees, leading to the Singapore Stock Exchange publishing additional prescriptions for prospective RTOs including a minimum issue price for reverse takeovers and new requirements for the listed company and its financial adviser in assessing acquisitions involving profit guarantees, denounced as a gimmick during the bull run of 2007.

3 BACKGROUND TO HONG KONG'S POSITION ON RTOs

The listing rules of the Stock Exchange of Hong Kong Ltd. (the "**Exchange**") provide for stringent regulation of RTOs. Major amendments to the Exchange's listing rules ("**Listing Rules**") took effect on 31 March, 2004 which introduced specific reverse takeover rules ("**RTO Rules**") to the Main Board Rules for the first time (previously RTO Rules were contained in the Listing Rules for the Exchange's Growth Enterprise Market ("**GEM**")) and aligned the existing GEM RTO Rules with the new Main Board RTO provisions. The RTO Rules were aimed at putting a stop to "back door listings" to which the Exchange had long objected: its argument being that they were being used to circumvent the Listing Rules.

The RTO Rules, in essence, require:

(i) an acquisition (or series of acquisitions) of assets which constitute both an attempt to achieve a listing of the relevant assets <u>and</u> a means of circumventing the Listing Rules' requirements for new listing applicants, to be treated as a new listing;

(ii) the assets to be acquired or the enlarged group to be able to meet the minimum criteria for listing;

(iii) the preparation of a listing document containing both the information required in a new applicant's listing document and the information required for a very substantial acquisition under Main Board Rule 14.69 (GEM Rule 19.69); and

(iv) Compliance with the announcement and shareholders' approval requirements applicable to a VSA.

The Rules also contain anti-avoidance provisions[15] to prevent a new controlling shareholder circumventing the RTO Rules by, for example, deferring the disposal of the listed issuer's existing business until after the injection of assets to the listed issuer shortly after the change of control, thereby avoiding classification of the asset injection as a VSA.

3.1 RTOs as Back Door Listing Route

Back door listings had been particularly popular in Hong Kong in the early 1990s when a number of companies incorporated in the People's Republic of China ("**PRC**") listed in this manner. The Exchange however viewed reverse takeovers with suspicion and in the ten years prior to the introduction of the Main Board RTO Rules in March 2004, had virtually eliminated the practice of injecting non-listed assets without a suitable track record for listing into a listed shell in conjunction with a change of control.

This was achieved through the publication in 1993 of a joint announcement by the Exchange and the Securities and Futures Commission which set out the principles governing RTO transactions. An RTO was defined as a transaction (or series of transactions within 12 months) that: (i) constituted an acquisition of non-listed assets at the level of a Very Substantial Acquisition; and (ii) resulted in a change of control through the introduction of a new majority holder.

[15] Main Board Rules 14.92 to 14.93 and GEM Rules 19.92 to 19.93 discussed further at Section 5 below.

At the same time as steps were introduced to discourage RTOs, the Exchange also made it possible for PRC companies to be listed on the Exchange as H share companies.

3.2 RTOs as Work-Out Tool

In addition, backdoor listings provided a well-trodden route for bank creditor driven restructurings of distressed listed companies. The point has been made that the March 2004 Rule changes (whose primary aim was the improvement of listed companies' corporate governance standards) stemmed from the Exchange's view at the time, that the corporate governance standards of certain Hong Kong listed companies were below par and that these companies adversely affected the overall quality of the market. However, that overriding concern failed to acknowledge any distinction between a rescue and non-rescue situation. For creditors of a distressed listed company, the listing status was often the "asset" that was most capable of being realised. Previously, it had been possible for bank creditors to achieve a disposal of a "listed shell" through the entry of a White Knight and so achieve some level of recoveries from their bad debt positions. This was often supplemented by a well-timed exit from an equity position held by the banks following the restructuring. This route was often preferable to the alternative of a liquidation from which the returns likely to be generated from the company's underlying assets were less certain.

At the time of the 2004 amendments, the point was made that their likely effect would be to erode the value of listed shells and make it more difficult for White Knights to rescue troubled issuers.

4 DEFINITION OF REVERSE TAKEOVER

4.1 The Definition

The preamble to Main Board Rule 14.06(6) and GEM Rule 19.06(6) defines a reverse takeover 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**:**

(i) **an attempt to achieve a listing of the assets to be acquired;** and

(ii) **a means to circumvent the requirements for new applicants** set out in Chapter 8 (GEM Chapter 11) of the Listing Rules (the "**Definition**"). (our emphasis added)

This is a principle based test and gives the Exchange a very broad discretion to label a transaction as an RTO should it view the transaction as an attempt to circumvent the listing rules.

4.2 The Bright Line Tests

The Listing Rules do not define the specific transactions which amount to an RTO. Instead, paragraphs (a) and (b) of Rules 14.06(6) and 19.06(6) set out the bright line tests which apply to two specific types of RTO:

According to those paragraphs, a "reverse takeover" **normally** refers to:

(a) an acquisition or a series of acquisitions of assets (aggregated under Rules 14.22 and 14.23) by a listed issuer which **constitute a very substantial acquisition ("VSA")** where there is, or which will result in, a **change of control** (as defined in the Takeovers Code (i.e. 30%)) of the listed issuer (other than at the level of its subsidiaries); or

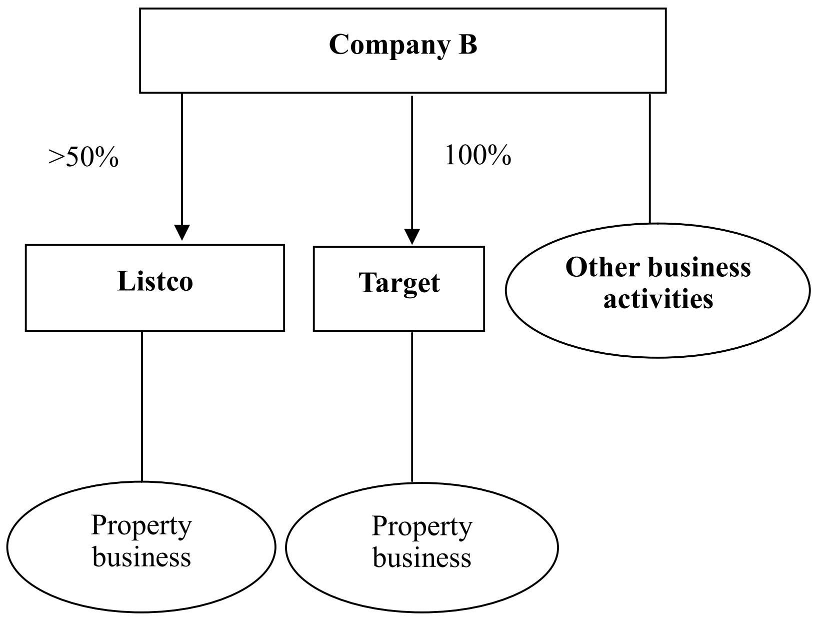
(b) an acquisition or a series of acquisitions of assets (aggregated under Rules 14.22 and 14.23) by a listed issuer which **constitute a VSA** from a person or group (or their associates) under any agreement or arrangement entered into by the listed issuer within **24 months** of that person or group gaining **control** of the listed issuer (where the original transaction did not constitute an RTO). In determining whether one or more transactions constitute a VSA, the denominator in the percentage ratio calculation is measured at the time of the change of control or the acquisition(s), whichever produces the lower figure.

A very substantial acquisition which falls within either of the bright line tests constitutes an RTO which will be treated as a new listing. Under the bright line tests, acquisitions in the 24 months after a change in control, which individually or together cross the threshold of a VSA, will constitute an RTO and be treated as a new listing.

4.3 VSAs within the Bright Line Tests

A VSA which falls within either of the bright line tests in Listing Rule 14.06(6)(a) or (b) (GEM Rule 19.06(6)(a) or (b)) constitutes an RTO and will be treated as a new listing notwithstanding that the requirements for a new listing are met. In Listing Decision LD29-2012 a listed issuer's acquisition of a company from its controlling shareholder within 24 months of a change in control was found to be within Listing Rule 14.06(b) and hence subject to the RTO Rules.

The simplified group structure was as follows:



Background

The case concerned an issuer listed on the Main Board of the Exchange ("Listco") which proposed to acquire the Target from its controlling shareholder, Company B.

A year before the proposed acquisition, Company B acquired a controlling interest in Listco and accounted for Listco as a subsidiary.

Listco was principally engaged in the property business. Company B was engaged in various business activities including certain property projects held through the Target.

The Transaction

Listco proposed to acquire Target from Company B and would issue new shares to Company B as consideration.

The transaction was a very substantial acquisition for Listco based on its size. Although it was made within 24 months of a change in control of Listco, it was submitted that the transaction should not be classified as a reverse takeover because:

- Company A had been engaging in property business for many years. It had substantive business operations and was not a shell company.
- The Target and Listco were engaged in the same type of business.
- The transaction was a group reorganisation to consolidate Company B's property business into Listco. Its purpose was not to achieve a listing of Target's business.
- The Target's business could meet the profit requirements for new listing applicants under Rule 8.05(1).

The Decision

The transaction was found to constitute a reverse takeover for Listco under Rule 14.06(6)(b) because it was a very substantial acquisition and Target was to be acquired from Company B within 24 months after it acquired control of Listco.

Although the transaction was a reorganisation of property business within Company B's group, Target was of a very significant size to Listco. The transaction, together with the change in control of Listco, was a means to list Target's property business.

4.4 Waivers where Transaction is within Bright Line Tests

Where a transaction falls within the bright line tests, it may be possible for the listed issuer to obtain a waiver from the RTO Rules if it can satisfy the Exchange that circumvention of the Listing Rules is not a material concern. The listing decisions indicate that a waiver application is more likely to be successful where the acquisition is related to the issuer's principal business. It should be noted however that the Exchange generally requires enhanced disclosure for VSAs which are very material to the listed issuer or may result in a fundamental change to its business.

Listing Decision LD59-2013: Successful Waiver Application

In Listing Decision LD59-2013, an electronic gaming company ("**Company C**") attempted to acquire patents in an overseas market from an individual ("**Mr. X**"), an executive director and substantial shareholder of Company C. The transaction was a very substantial acquisition and connected transaction for Company C, which would provide cash and consideration shares as consideration. Mr. X would hold more than 30% of Company C's enlarged share capital after the transaction, and would apply for a whitewash waiver under the Takeovers Code to avoid the requirement to make a mandatory general offer. Since this transaction was a very substantial acquisition that would result in a change of control in the listed issuer, it would be an RTO under Rule 14.06(6)(a).

Company C sought a waiver from Rule 14.06(6)(a) on the basis that the purpose of acquiring the patents was to expand its gaming business overseas and its existing business was profitable and operating on a substantive scale. The acquisition was not significantly larger than Company C. Additionally, Company C argued that its disclosure of the acquisition in its circular would be of a standard comparable to that required in an IPO prospectus, and would include a valuation report and details of its due diligence on the patents being acquired.

The Decision

The Exchange considered that the acquisition of the patents was an RTO within the ambit of the under Rule 14.06(6)(a). However, it accepted Company C's submission that the transaction was related to its principal business and was not an attempt to achieve a listing of the patents while circumventing the Listing Rule requirements. The Exchange therefore waived Rule 14.06(6)(a) and classified the acquisition as a very substantial acquisition and a connected transaction, but not an RTO.

Listing Decision LD58-2013 – Unsuccessful Waiver Application

A listed issuer is likely to have more difficulty in obtaining a waiver for a transaction falling within the bright line tests if it is a listed shell. In Listing Decision LD58-2013, the acquiring company ("**Company A**") failed to obtain a waiver of Rule 14.06(6). Company A was a suspended Main Board company that had delisted and ceased operations because it did not maintain a sufficient level of assets or operations as required by Rule 13.24. Company A attempted to acquire the Target (as part of its proposal for the resumption of trading in its own securities) in exchange for the issue of consideration shares that would have comprised over 90% of its share capital. The vendor in the transaction would have become the controlling shareholder of Company A and it intended to place down its shares in Company A to meet the public float requirement before the resumption of trading.

The acquisition would be a very substantial acquisition that resulted in a change in control of Company A, a listed issuer, putting it within the bright line test under

Rule 14.06(6)(a), thus making it an RTO. However, Company A requested that the Exchange should not regard the transaction as an RTO because the Target could meet the trading record requirements for a new listing applicant under Rule 8.05, citing Listing Decision LD95-1.

However, the Exchange refused to grant the waiver on the basis that:

- the transaction clearly fell within the ambit of Rule 14.06(6)(a);
- Company A was a shell company and the vendor in the transaction was trying to use that shell to achieve a listing of the Target's business without going through the listing application process; and
- the circumstances of the case were unlike those of Listing Decision LD95-1 because, in that case, the investor who gained control over the listed issuer did not inject assets into it as the vendor would have injected assets into Company A.

4.5 Transactions outside the Bright Line Tests

The Listing Committee's 2007 Annual Report confirmed that while the bright line tests in paragraphs (a) and (b) of Rule 14.06(6) refer to two specific forms of reverse takeovers, these are not meant to be exhaustive. Transactions which are in substance backdoor listings, but do not fall strictly within paragraphs (a) and (b) of the Rule, may still be considered reverse takeovers subject to the Listing Rules.

No Requirement for a Change of Control

It was made clear that a change of control of the listed issuer is not required for a transaction to be classified as an RTO in the Exchange's Listing Decision 75-1 of October 2009.[16] The case concerned a company ("**Company A**") which had long been suspended from trading. At the time of suspension, Company A and its subsidiaries (the "**Group**") were principally engaged in the business of nurturing, selling and trading tree seedlings and seeds. Company A agreed with a third party to dispose of its entire interest in a subsidiary, which at the time conducted the principal business of the Group (the "**Disposal**"). The Disposal constituted a VSA for Company A.

As part of the proposal to resume trading, Company A would enter other transactions and arrangements including:

(i) equity fund raising; and

(ii) acquisitions of serviced apartments and elderly home businesses ("**New Businesses**") from independent third party vendors for cash consideration (the "Acquisitions").

Following the Disposal, the Group had ceased to operate its original principal business. Company A intended to focus on the New Businesses.

The Company argued that notwithstanding that based on the percentage

[16] http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/2009listdec.htm

ratio calculations, the Acquisitions would be a VSA, the transaction did not constitute an RTO since the Acquisitions and other transactions did not involve a change in control.

The Exchange disagreed. It referred to the statement in the 2007 Listing Committee Annual Report that paragraphs (a) and (b) of Rule 14.06(6) are not exhaustive and that transactions that are in substance backdoor listings but do not fall within the bright line tests may still be considered as reverse takeovers. It determined that:

(i) the Group had disposed of the subsidiary and no longer retained any material operating assets and ceased to conduct its original principal business. Company A was in substance a listed shell.

(ii) The Acquisitions formed part of a series of transactions and arrangements which constituted an attempt to achieve a listing of the New Businesses.

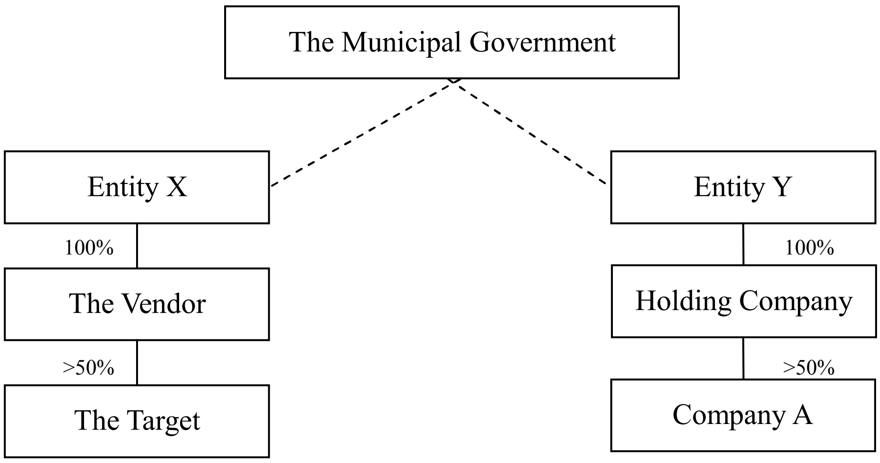
(iii) The Acquisitions would constitute a reverse takeover for Company A and Company A would be treated as a new listing applicant under Rule 14.54.

How does the Exchange look at "Change in Control"?

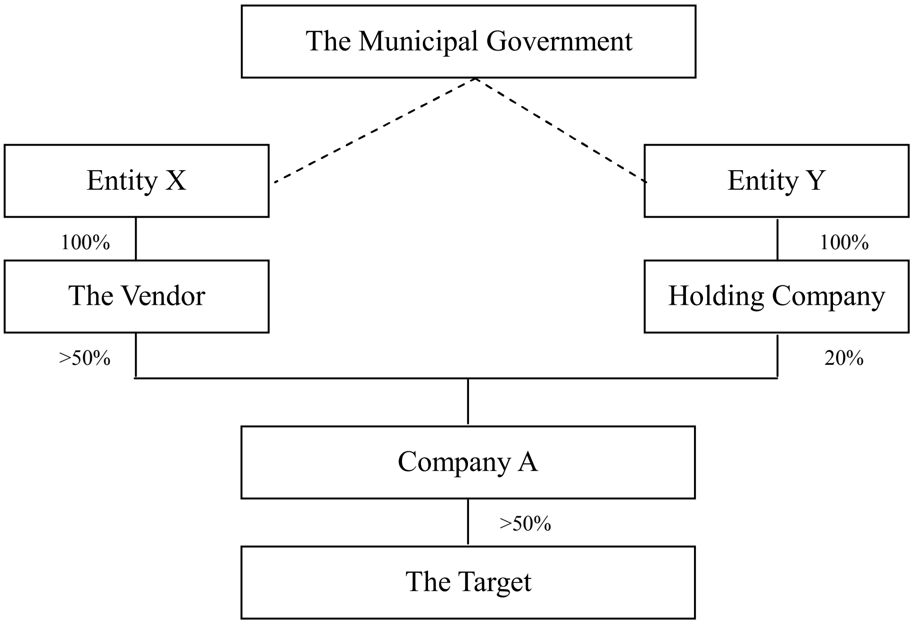
Listing Decision 75-2

The case involved a change in direct control between two subsidiaries of the municipal government. The simplified group structures before and after the Acquisition are:

<u>Before the Acquisition</u>



After the Acquisition



1. Company A was a Main Board listed company and proposed to acquire from the Vendor its interest in the Target (the **"Acquisition"**). Company A and the Target had the same line of business.

2. Since Company A would settle part of the consideration by issuing new shares to the Vendor, the Acquisition would result in a change in its shareholding structure:

   i. the Holding Company's shareholding in Company A would be diluted to about 20% of the enlarged issued share capital:

   ii. the Vendor would hold more than 50% of Company A's enlarged issued share capital. Under Note 6(a) to Rule 26.1 of the Takeovers Code, the Vendor was granted a waiver from its obligation to make a general offer for Company A as a result of the Acquisition.

   iii. The Acquisition was a connected transaction for Company A as the Exchange had deemed the Vendor and its associates to be Company A's connected persons since the listing of Company A. Based on the percentage ratio calculation, the Acquisition was also a very substantial acquisition.

   iv. Company A sought the Exchange's confirmation that the Acquisition was not a reverse takeover under Rule 14.06(6). It submitted that although the Acquisition would result in the Vendor acquiring a controlling interest in Company A, there would not be a change in control under Rule 14.06(6) because:

      - Both Entity X and Entity Y were subordinate departments of the Municipal Government and under its supervision. Through these entities, the Municipal Government had exercised control over each of the Holding Company, Company A, the Vendor and the Target, including through the exercise of voting rights.

- The Municipal Government had, and would continue to have, ultimate control over Company A before and after the Acquisition.

The Decision

The Acquisition was not regarded as a reverse takeover of Company A since the Municipal Government would remain Company A's controlling shareholder following the acquisition, and there would not therefore be a change in its ultimate control as a result of the Acquisition.

The Exchange also took into account the assessment of "control" under the Takeovers Code. In this case, the Takeovers Executive had granted a waiver to the Vendor from its obligation to make a general offer under Note 6(a) to Rule 26.1 of the Takeovers Code. This was different from the situation where the control of an issuer changed and a whitewash waiver was granted subject to independent shareholders' approval under the Takeovers Code.

The decision has implications for the possible use of reverse takeovers to restructure organizations, as so long as the ultimate control of the organization remains with the same entity, and that entity takes an active controlling role, then the subsidiaries should be free to change their lower level control structure.

5 RESTRICTION ON DISPOSALS AFTER A CHANGE OF CONTROL

5.1 Anti-Avoidance Provisions

In order to prevent circumvention of the RTO Rules, MB Rules 14.92 and 14.93 (GEM Rules 19.91 and 19.92) provide that an issuer may not dispose of its existing business within twenty-four months of a change of control unless the assets acquired after the change of control meet the requirements of Main Board Rule 8.05/GEM Rule 11.12A. If this is not the case, the transaction is treated as a new listing.

These Rules allow certain (i.e. small) assets to be sold, but the "existing business" must be maintained. The Rules pose a problem in cases where an outgoing shareholder is reluctant to sell the listed vehicle without retaining certain assets.

5.2 Guidance on Disposal of Existing Business after a Change of Control: Listing Committee Annual Report 2008

It was acknowledged in the Listing Committee's 2008 Annual Report that the strict application of Rules 14.92 and 14.93 (and their GEM equivalents) went beyond the original intention behind them. The aim was to prevent circumvention of the RTO Rules by the new controlling shareholder structuring the RTO as a series of transactions, e.g. by deferring the disposal of the existing business until after the injection of assets to the listed issuer shortly after the change of control, thereby avoiding classification of the asset injection as a VSA.

However, it was noted that the drafting of the Rules supports a narrower interpretation and could effectively restrict a listed issuer from disposing any of its existing businesses for legitimate reasons within 24 months of a change of control – even where there is no asset injection.

Consequently, at a policy meeting in April 2008, the Listing Committee endorsed a proposal to restore the original intention of the Rules by providing that the disposal restriction would apply in circumstances where: (a) there has been an injection of assets from the new controlling shareholder (thus raising a legitimate concern about a reverse takeover); and (b) where taking into account the disposal(s), the asset injection (or series of injections) from the new controlling shareholder during the period leading to and after the change in control would have resulted in a VSA.

Accordingly the disposal restriction applies only in the above circumstances and not to a disposal following a change in control where there has been no asset injection from the incoming controlling shareholder.

5.3 Exchange Listing Decision (HKEx-LD7-2011) regarding restrictions on disposal after change in control

The Exchange published in March 2011, a listing decision (HKEx-LD7-2011) on an attempt by a Main Board issuer **("Company A")** to circumvent certain elements of the regulatory regime, set out in Chapter 14 of the Listing Rules, governing the conduct of reverse takeovers. This effort at circumvention concerned Listing Rule 14.92, which prevents a listed issuer from disposing of its current business for a period of 24 months subsequent to a change in control. Company A sought a waiver from this Rule. However, the Exchange refused to grant the waiver, principally on the grounds that Company A was attempting to defeat the policy goals of Rule 14.92. The Exchange went on to state that if Company A persisted with the disposal, it would be treated as a new listing applicant under Rule 14.93.

The attempt at circumventing the relevant rules of Chapter 14 involved delaying the disposal of Company A's current business until after it had signed an agreement to acquire another business, in the hope of avoiding triggering the percentage ratio[17] which constitutes a "very substantial acquisition" [18] under Chapter 14. The classification of an acquisition as a very substantial acquisition leads to the triggering of the RTO Rules.

The key point made by the Exchange was that Rules 14.92 and 14.93 are designed to eliminate the possibility of companies circumventing the effect of Rule 14.06(6). Examples of the kind of circumvention which these Rules are meant to prevent include situations where the new controlling shareholder structures a reverse takeover as a series of transactions. The specific example given by the Exchange is where the new controller(s) inject assets into the listed issuer soon after

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17 Under Rule 14.07 the percentage ratios are the figures, expressed as percentages, which are the result of various calculations designed to relate the scale of a transaction to the scale of a listed issuer engaged in a transaction. For example, the total assets which are the subject of the transaction divided by the total assets of the listed issuer will give one the assets ratio of the transaction.

18 Rule 14.06 (5) defines a very substantial acquisition as an acquisition or a series of acquisitions (aggregated under rules 14.22 and 14.23) of assets by a listed issuer where any percentage ratio is 100% or more.

assuming control, but defer the disposal of the issuer's existing business. This procedure permits the new controller(s) to avoid classifying the asset injection as a very substantial acquisition, as it ensures that the percentage ratios of the asset acquired will not reach 100% or more.

The Exchange noted that the wording of Rule 14.92 allows for a stricter reading of the section, one which prevents an issuer from selling any of its existing businesses within the 24 months subsequent to a change in control, even where there is no asset injection and the sale has a legitimate business rationale underlying it. The Exchange then stated in the decision that Rule 14.92 should be interpreted to meet the policy intent of obstructing the circumvention of Rule 14.06. With this in mind, the Exchange noted that a waiver from Rule 14.92 may be granted to issuers so long as:

(v) an injection of assets has not been made by the new controlling shareholder into the listed issuer; and

(vi) after factoring in the disposal(s) of the existing business of the listed issuer, this asset injection (or injections), made in the lead up to and subsequent to the change in control, would not have constituted a very substantial acquisition on the part of the listed issuer.

In the case under review, the Exchange looked at the overall effect of the change in control, acquisition and disposal, and, having identified an attempt to undermine the policy goals of Rule 14.92, refused to grant the waiver.

6 VSAs OUTSIDE THE BRIGHT LINE TESTS

6.1 Exchange Guidance

The Exchange's Guidance Letter HKEx-GL78-14 published in May 2014 sets out the Exchange's current practice on the application of the RTO Rules. If a transaction falls outside the bright line tests, the Exchange will apply the principle based test to assess whether the 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 Exchange will treat the transaction as an RTO only if it considers it to be an "extreme case".[19]

6.2 Relevant Factors in "Extreme Case" Determination

The following factors are taken into account in determining whether a backdoor listing is an extreme case:

(i) The size of the acquisition relative to the size of the issuer.

The Exchange does not prescribe an absolute threshold in determining whether the size of a transaction is extreme. Instead, in assessing the impact of the acquisition on the issuer, the Exchange takes into account other criteria such as the nature and scale of the issuer's existing business after the acquisition, and whether the acquisition will result in a

[19] Exchange Guidance Letter HKEx-GL78-14 at paragraph 7.

fundamental change in the issuer's business.

(ii) Quality of the acquired business – whether it can meet the trading record requirements for new listings, or whether it is unsuitable for listing.

An acquisition of a target business unsuitable for listing will likely be considered a circumvention of the new listing requirements (e.g. early exploration companies or illegally operated businesses).

Acquisitions of new businesses or assets that have no track record or have yet to commence operations are more likely to be treated as new listings since enhanced disclosure is likely to be of limited use. This is particularly so where the target's business is completely different from that of the issuer (see Listing Decision LD95-4 which is summarised in Annex C)

(iii) The nature and scale of the issuer's business before the acquisition (a key question is whether it is a listed shell).

If an issuer carries carries on minimal operations (e.g. a shell company), a material asset injection is more likely to be considered as "extreme" because the target assets would be listed post-acquisition (e.g. a PN17 company[20]).

The Exchange will consider the nature of the issuer's existing business and its financial position. An issuer's business is more likely to be considered as a shell company if the issuer operates:

- a trade business that has a low level of activities and generates minimal gross profit and losses; or

- a business of "treasury management" of its substantial positions in cash and short-term investments.

(iv) Any fundamental alteration to the issuer's principal business (e.g. the existing business would be discontinued or very immaterial to the enlarged group's operations post acquisition).

Acquisition of a business that is completely different to the issuer's existing business is more likely to be viewed as a means to achieve the listing of the target assets, particularly:

- where the target business is specialised while the present management is not; and

- where the issuer's existing business is so immaterial that the issuer would be substantially carrying on only the new business post-acquisition.

The Exchange does not normally consider acquisitions of assets for expansion or development of existing business as "extreme".

[20] PN17 company: a company that is suspended and in the delisting stages under Practice Note 17 to the Rules (GEM Rule 9.15). See Listing Decision LD75-1.

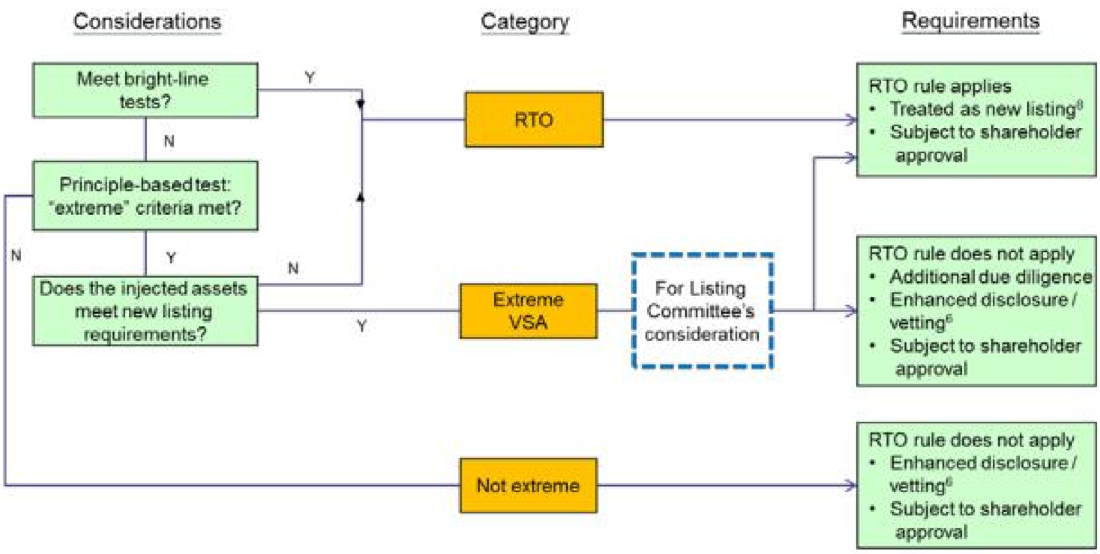
(v) Any other events and transactions, whether historical, proposed or intended, which, together with the acquisition, form a series of arrangements designed to circumvent the RTO Rules (e.g. a disposal of the issuer's original business simultaneously with a very substantial acquisition).

Proposals involving an asset swap, or disposal of the existing business to the exiting shareholder may be indications that the issuer is "cleaning" its "shell" to achieve a listing of the target business.

(vi) Any issue to the vendor of Restricted Convertible Securities which would provide it with de facto control of the issuer. Restricted Convertible Securities are highly dilutive convertible securities with a conversion restriction mechanism (e.g. restriction from conversion that would cause the securities holder to hold 30% interest or higher) which avoids triggering a change of control under the Code on Takeovers and Mergers.

6.3 Treatment of Extreme Cases

The flowchart below summarises the RTO assessment and requirements.



Extreme cases unable to meet new listing requirements

Where the Exchange considers a VSA to be an "extreme case" by reference to the criteria set out in paragraph 6.2 above, it will be treated as an RTO if the assets to be acquired (or the enlarged group) do not satisfy the conditions for a new listing. The transaction will therefore not be able to proceed.

Extreme cases able to meet new listing requirements

A VSA which the Exchange considers to be an "extreme case" will be treated as an extreme very substantial acquisition ("**extreme VSA**") where:

- the assets to be acquired can meet the minimum profit requirement under Rule 8.05 (the positive cash flow requirement under GEM Rule 11.12A); and

- circumvention of the new listing requirements is not a material concern.

Extreme VSAs are presented to the Listing Committee for its decision.

If the Listing Committee determines that the RTO Rules apply, the issuer will be treated as a new listing applicant and will be subject to the listing requirements for new applicants (see paragraph 7 below).

If the Listing Committee determines that the RTO Rules will **not** apply, the issuer will 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 acquisition.[21]

For further information on these requirements, please see paragraph 9 below. The transaction also needs to follow the requirements for VSAs under Chapter 14 (GEM Chapter 19) including the requirement for shareholders' approval.

6.4 Treatment of non-extreme cases

If a VSA is not considered to be extreme, the issuer may nevertheless be required to prepare a transaction circular under an enhanced disclosure and vetting approach.

7 LISTING RULE REQUIREMENTS FOR AN RTO

7.1 Treatment as New Listing

Where a listed issuer proposing a reverse takeover is treated as a new listing applicant, the enlarged group or the assets to be acquired must be able to meet the financial tests in Main Board Rule 8.05 or GEM Rule 11.12A and the enlarged group must be able to meet all other listing criteria of Main Board Chapter 8 or GEM Chapter 11 of the Listing Rules (Main Board Rule 14.54/GEM Rule 19.54).

The listed issuer must comply with the procedures and requirements for new listing applicants set out in Chapter 9 of the Main Board Rules (Chapter 12 of the GEM Rules) and must issue a listing document and pay the initial listing fee. A reverse takeover listing document is required to include virtually all the information required by Part A of Appendix 1 to the Listing Rules in addition to the information required for a very substantial acquisition under Main Board Rules 14.63 and 14.69 (GEM 19.63 to 19.69). The listed issuer is additionally required to appoint a sponsor which will need to conduct full due diligence and the new listing will need to be approved by the Exchange's Listing Committee or its Listing Division in the case of an issuer listed on GEM.

7.2 Announcement Requirement

The applicant must make an announcement to all shareholders regarding the RTO in

[21] Exchange Guidance Letter HKEx-GL78-14 at paragraph 9.

accordance with Main Board Rule 2.07C/ GEM Rule 16.17. Under Rule 13.52(2)(a) (GEM Rule 17.53(2)(a)), an announcement of a reverse takeover (or a VSA) is subject to pre-vetting by the Exchange. The announcement must contain all pertinent information about the transaction, including the matters listed in Main Board Rules 14.58 and 14.60 (GEM Rules 19.58 and 19.60). Any other pertinent information must also be included.

An issuer may be required to suspend trading in its shares pending publication of the acquisition announcement. The suspension period must be kept as short as possible and issuers should note that suspension does not relieve them of their obligation to announce inside information under the Securities and Futures Ordinance.

<u>Documents to be submitted with the acquisition announcement for pre-vetting</u>

The issuer should submit the following documents to the Exchange together with the acquisition announcement for pre-vetting:

- draft financial statements / accounts of the target business over the track record period;

- where the consideration for the acquisition is supported by a valuation, the valuation report and the underlying assumptions;

- for an acquisition of natural resources, the competent person's report to support the amount of estimated resources and reserves, the working capital forecast memorandum to demonstrate sufficiency of the enlarged group's working capital; and

- for an acquisition of business under contractual arrangements, a legal opinion to demonstrate that such arrangements meet the conditions set out in Exchange Guidance Letter HKEx-GL77-14.

7.3 Requirement for Shareholders' Approval

An RTO must be made conditional on being approved by shareholders in general meeting and the listing document must be sent to shareholders at the same time as, or before, the listed issuer gives notice of the general meeting to approve the transaction. The announcement of the reverse takeover must state the expected date of despatch of the listing document and, if this is more than 15 business days after the publication of the announcement, reasons for this must be given. The listing document must include an accountants' report for the 3 preceding financial years on the business, company or companies to be acquired (Main Board Rule 14.69(4) and GEM Rule 19.69(4)).

At a general meeting to approve an RTO, any shareholder and his associates are barred from voting if the shareholder has a "material interest" in the transaction. In relation to an RTO, the Listing Rules further require that where there is a change in control of the listed issuer and the existing controlling shareholder(s) will dispose of shares to any person, the existing controlling shareholder(s) cannot vote in favour of the acquisition of assets from the incoming controlling shareholder or his associates at the time of the change in control. This prohibition does not however apply where the decrease in the outgoing shareholder's shareholding results solely from a dilution through the new issue of shares to the incoming controlling shareholder rather than a disposal of shares by the outgoing shareholder.

7.4 Other Regulatory Issues

Rule 25 of the Takeovers Code on Special Deals with Favourable Conditions prohibits an offeror and its associates from entering into a deal to buy a company's shares which involves favourable conditions being offered to one or more shareholders which are not available to all the other shareholders.

In addition, if there is a whitewash application for a waiver from the obligation to make a general offer to all shareholders by the incoming shareholder, all connected shareholders are likely to be barred from voting on it, as one of the conditions for the grant of a waiver of the mandatory offer obligation is that the transaction is approved at a shareholders' meeting by an "independent vote" – i.e. by shareholders "who are not involved in or interested in, the transaction". (Note 1 to Rule 26)

8 MEETING THE CRITERIA FOR A NEW LISTING APPLICANT

The enlarged group or the assets to be acquired will need to meet the requirements for listing which in the case of a Main Board listing will require the applicant to satisfy the requirements of Main Board Rule 8.05 as to operating history and management and satisfy one of the three financial tests (profit test, market capitalization/revenue test or market capitalization/revenue/cash flow test) which are summarised in Annex A to this note. An applicant for listing on GEM will need to meet the positive cash flow requirement and requirements as to operating history and management of GEM Rule 11.12A.

The enlarged group must also meet all other basic listing conditions in Chapter 8 (Chapter 11 of GEM), as summarised in Annex A to this note.

8.1 Meeting the Initial Listing Criteria: Listing Decision 44-1

Listing Decision 44-1 related to satisfaction of the public float. The issue was whether in a case where an asset injection caused Company A to be deemed a new listing applicant, the minimum public float requirement under Main Board Rule 8.08 could be satisfied by the placing of existing and/or new shares of Company A prior to the completion of the asset injection.

The Exchange decided that the placing arrangements by the company and/or its parent to maintain the public float before completion of the assets injection were acceptable. It further granted a waiver of Main Board Rule 10.07 which prohibits a person shown by the listing document to be a controlling shareholder from disposing of its shares in the listed company for 6 months following listing. The waiver allowed the parent company, a controlling shareholder, to place down its shares during the restricted period.

8.2 Implications of an RTO of Mineral or Petroleum Assets

Chapter 18 of the Main Board Rules and Chapter 18A of the GEM Rules impose specific requirements to be met by new applicant mining and petroleum companies in addition to the basic requirements for listing contained in Chapters 8 and 11 of the Main Board Rules and GEM Rules, respectively.

Chapter 18 (GEM Chapter 18A) apply to a **Mineral Company** which is defined as *"a new applicant whose Major Activity (whether directly or through its subsidiaries) is the exploration for and/or extraction of Natural Resources,* ***or a listed issuer that completes a Relevant Notifiable Transaction involving the acquisition of Mineral or Petroleum Assets****"*.

The term "Major Activity" is an activity of an issuer and/or its subsidiaries which represents 25% or more of the total assets, revenue or operating expenses of the issuer and its subsidiaries. When assessing whether or not this threshold has been reached, reference should be made to the issuer's latest audited consolidated financial statements.

Listed issuers engaged in the resources sector when the new regime became effective were not automatically treated as Mineral Companies. However, they will become Mineral Companies once they complete a Major Transaction, Very Substantial Acquisition or Reverse Takeover involving the acquisition of Mineral or Petroleum Assets.

Thus a listed issuer which engages in a reverse takeover of a company involved in the resources sector will be treated as a Mineral Company. In addition to adhering to the basic conditions for listing, as set out in Chapter 8 of the Main Board Rules or Chapter 11 of the GEM Rules, if treated as a new applicant under the RTO Rules, the listed issuer must also satisfy the additional eligibility requirements for mineral and petroleum companies which are summarized in Annex B to this Note.

9 REQUIREMENTS FOR EXTREME VSAs NOT SUBJECT TO RTO RULES

As mentioned above, where the Listing Committee determines that the RTO Rules do not apply to an extreme VSA, the issuer will be required to:

- prepare a transaction circular under an enhanced disclosure and vetting approach;
- appoint a financial adviser to conduct due diligence on the acquisition.

The transaction also needs to follow the requirements for VSAs under Chapter 14 (GEM Chapter 19) including the requirement for shareholders' approval.

9.1 Announcement Requirement

The issuer must make an announcement to all shareholders regarding the VSA containing the information required by Main Board Rules 14.58 and 14.60 (GEM Rules 19.58 and 19.60). An announcement of a VSA is subject to pre-vetting by the Exchange under Rule 13.52(2)(a) (GEM Rule 17.53(2)(a)).

9.2 Transaction Circular Disclosure

Where the Listing Committee determines that the RTO Rules do not apply to an extreme VSA, the issuer should ensure that the transaction circular contains material information about the target and the future business prospects of the issuer. In doing so, it is required to apply the standard of disclosure for listing documents of new listing applicants.

In particular, issuers should disclose their intention to make significant changes in: (i) the enlarged group's business and/or arrangements for potential acquisitions or disposals of assets; (ii) the issuer's board composition; and (iii) the target's management.

Issuers are required by Hong Kong Accounting Standards 36 – Impairment of Assets, to conduct an impairment assessment of the target for the purpose of preparing pro forma financial statements in the circular, adopting a valuation methodology that is consistent with the accounting standards and the issuer's accounting policy. Issuers should make appropriate pro forma adjustments taking into account any impairment of assets, based on the valuation reports and in accordance with the accounting standards for impairment. Issuers' auditors should provide reasonable assurance on the pro forma adjustments applying the Hong Kong Standard on Assurance Engagements 3420, "Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus".

Where there are material impairments, issuers should also disclose the following:

- the results of such impairment assessment in the circular; and
- information about the valuation including the methodology adopted and major assumptions.

9.3 Responsibilities of the Financial Adviser

Attachment 1 to Exchange Guidance Letter HKEx-GL78-14 sets out the responsibilities of, and the scope of work to be performed by, the financial adviser appointed to conduct due diligence on an extreme VSA which is not a RTO. The issuer and its financial adviser are required to observe the following:

- The financial adviser should be:
  - licensed or registered under the Securities and Futures Ordinance for Type 6 regulated activity;
  - permitted under its licence or certificate of registration to undertake sponsor work;
  - required to appoint a transaction team that comprises staff with appropriate levels of knowledge, skills and experience and include a Principal[22] as the team's supervisor; and
  - 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 to the guidance letter.
- The extent of the financial adviser's work and scope of due diligence

22 As defined in Paragraph 17 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

should be referenced to Practice Note 21 to the Rules (Practice Note 2 to the GEM Rules). The financial adviser is expected to refer to the procedures sponsors would typically perform. Since the scope and extent of due diligence appropriate for any transaction may be different from the typical examples provided in the Practice Note, the financial adviser must exercise its judgment as to what investigations or steps are appropriate for a particular transaction and the extent of each step.

- The issuer should note that the financial adviser's due diligence work on the transaction would not relieve its directors of their responsibilities and obligations under the Listing Rules.

- The issuer and its directors should assist the financial adviser to perform its duties:

  - the issuer should afford the financial adviser full access at all times to all persons, premises and documents relevant to its duties. In particular, the terms of engagement with experts retained to perform services related to the transaction should contain clauses entitling the financial adviser access to:

    i. any such expert;

    ii. the expert's reports, draft reports (both written and oral) and terms of engagement;

    iii. information provided to or relied on by the expert;

    iv. information provided by the expert to the Exchange or the Securities and Futures Commission (the Commission); and

    v. all other correspondence exchanged between the issuer or its agents and the expert, or amongst the expert, the issuer and the Exchange or Commission.

  - The issuer should keep the financial adviser informed of any material change to any of the above information previously given to or accessed by the financial adviser.

  - The issuer should provide to or procure for the financial adviser all necessary consents to the provision of the above information to the financial adviser.

The Financial Adviser's Declaration

Attachment 2 to the guidance letter sets out the form of declaration which the financial adviser is required to give to the Exchange in respect of an extreme VSA. This is in similar form to the sponsor's declaration given to the Exchange in respect of a new listing application (as set out in Appendix 19 to the Listing Rules and Form G of Appendix 7 to the GEM Rules). This requires declarations by the financial adviser to the following effect:

- that having made reasonable due diligence inquiries, the financial adviser has reasonable grounds to believe and believes that:

  - the assets to be acquired meet the minimum profit requirements under Rule 8.05 (or the positive cash flow requirement under GEM Rule 11.12A) and the enlarged group meets all other conditions for listing;

  - the issuer's circular contains sufficient information to enable a reasonable person to form a justifiable opinion of the transaction and the financial condition and profitability of the assets to be acquired;

  - the information in the non-expert sections of the circular is complete and accurate in all material respects and not misleading in any material respect;

  - there are no other material issues relating to the transaction which should be disclosed to the Exchange;

- that in relation to each expert section of the circular, having made reasonable due diligence inquiries, it has reasonable grounds to believe and believes that:

  - material factual information relied on, but not verified by, the expert is complete and accurate in all material respects;

  - the material bases and assumptions on which the expert sections are based are fair, reasonable and complete;

  - the expert is appropriately qualified, experienced and sufficiently resourced to give the relevant opinion;

  - the expert's scope of work is appropriate to the opinion required; and

  - the expert is independent from the issuer, its directors and controlling shareholders, the counterparty to the transaction and the assets to be acquired and the directors and controlling shareholders of the counterparty to the transaction; and

- in relation to the information in the expert reports, the financial adviser, as a non-expert, after performing reasonable due diligence, has no reasonable grounds to believe that the information is untrue, misleading or contains any material omissions.

10 ASSET INJECTIONS SATISFYING THE LISTING REQUIREMENTS

One of the remaining paths for rescuing a distressed listed company remains the injection of assets which meet the Listing Rules' requirements for listing. This is acceptable to the Exchange as the issuer is subject to the full requirements of the Listing Rules and will follow the process for a new listing. Transactions in the twenty-four months after the restructuring may be subject to the Notifiable Transactions requirements, but will not need to be aggregated with the original RTO transaction as the RTO (and new listing) has already occurred.

The downside for bank creditors leading a restructuring is that the pool of investors with assets meeting the listing requirements, and who are willing to invest in this type of restructuring, is likely to be small. As the investor is bringing his own assets, the likelihood is that he'll be in a strong position to negotiate down the price for the listed company. Creditor banks who take an equity position in the restructuring should benefit in the long term given the injection of new assets. In the short-term, however, commentators have remarked that the immediate cash payout is likely to be substantially less than on a cash subscription type restructuring.

11 CASH SUBSCRIPTIONS AND BUSINESS RESUSCITATIONS: MAIN BOARD RULE 13.24/GEM 19.24

Cash injections and business resuscitations as a route to corporate rescues run into problems under MB Rule 13.24 (GEM 19.24).

These Rules provide that:

"An issuer shall carry out directly or indirectly, 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."

Where a listed issuer's assets consist wholly or substantially of cash or short-dated securities (i.e. securities such as bonds, bills or notes which have less than a year to maturity), it will not be considered suitable for listing and trading in its securities will be suspended (Main Board Rule 14.82 and GEM Rule 19.92).

The difficulty in rescue situations is that in many cases the operations of the listed issuer have ceased to operate. The problems with a cash injection (which has never been classed as a Notifiable Transaction) stem from Rule 13.24. If the Rule 13.24 requirements are satisfied, there is then the issue of the 24-month period during which any injection of new assets into the listed company will be aggregated with the restructuring transaction and the aggregated transaction constituting a VSA. The issuer would then be treated as a new listing applicant. For the investor, the question will be whether the business can be sustained for 24 months without any injection of assets.

JULY 2014

ANNEX A
Summary of Listing Criteria for New Applicants

	MAIN BOARD				**GEM**
Financial Requirements	Applicants must meet one of 3 financial tests				A GEM applicant must have: Positive cashflow from operating activities in the ordinary and usual course of business of HK$20 million in aggregate for the latest 2 financial years
		1. Profit Test	**2. Market Cap/ Revenue Test**	**3. Market Cap/ Revenue Cash flow Test**	
	Profit	At least HK$50 million in the last 3 financial years (with profits of at least HK$20 million in the most recent year, and aggregate profits of at least HK$30 million recorded in the 2 years before that)	-	-	
	Market Cap	At least HK$200 million	At least HK$4 billion at the time of listing	At least HK$2 billion at the time of listing	Market cap of HK$100 million at the time of listing
	Revenue	-	At least HK$500 million for the most recent audited financial year	At least HK$500 million for the most recent audited financial year	
	Cashflow	-	-	Positive cashflow from operating activities of at least HK$100 million in aggregate for the 3 preceding	

	MAIN BOARD	GEM
	financial years	
Operating History and Management	Main Board applicants must have: • 3 years' operating history; • Management continuity for at least the 3 preceding financial years; and • Ownership continuity and control for at least the most recent audited financial year.	GEM applicants must have: • A trading record period of at least 2 full financial years; • Management continuity for at least the 2 preceding financial years; and • Continuity of ownership and control throughout the full financial year before listing.
Public Float	At least 25% of the issuer's total issued share capital (subject to a minimum of HK$50 million for Main Board applicants and HK$30 million for GEM applicants) must be held by the public at all times. For issuers with an expected market capitalisation at listing of at least HK$10 billion, the Exchange may accept a public float of between 15% and 25%.	
Spread of Shareholders	The shares in the hands of the public must be held by at least 300 persons. No more than 50% of the publicly held shares at the time of listing can be beneficially owned by the 3 largest public shareholders.	The shares in the hands of the public must be held among at least 100 persons. No more than 50% of the publicly held shares at the time of listing can be beneficially owned by the 3 largest public shareholders.

ANNEX B

Listing Eligibility Requirements for Mineral and Petroleum Companies

1. Right to explore for and/or extract Natural Resources (MB Rule 18.03(1)/GEM Rule 18A.03(1))

New applicant Mineral Companies must be able to demonstrate that they have the right to participate actively in the exploration for and/or extraction of resources, either by having control over a majority (by value) of the assets in which they have invested or through other rights, which give them significant influence in decisions concerning the exploration for and/or extraction of those resources (MB Rule 18.03(1) (GEM Rule 18A.03(1)).

The Exchange recognises that in practice, companies often engage in mineral extraction or exploration activity under joint venture agreements, product sharing contracts or specific government mandates. Therefore, the Exchange will consider, on a case-by-case basis, whether or not to allow an applicant to rely on adequate agreements where a third party possesses relevant rights, in order to satisfy this eligibility requirement.

2. Ineligibility of Early Stage Exploration Companies

New applicant Mineral Companies must have at least a portfolio of Indicated Resources (in the case of minerals) or Contingent Resources (in the case of petroleum) that are identifiable under one of the accepted reporting standards and substantiated in the report of an independent expert (MB Rule 18.03(2)/GEM Rule 18A.03(2)). The portfolio must also be of sufficient substance to justify a listing. These requirements therefore render early stage exploration companies ineligible for listing.

3. Working Capital Requirement

New applicant Mineral Companies must demonstrate that they have sufficient working capital for 125% of their budgeted needs for the next twelve months (MB Rule 18.03(4)/GEM Rule 18A.03 (4)). The working capital requirements must include, as a minimum, general and administrative costs, property holding costs and the cost of proposed exploration and development. Applicants that have commenced production must also provide an estimate of its cash operating costs.

4. Waiver of Main Board Financial Tests/GEM Trading Record Requirement

Main Board Rule 18.04 provides that if a new applicant Mineral Company cannot meet the financial track record requirements under Listing Rule 8.05, those requirements may be waived if the board and senior management, taken together, have a minimum of five years' experience relevant to the mining and/or exploration activity that the applicant is pursuing.

Under GEM Rule 18A.04, the Exchange may accept a trading record period of less than the two financial years specified in Rule 11.12A (and an accountants' report covering a shorter period than that specified in rule 11.10) for a new applicant Mineral Company, provided that its directors and senior managers, taken together, have at least five years' relevant industry experience. However, where the Exchange accepts a trading record of less than two financial years, a new applicant must still meet the cash flow requirement of HK$20 million for that shorter trading record period, in accordance with Rule 11.14.

ANNEX C

Summary of Listing Decisions involving VSAs falling outside the bright line tests

Listing Decision LD 95-1: the Approach where an extreme case does not attempt to circumvent the requirements for new listings applicants

In this Listing Decision, released in July 2010, the Exchange considered whether a company, whose main business was in security investments and manufacturing and trading battery products ("**Company A**"), would:

(i) become a cash company due to its proposed placing of convertible notes; and

(ii) have its proposed acquisition of an insurance company ("the **Target**") treated as a reverse takeover by the Exchange.

Company A proposed to raise funds to be used as working capital and for potential investment prospects by placing new shares to independent placees (the "**First Placing**"). This placing would result in Company A's assets being comprised almost entirely of cash, making it a cash company under Main Board Rule 14.82. A listed issuer is treated as a cash company when, for any reason, its assets consist entirely or largely of cash or short dated securities. This leads to the company not being regarded as fit for listing and trading in its securities being suspended.

Soon after the announcement of the First Placing, Company A made an agreement to acquire the Target from an independent vendor in cash (the "**Acquisition**"), a transaction amounting to a very substantial acquisition. The Target was a considerably larger entity than Company A, which created an issue as to whether the Acquisition constituted a reverse takeover under Rule 14.06 (6).

In order to avoid being treated as a cash company and having trading in its securities suspended, Company A cancelled the First Placing, replacing it with a scheme involving the issuing of convertible notes to raise funds (the "**Second Placing**"), which would be redeemed within two weeks if the Acquisition did not go ahead.

Company A argued that Rule 14.06 (6) did not apply to the Acquisition as it would not cause a change in control to occur at the company, and also that the vendor had no intention of circumventing the IPO requirements. Rather the transaction constituted a forced sale by the vendor of its major assets with no prerequisite in relation to the listing status of the purchaser.

<u>The Exchange on whether Company A was a cash company</u>

Despite the revised technique of fund raising adopted by Company A, the Exchange determined that its assets would still largely consist of cash immediately after the Second Placing transaction. This would result in trading in its securities being suspended under Rule 14.83 and in order to avoid this, Company A restructured the Second Placing to prevent itself from becoming a cash company at any time, by making it subject to the conclusion of the Acquisition.

<u>The Exchange on whether the Acquisition should be regarded as a reverse takeover</u>

It was noted that the two tests detailed in Rule 14.06(6) are not exhaustive, and transactions effectively amounting to backdoor listings can be treated as reverse takeovers, although in practice this only occurs in extreme cases. The Exchange considered the Acquisition to be an extreme case, primarily on the grounds that it was very significant for Company A and the target operated in a completely different business. The Acquisition would have the effect of changing Company A's business and was an attempt to achieve a listing of the Target's business.

However the Exchange found that the Acquisition was not an attempt to circumvent the requirements for new listing applicants detailed in Rule 8.05(1)(a). Key factors in this finding were that the Target only failed to comply with the profit requirements under that section due to the effect of the global economic downturn, as opposed to a substantial decline in its ability to generate revenue, and the Target's ability to meet the capitalisation/revenue test under Rule 8.05(3).

The Exchange decided that it would not treat the Acquisition as an RTO, and that the policy aims of the RTO Rules would be satisfied, once the following conditions were adhered to:

(i) Company A would publish a circular with a level of disclosure comparable to an IPO prospectus;

(ii) The Circular would explain that the Target's loss in the most recent year was transitory in nature and not due to serious deterioration of its operational capabilities; and

(iii) Company A would appoint an adviser to perform due diligence on the Target and undertake duties and obligations commensurate with those of a sponsor for a new listing application under the Rules.

Listing Decision LD 95-2

In this Listing Decision, released in July 2010, the Exchange assessed whether an acquisition by a Main Board issuer ("**Company A**") constituted a reverse takeover under Rule 14.06(6), and also considered the issue of whether or not the occurrence of a change in control was relevant to the evaluation of whether or not an acquisition constituted an RTO.

Company A was involved in the sale, design and manufacture of toys (the "**Original Business**") and conducted an open offer in order to raise funds for general working capital. When this open offer was made, Company A's chairman and controlling shareholder ("**Mr B**") did not avail of the opportunity to take up new shares and as a consequence his interest in Company A diminished from 40% to 8%. He then retired as chairman and as a director. Almost contemporaneously with this, Company A started in the business of property holding and research and the development of electric bus batteries. However, these activities were small in scale and not of great importance to Company A.

<u>Proposed acquisition and disposal</u>

Four months subsequent to the open offer completing, Company A proposed to acquire the Acquisition Target company, which was engaged in the manufacture of solar panels, from the Vendor (the "**Acquisition**"). This transaction would amount to a very substantial acquisition. Company A also intended to sell the Original Business to Mr B (the "**Disposal**"), with this transaction amounting to a very substantial disposal and also being contingent on the completion of the Acquisition. The rationale behind the Acquisition and Disposal, according to Company A, was that the former would allow it to commence business in a new high growth area and the latter would permit the realisation of its investment in what was a loss making venture. Company A claimed that the Acquisition did not amount to an RTO under Rule 14.06(6) due to the fact that:

(i) there would be no change of control of Company A (as defined in the Takeover Code) as a consequence of the Acquisition and the Disposal; and

(ii) the controlling stake in Company A had not changed hands in the 24 months before the agreements for the Disposal and Acquisition completed (Listing Rule 14.92 states that a listed issuer which disposes of its current business in the 24 months subsequent to a change in control will be treated as a new listing applicant).

The Exchange's Analysis

The two bright line tests for RTOs detailed in Rule 14.06 (6) are not exhaustive, and transactions effectively amounting to backdoor listings can be treated as RTOs. The Exchange accepted that the bright line tests did not apply in this case as the Acquisition would not result in a change in control, nor did the Vendor take control of Company A within the 24 month period before the completion of the Acquisition.

However, if the Acquisition was viewed by the Exchange as an RTO under Rule 14.06(6), and furthermore as an extreme case, then the initial listing requirements would apply to the acquisition. In evaluating whether or not this was the case, the Exchange took the following into account:

- the consequence of the Acquisition and Disposal would be a complete change in the business undertaken by Company A. The outcome of the transactions, when taken together, was that Company A would sell the Original Business to Mr B, while acquiring a whole new business from the Vendor and effectively listing it.

- the Acquisition Target had no trading record and was not capable of meeting the profit test for new applicants detailed in Rule 8.05 (1)(a).

The Exchange stated that the argument advanced by Company A, that the Acquisition could not be an RTO, as it would not cause a change in control (under the Takeover Code), was irrelevant. The Exchange highlighted the definition of an RTO under Rule 14.06 (6), which is an acquisition which the Exchange believes to be an attempt to list the assets acquired and circumvent the new listing requirements.

After considering the above factors, the Exchange found that the Acquisition was a component of a series of transactions designed to circumvent the obligations placed on new applicants and was also an extreme case. The listed issuer was therefore treated as a new listing applicant.

Listing Decision LD57-2013

Another extreme case of an RTO that did not meet the bright line tests in Rule 14.06(6) is Listing Decision LD57-2013. The Main Board listed issuer in this case ("**Company A**") attempted to acquire half of the share capital of the target company ("**Target**") in consideration of cash, consideration shares and convertible bonds. The consideration shares and convertible bonds issued would have comprised 180% of Company A's existing share capital, but the terms of the convertible bonds would not allow a conversion which would trigger a mandatory general offer under the Takeovers Code. The acquisition would have constituted a very substantial acquisition according to size tests. The Target's principal business was entirely different from those of Company A and following completion, the Target's shares would be accounted for as an interest in an associated company or an investment in Company A's financial statements.

The Exchange's Analysis

Neither of the bright line tests under Rule 14.06(6) applied; the transaction would not have resulted in a change in control under Rule 14.06(6)(a), nor would the target company have gained control of Company A within the 24 months prior to completion of the acquisition as required under Rule 14.06(6)(b). However, the Exchange concluded that the acquisition would be an RTO in essence for the following reasons:

- Not only would the transaction be a very substantial acquisition, but on completion, Company A's existing business and assets would be relatively immaterial to the enlarged group; and

- Neither the assets being acquired nor the enlarged group could meet the requirements of Rule 8.05(1), which requires new listing applicants to have a trading record of:

  - three financial years;

  - HK$20 million in profits for the most recent year; and

  - HK$30 million in profits (in aggregate) for the preceding two years.

Company A argued that the enlarged group would satisfy the profits test under Rule 8.05(1), but the Exchange determined that the Target's trading record should not be included for the purposes of the Rule since Company A would account for the assets being acquired as an interest in an associated company or an investment. Company A had recorded losses in the years before the proposed acquisition and the enlarged group (excluding the shares in the Target) could not meet Rule 8.05. The Exchange considered this to be an extreme case of an RTO. The acquisition did not meet the bright line tests under Rule 14.06(6), but as a transaction intended to list the shares in the target while circumventing the listing requirements, it was nevertheless an RTO in essence.

Listing Decision 95-4 on Application of the RTO Rules to Extreme Cases

In this Decision, released in July 2010, the Exchange was tasked with assessing whether or not a company's proposed acquisition should be regarded as an RTO under Rule 14.06 (6). It also considered the effect of both the old and new Chapter 18 Rules.

The company ("**Company A**") was engaged in the sale of machinery and equipment (the "**Existing Business**") and proposed to acquire a company (the "**Target**") from an independent third party (the "**Vendor**"), in a transaction constituting a very substantial acquisition. The Target was active in the oil and natural gas exploration, extraction and processing sectors. It held exploration and extraction rights in two gas fields, with one being in the preliminary exploration stage and exploration yet to commence on the other. However, Company A intended to continue the Existing Business after the Acquisition.

Main Board Rule 18.02(1)

This Rule was part of the pre-June 2010 regulatory framework for mineral companies, which was in force at the time of this case. It stated that an application for listing from a company whose current activities consist solely of exploration will not normally be considered by the Exchange, save where the issuer is able to demonstrate "*the existence of adequate economically exploitable reserves of natural resources, which must be substantiated by the opinion of an expert, in a defined area over which the issuer has exploration and exploitation rights.*"

The Exchange's Analysis

In classifying the Acquisition as an RTO under Rule 14.06(6), the Exchange was swayed by the following factors:

- the Acquisition met the requirements for classification as a very substantial acquisition, and, in terms of scale, would be significant for Company A. After the Acquisition, the Target's business would represent a considerable portion of Company A's business, and would involve an activity totally different from the Existing Business. The Exchange concluded that the Acquisition was a method of achieving a listing of the Target's business.

- the Target had generated no revenue at the time when the Acquisition was due to take place, meaning that it could not meet the profit test for new applicants in Rule 8.05(1).

- the Target fell within the classification of an early stage exploration company, as described in Rule 18.02(1), and was unsuitable for listing as Company A failed to demonstrate that the gas fields had the required reserves.

The Exchange also noted that even had the current Chapter 18 been in effect, the Target would still have been unsuitable for listing, as it would not have been able to show that it had a portfolio of identifiable resources (i.e. for oil and gas companies, Contingent Resources as defined in the new Chapter 18).

The Exchange finished by stating that the proposed Acquisition was a transaction aimed at achieving a listing of the Target's business and circumventing the requirements for new listings. It was an extreme case and must be viewed as an RTO under Rule 14.06 (6).

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