



Hong Kong

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## HKEX CONSULTS ON TIGHTENED HKEX LISTING RULES ON BACKDOOR LISTINGS AND SHELL COMPANIES

### 1. Introduction

The Stock Exchange of Hong Kong Limited (**Hong Kong Stock Exchange or HKEx**) published a Consultation Paper on Backdoor Listing, Continuing Listing Criteria and Other Rule Amendments<sup>1</sup> (**Consultation Paper**) on 29 June 2018 containing proposals to tighten the HKEx Listing Rules on reverse takeovers (i.e. backdoor listings) and the criteria for continued listing which are aimed at preventing the listing and continued listing of “shell companies” due to the HKEx’s concerns that these companies may become vehicles for backdoor listings. While the activities targeted by the proposals are confined to a relatively small sector of the market, HKEx notes that “these activities invite speculative trading and can lead to opportunities for market manipulation, insider trading and unnecessary volatility in the market which are not in the interest of the investing public.”

Responses to the consultation should be submitted by 31 August 2018.

In the Consultation Paper, HKEx is seeking views on proposed HKEx Listing Rule changes which will codify its practices in regulating backdoor listings and impose new requirements to deal with specific issues and backdoor transaction structures, for example where new investors obtain de facto control of an issuer which is then used as a listing platform to acquire new businesses and circumvent the new listing requirements, or issuers which make acquisitions by a series of small

acquisitions or acquire a new business that fails to satisfy the new listing requirements and then dispose of their original businesses.

HKEx has noted that the proposals are not intended to restrict listed issuers from legitimate business expansion or diversification that are part of the issuers’ business strategies and that it is aware of the impact of the proposed changes to the continuing listing criteria on a limited number of issuers. Under the proposals, there will be a transitional period of 12 months for those issuers to take corporate actions to comply with the amended continuing listing criteria. HKEx is conducting a separate review of the specific requirements applicable to listed issuers publishing audited financial statements with disclaimer or adverse audit opinions. It is apparently developing proposed Listing Rule amendments in this area to enhance the quality and reliability of financial information and any such amendments will include an appropriate transitional period for those issuers to remedy the audit issues and comply with the new Listing Rules. A further consultation paper will be published later this year to seek market views.

Separately, HKEx issued new Guidance Letter HKEx-GL96-18 giving examples of circumstances which may give rise to concerns that a listed issuer or its business is no longer suitable for listing. For example, HKEx may question an issuer’s suitability for listing if it has concerns that the issuer may be carrying on its business for the purpose of maintaining a listing status, rather than genuinely operating a business of substance.

<sup>1</sup> <https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/June-2018-Backdoor-and-Continuing-Listing/Consultation-Paper/cp201806.pdf?la=en>

## 2. The Consultation Paper's Key Proposals

### 2.1 Proposals relating to backdoor listings

#### 1. RTO Definition Amendments

##### a) *Principle based test – codification and modification*

The principle based test for a reverse takeover transaction (**RTO**) set out in Guidance Letter GL78-14 will be codified in a Note to proposed Listing Rule 14.06B with modifications to two assessment criteria to:

- i) extend the current criterion “issue of restricted convertible securities” to include any change in control or de facto control of the issuer. Indicative factors of a change in de facto control will include: (A) a substantial change in board / key management; (B) change in single largest substantial shareholder, and (C) the issue of restricted convertible securities; and
- ii) clarify the “series of arrangements” criterion to include transactions and/or arrangements that are in reasonable proximity (normally within 36 months) or are otherwise related. These may include changes in control/ de facto control, acquisitions, disposals or termination of the original businesses, and in some circumstances, greenfield operations or equity fundraisings related to acquisitions of new lines of businesses.

The entire series of transactions and/or arrangements would be treated as if it were one transaction (consequently, a disposal may trigger an RTO ruling on a previously completed acquisition in the same series, or a number of smaller acquisitions may form an RTO).

##### b) *Modification of the bright line tests*

The bright line tests will be modified so that:

- i) the RTO Rules will apply to very substantial acquisition(s) from the controlling shareholder within 36 (instead of 24) months from a change in control (as defined under the Takeovers Code); and
- ii) the restriction on disposals will restrict any material disposal at the time of or within 36 months after a change in control of the issuer (as defined under the Takeovers Code) unless the remaining business, or any assets acquired after the change in control can meet Listing Rule 8.05. HKEx will also apply the disposal restriction to a material disposal at the time of or within 36 months after a change in the issuer's single largest shareholder.

##### c) *Prohibition on backdoor listings through large scale issues of securities*

HKEx Guidance Letter GL84-15 will be codified to disallow backdoor listings through large scale issues of securities for cash where 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. Tightened compliance requirements for RTOs and extreme transactions

The proposals aim to discourage the use of “shell” companies for backdoor listings and to ensure the acquisition targets that are the subject of a new listing under the RTO Rules are suitable for listing. Under the proposals:

- a) The acquisition targets must be suitable for listing (under Listing Rule 8.04) and meet the trading record requirements for new applicants (Listing Rule 8.05) and the enlarged group must satisfy all new listing criteria (except Listing Rule 8.05);
- b) In the case of issuers that do not comply with Listing Rule 13.24 (typically suspended companies), each of the acquisition targets and the enlarged group must comply with all new listing requirements;

- c) The “extreme VSAs” category set out in HKEx Guidance Letter GL78-14 will be codified and renamed as “extreme transactions”. Shell companies are not eligible for this category and accordingly, the issuer must either:
- i) operate a principal business of substantial size; or
  - ii) have been under the long-term control of a large business enterprise and the acquisition forms part of a business restructuring with no change of control; and
- d) Where an RTO or extreme transaction involves a series of transactions and/or arrangements, issuers must include the pro forma income statement of all acquisition targets and any new business developed that are part of the series in the listing document or circular.

## 2.2 Proposals relating to continuing listing criteria

The proposed amendments to the criteria for continuing listing are intended to address specific concerns relating to certain issuers that seek to maintain their listing status by holding significant assets or investments, rather than by operating businesses that have substance and are viable and sustainable in the longer term. The proposals:

- a) Amend Listing Rule 13.24 on sufficiency of operations

A listed issuer will be required to carry out a business with a sufficient level of operations and assets of sufficient value to warrant its continued listing (and not sufficient operations of assets as set out in the current Listing Rule). This excludes any securities trading and/or investment activities (other than those of a Chapter 21 investment company). A listed issuer that does not operate a business that has substance and/or is viable and sustainable will not comply with the revised Listing Rule.

- b) Amend Rules 14.82 and 14.83 on cash companies

The definition of “short-dated securities” in the cash company Listing Rules will be amended to include investments that are easily convertible into

cash (e.g. investments in listed securities). The exemption for securities brokerage companies will only apply to clients’ assets.

- c) Proposed Transitional Arrangements

A 12-month transitional period will apply for issuers not meeting the amended continuing listing criteria. No transitional period will apply to the amendments to the RTO Rules. However, if issuers conduct transactions in order to re-comply with the new Listing Rules, HKEx will take this into consideration in order to facilitate their re-compliance.

## 2.3 Other Proposed HKEx Listing Rule Amendments

HKEx is proposing to improve the Listing Rules in the following areas:

- a) Securities Transactions

- i) The revenue exemption from the notifiable transaction requirements will only be available to purchases and sales of securities if they are conducted by members of an issuer group that are subject to the supervision of prudential regulators (i.e. banking companies, insurance companies or securities houses); and

- ii) Issuers will be required to disclose in their annual reports details of each securities investment that represents 5% or more of their total assets.

- b) Significant Distribution in Specie of Unlisted Assets

Listing Decision LD75-4 will be codified to impose further requirements on a distribution in specie that is equivalent in size to a very substantial disposal, comparable to the requirements for a withdrawal of listing.

- c) Other Matters relating to Notifiable and Connected Transactions

HKEx has proposed:

- i) Disclosure of 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;
- ii) Disclosure by way of announcement if there is:
  - A. any change to a guarantee referred to in (i) above; or
  - B. the actual financial performance of the target acquired fails to meet the guarantee (this is currently only required for connected transactions);
- iii) Disclosure of:
  - A. the identities of the parties to a transaction in announcements of notifiable transactions; and
  - B. the identities and activities of the parties to the transaction and of their ultimate beneficial owners in connected transaction announcements;
- iv) Listing Rule amendments to clarify that where any calculation of the percentage ratios produces an anomalous result or is inappropriate to the sphere of activity of the listed issuer, HKEx (or the issuer) may apply an alternative test that it considers appropriate to assess the materiality of a transaction under Chapter 14 or 14A.

acquired and a means to circumvent the requirements for new applicants under Chapter 8 of the Listing Rules (the **principle based test**).

The Listing Rules give the following two examples of RTOs:

- i) 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) of the listed issuer (other than at the level of its subsidiaries); or
- ii) a 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) of the listed issuer (other than at the level of its subsidiaries) (the **bright line tests**).

The RTO Rules are aimed at preventing the circumvention of the new listing requirements. HKEx published Guidance Letter GL78-14 in May 2014 providing guidance on its application of the RTO Rules and adopting the principle based test.

Under the principle based test, the Stock Exchange applies six assessment criteria in assessing whether a transaction constitutes an attempt to achieve a listing of the assets to be acquired and a means to circumvent the requirements for new listing. The six criteria are:

- i) the size of transaction relative to the size of the issuer;
- ii) the quality of the business to be acquired - whether it can meet the trading record requirements for listings, or whether it is unsuitable for listing (e.g. an early stage exploration company);
- iii) the nature and scale of the issuer's business before the acquisition (e.g. whether it is a listed shell);
- iv) any fundamental change in the issuer's principal business (e.g. the existing business would be discontinued or very immaterial to the enlarged group's operations after the acquisition);
- v) other events and transactions (historical, proposed or intended) which, together with the acquisition, form a series of arrangements to circumvent the

### 3. Proposals relating to Backdoor Listing - Definition of an RTO transaction

#### 3.1 Current definition and practice

A reverse takeover is currently defined by Listing Rule 14.06(6) as an issuer's acquisition or a series of acquisitions of assets (the **target**) which, in the opinion of the Hong Kong Stock Exchange, constitutes, or is part of a transaction or arrangement or series of transactions or arrangements which constitute, an attempt to achieve a listing of the assets to be

RTO Rules (e.g. a disposal of the issuer's original business simultaneously with a very substantial acquisition); and

- vi) any issue of restricted convertible securities to the vendor which would provide it with de facto control of the issuer.

### 3.2 Issues and Findings

#### 1) Large scale issues of securities

The structure of RTO transactions changed after the publication of Guidance Letter GL78-14. Certain issuers undertook large scale share subscriptions that led to the introduction of new controlling shareholders who would use the injected funds to commence greenfield operations unrelated to the issuers' original businesses. As there were no acquisitions, the RTO Rules did not apply to the new businesses, however the new controlling shareholders effectively acquired a listed shell for the operation of a new business and thereby circumvented the new listing requirements.

#### 2) Series of transactions and/or arrangements

There have also been cases where issuers have built up a new business via a series of smaller acquisitions, or acquired a new business and then disposed of its original business, in order to circumvent the new listing requirements. The transactions and/or arrangements together, in effect, fundamentally changed the nature of the issuer's principal business.

In certain cases, investors have acquired control of listed issuers and used the issuers as a listing platform to obtain new businesses unrelated to the original businesses. Some issuers would then completely change their principal business by disposing, terminating or diminishing over time their original business, whilst others would conduct multiple new businesses in different sectors through a series of acquisitions and greenfield operations.

The Hong Kong Stock Exchange has applied the "series of arrangements" criterion to aggregate acquisitions conducted over a short period and which, together, would result in the issuer's substantial involvement in a new business entirely different from its principal business. However, there are ambiguities in the current Listing Rules. In addition, the RTO Rules currently would not apply to an acquisition where an issuer acquired a new business prior to disposing of its original businesses.

### 3.3 Proposed Amendments to the RTO Rules

- 1) Codify the six assessment criteria currently set out in Guidance Letter GL78-14 (with modifications) while retaining the principle based test in the RTO Rules (proposed Listing Rule 14.06B)

The Stock Exchange considers that the RTO Rules should be principles based and not a bright line test. It also considers that the current RTO Rules and the criteria specified in Guidance Letter GL78-14 (subject to modification) provide a suitable framework to deal with backdoor listings, providing flexibility to address changing RTO structures without imposing undue restrictions on issuers' legitimate business activities.

It thus proposes to codify the six assessment criteria under the principle based test set out in Guidance Letter GL78-14 as a Note to the proposed Listing Rule 14.06B. The six assessment criteria are subject to modifications as set out in proposals (2) and (3) below.

- 2) Extend the current criterion "issue of restricted convertible securities" in the principle based test to include any change in control or de facto control of the issuer

One of the current six criteria under Guidance Letter GL78-14 is "any issue of Restricted Convertible Securities to the vendor which would provide it with de facto control of the issuer". The Stock Exchange proposes that this criterion should be modified in the codification of the guidance letter under proposed Listing Rule 14.06B to refer to any change in control (as defined in the Takeovers Code) or de facto control of the listed issuer (other than at the level of its subsidiaries).

Under proposed Listing Rule 14.06B, the Stock Exchange regards a change in control or de facto control as a material factor when determining whether a transaction is an RTO, because the major shareholder may oversee the operations and business direction of the issuer in appointing the board of directors. The Hong Kong Stock Exchange will also consider the influence a new major shareholder may have over the issuer when determining whether there is a change in de facto control of the listed issuer (other than at the level of its subsidiaries). Factors the Stock Exchange will consider include:

- a) any substantial change in the issuer's board of directors and key management;
- b) any change in its single largest substantial shareholder; and

- c) as consideration for an acquisition, any issue of restricted convertible securities (that is, convertible securities with a conversion restriction mechanism) to circumvent triggering a change in control under the Takeovers Code, to a vendor.

### 3) Clarify the “series of arrangements” criterion

A further criterion under Guidance Letter GL78-14 is “other events and transactions (historical, 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)”. It is proposed to clarify this criterion in its Listing Rules codification.

Currently, the RTO Rules only apply to acquisitions and may not apply where an issuer has disposed of its original business following an acquisition of a new business, which in effect is the listing of the acquired business. There is also no guidance on the applicable period for assessing a series of arrangements, or as to how to assess the size of the new business when determining “size of the target’s business relative to the size of the listed issuer’s existing business”. Further, the “series of arrangements” criterion should deal with the situation where issuers and major shareholders carry out a series of smaller transactions and/or arrangements over time to attain a listing of new businesses.

Under proposed Listing Rule 14.06B, the Hong Kong Stock Exchange will take into account, as a factor, other transactions or arrangements (historical, proposed or intended) which, together with the acquisition(s), form a series of arrangements to list the acquisition targets. These transactions or arrangements may include changes in control/de facto control, acquisitions, disposals or termination of the original business and, in some circumstances, greenfield operations or equity fundraisings related to, or for the development of, newly acquired businesses. The Stock Exchange may consider acquisitions and other transactions or arrangements as a series if they occur in reasonable proximity to each other (which normally refers to a period of 3 years or less) or are otherwise related.

According to the Consultation Paper, this criterion should not unduly restrict issuers’ business expansion or diversification that occur over a reasonable period where there is increased public disclosure on issuers’ business operations and developments. A transaction or arrangement that falls outside of the three-year period would not usually be regarded by the

Stock Exchange as part of the series, except where there are specific concerns regarding circumvention of the RTO Rules. The Listing Rules may be applied where an issuer has acquired and/or developed multiple new businesses in different sectors over the three-year period and there are concerns regarding “shell” activities.

The Stock Exchange will consider whether the size of an acquisition is very substantial. According to the Consultation Paper, the calculation of the percentage ratios for acquisitions in a series of transactions would be as follows:

- a) the denominator would be the lower of:
  - i) the issuer’s published financial figures for the immediate past financial period (i.e. revenue/profits/assets) or market capitalisation prior to the first transaction in the series; and
  - ii) its latest published financial figures or market capitalisation at the time of the last transaction in the series; and
- b) the numerator would be the aggregation of the financial figures of the targets acquired and/or to be acquired or the considerations for the acquisitions at the time of the respective acquisitions.

The Stock Exchange may determine that there is a fundamental change in an issuer’s principal business where its new businesses in aggregate are material in size compared to its original business (that is, the business it carried out prior to the first transaction/event in the series) at the time of the latest proposed transaction in the series, with reference to the financial figures in its and the targets’ most recently published accounts.

The Stock Exchange considers the effect of all transactions and/or arrangements as a whole. Thus, where an acquisition of a new business occurred at an earlier period within the three-year period, by treating the series of arrangements as one transaction, the RTO Rules may apply to that completed transaction. Therefore, it is no longer necessary for the proposed (last) transaction to be an acquisition to trigger the RTO Rules.

The Stock Exchange may also impose additional requirements on an issuer where it considers that a proposed transaction, together with a series of transactions and/or arrangements, is a pre-ordained strategy to avoid the new listing requirements.

For example, it may require the issuer to engage a financial adviser to conduct due diligence and make enhanced disclosures on its completed acquisitions in a series. The SFC may also take separate regulatory action (if appropriate) under the Securities and Futures Ordinance (Cap. 571) (the **SFO**) and/or the Securities and Futures (Stock Market Listing) Rules (Cap. 571V).

4) Retain and modify the bright line tests under current Listing Rule 14.06(6) and current Listing Rules 14.92 and 14.93

The Hong Kong Stock Exchange proposes to retain the bright line tests for RTOs under current Listing Rules 14.06(6)(a) and (b) in a Note to the new Listing Rule 14.06B, with a modification to increase the period for a very substantial acquisition of assets from within 24 months to within 36 months.

A listed issuer is restricted under Listing Rules 14.92 and 14.93 from disposing of its existing business for 24 months after a change in control (as defined in the Takeovers Code), unless the assets acquired from the new controlling shareholder (and its associates) and any other assets obtained after the change in control can satisfy the financial tests of Listing Rule 8.05.

Listing Rules 14.92 and 14.93 are proposed to be replaced by a new Listing Rule 14.06E, pursuant to which a listed issuer may not carry out a material disposal (or a disposal by way of distribution in specie that amounts to a material disposal) of its existing business:

- a) when there is a proposed or intended change in control (as defined in the Takeovers Code) of the issuer (other than at the level of its subsidiaries); or
- b) for a period of 36 months from a change in control (as defined in the Takeovers Code), unless the requirements of Listing Rule 8.05 (or Listing Rules 8.05A or 8.05B) can be satisfied by:
  - i) the remaining group; or
  - ii) the assets acquired from the new controlling shareholder or its associates and any other assets obtained after the change in control.

These proposals thus:

- a) extend the restriction period from 24 months to 36 months;

- b) apply the restriction period to a material disposal or distribution in specie (rather than a mere disposal);
- c) extend the restriction to also apply where there is a proposed or intended change in control, or at the time of the change in control (to address shell structures where a controlling shareholder disposes of its interest and buys back a material part of the issuer's principal business); and
- d) disapply the restriction if the remaining group (and not merely assets obtained after the change in control) can satisfy the requirements of Listing Rule 8.05 (or Listing Rules 8.05A or 8.05B).

A new Note to proposed Listing Rule 14.06E will give the Hong Kong Stock Exchange the discretion to apply the rule to a material disposal (or a disposal by way of distribution in specie that amounts to a material disposal) of an issuer's existing business:

- a) when there is a proposed or intended change in the single largest substantial shareholder of the issuer; or
- b) for a period of 36 months from such change, if the Stock Exchange considers that the disposal (or distribution in specie) may be part of a series of arrangements to circumvent the new listing requirements.

This proposal deals with the situation where a substantial shareholder obtains de facto control, and the issuer develops a new business and disposes of the original business, and the series of transactions would not fall under the new listing requirements and/or the proposed RTO Rules (which apply to acquisitions).

5) Codify the current "extreme VSA" requirements (proposed Listing Rule 14.06C)

The RTO Rules apply to acquisitions that attempt to achieve a listing of the assets to be acquired and a means to circumvent the requirements for new applicants in Chapter 8 of the Listing Rules. Circumvention of the new listing requirements would not be a material concern if the target business satisfies Chapter 8 eligibility and suitability listing requirements and, according to Guidance Letter GL78-14, the proposed acquisition may be classified as an extreme VSA. The guidance letter requires issuers to prepare a transaction circular under an enhanced

disclosure and vetting approach, and to appoint a financial adviser to conduct due diligence on the acquisition who must provide a declaration to the Stock Exchange regarding its due diligence.

The Stock Exchange proposes to codify the extreme VSA requirements under Guidance Letter GL78-14, and classify this type of transaction as an “extreme transaction” under the Listing Rules, and to introduce additional requirements for extreme transactions.

Under new Listing Rule 19.06C, an “extreme transaction” is a proposed and/or completed acquisition or series of acquisitions of assets (the **acquisition targets**) by an issuer, which individually or together with other transactions or arrangements, may, by reference to the factors specified in Note 1 to Listing Rule 14.06B, have the effect of achieving a listing of the acquisition targets, and the Hong Kong Stock Exchange is satisfied that it is not an attempt to circumvent the requirements for new applicants in Chapter 8, and:

- a) either:
  - i) the issuer has been operating a principal business of a substantial size, which will continue after the transaction; or
  - ii) the issuer has been under the control of a large business enterprise for a long period (normally not less than 3 years), and the transaction forms part of a business restructuring of the issuer and would not result in a change in control (as defined in the Takeovers Code) of the listed issuer (other than at the level of its subsidiaries); and
- b) the acquisition targets and the enlarged group satisfy Listing Rule 8.04. In addition, the acquisition targets must satisfy Listing Rule 8.05 (or Listing Rules 8.05A or 8.05B) and the enlarged group meets all the new listing requirements of Chapter 8 of the Listing Rules (except Listing Rule 8.05).

According to the Consultation Paper, the Hong Kong Stock Exchange would usually classify an acquisition (or a series of acquisitions) as an “extreme transaction(s)” in circumstances where:

- a) an issuer carries out very significant business expansions and/or diversifications and the issuer has been operating a business of substantial size; or
- b) the acquisitions arise from group reorganizations.

Issuers with “shell” like characteristics are not able to benefit from the extreme transaction classification. The Stock Exchange provides general guidance in its Consultation Paper that “a principal business with substantial size” may include a principal business with annual revenue or total asset value of at least HK\$1 billion (excluding any revenue or assets not attributable to the issuer’s original principal business and any revenue or assets attributed to a newly acquired or developed business). In determining whether an issuer’s principal business is of substantial size, the Hong Kong Stock Exchange would also consider its financial position, the nature and operating model of its business and future business plans.

Pursuant to proposed new Listing Rule 14.53A, in the case of an extreme transaction, the listed issuer must comply with the following requirements (which are consistent with the requirements under GL78-14):

- a) comply with the requirements for very substantial acquisitions set out in Listing Rules 14.48 to 14.53. The circular must contain the information required under Listing Rule 14.69; and
- b) appoint a financial adviser to perform due diligence on the assets subject to the acquisition (and any assets and businesses subject to a series of transactions and/or arrangements, if any). The financial adviser must submit to the Stock Exchange a declaration in relation to the due diligence conducted before the bulk-printing of the circular for the transaction.

Under proposed Listing Rule 13.87B, the financial adviser must be a person licensed or registered for Type 6 regulated activity under the SFO, and permitted under its license or certificate of registration to undertake sponsor work. The financial adviser is also required to submit to the Hong Kong Stock Exchange an undertaking to comply with the Listing Rules and co-operate in any investigation conducted by the Stock Exchange.



Where the Hong Kong Stock Exchange is of the view that an acquisition may be an “extreme transaction”, such transaction would be presented to the Listing Committee who would determine whether it is an “extreme transaction” or an RTO.

6) Impose additional requirements for transactions classified as RTOs and extreme transactions

Currently, the Hong Kong Stock Exchange treats a listed issuer proposing an RTO as if it were a new listing applicant (Listing Rule 14.54). The enlarged group or the assets to be acquired must be able to satisfy Listing Rule 8.05 and the enlarged group must be able to meet all other basic conditions for listing under Chapter 8. This rule currently applies to extreme VSAs as well.

The Stock Exchange proposes to amend Listing Rule 14.54 (applicable to RTOs) and add Listing Rule 14.06C(2) (applicable to extreme transactions) so that:

- a) the assets acquired and/or to be acquired (the **acquisition targets**) and the enlarged group must satisfy the requirements of Listing Rule 8.04 (suitability for listing); and
- b) the acquisition targets must satisfy the requirements of Listing Rule 8.05 (or Listing Rules 8.05A or 8.05B) and the enlarged group must satisfy all new listing requirements under Chapter 8 (except Listing Rule 8.05).

This proposal results from isolated cases where acquisition targets have not satisfied Chapter 8’s new listing requirements, and investors have acquired a “listed shell” and conducted an RTO, instead of an initial public offer.

It is also proposed to add a provision under Listing Rule 14.54 so that where an RTO proposed by a listed issuer fails to comply with Listing Rule 13.24, each of the acquisition targets and the enlarged group must meet all new listing requirements under Chapter 8.

Under a proposed Note to Listing Rule 14.54, if the Hong Kong Stock Exchange is aware of information suggesting that an RTO is proposed to avoid any new listing requirement, the listed issuer must demonstrate that each acquisition target satisfies all Chapter 8 new listing requirements.

Under current Listing Rule 14.57, an issuer proposing an RTO must comply with the procedures and requirements for new listing applications under Chapter 9. For RTOs which entail a series of acquisitions, both the completed acquisition(s) and the proposed acquisition must comply with documentary requirements, which includes the production of accountants’ reports and pro forma financial information. Currently, the Listing Rules do not offer guidance on the determination of the track record period and the presentation of the financial information.

The Stock Exchange proposes to add a new Listing Rule 14.57A which will provide that where there is an extreme transaction or RTO involving a series of transactions and/or arrangements:

- a) the track record period will usually include the three financial years immediately prior to the issue of the circular or listing document seeking shareholders’ approval for the most recent transaction of the series; and
- b) the circular or listing document must include the pro forma income statement of all the acquisition targets in the series of acquisitions (and any new businesses developed by the issuer that form part of the series, where applicable) for the track record period in order to demonstrate that the requirements under Listing Rule 8.05 (or Listing Rules 8.05A or 8.05B) are satisfied.

A proposed new Listing Rule 4.30 provides that the pro forma income statement should combine the historical income statements of the acquisition targets as if they had been operated as a single group on an aggregated basis since the start of the track record period. The pro forma financial information must be published for each financial year/period of the track record period. The unadjusted information must be derived from the acquisition targets’ accountants’ reports for the track record period. The pro forma financial information must be reported on in the circular or listing document by the auditors or reporting accountants.

7) Add a new Listing Rule 14.06D to codify, with modification, the practice set out in Guidance Letter GL84-15 to regulate backdoor listings through large scale issues of securities

The Hong Kong Stock Exchange has applied the cash company provisions of the Listing Rules (**Cash Company Rules**) to prevent large scale issues of securities where the funds raised

would be applied to greenfield operations of new businesses with little or no relation to the company's existing principal business, and which, in the opinion of the Stock Exchange, are a means to list the new businesses and circumvent the new listing requirements. The Stock Exchange's approach to applying the Cash Company Rules is set out in Guidance Letter GL84-15.

The Stock Exchange proposes to codify the practice set out in Guidance Letter GL84-15 (with modification) under a new anti-avoidance provision, Listing Rule 14.06D. According to the proposed new Listing Rule, the Stock Exchange may refuse to grant listing approval for new shares where an issuer proposes a large scale issue of new shares (including any warrants, options or convertible securities) for cash with the intention of acquiring and/or developing a new business that is expected to be substantially larger than its existing principal business, where in the Stock Exchange's opinion, the issue is a means to circumvent the new listing requirements and to achieve a listing of that new business.

The modification means that the anti-avoidance restrictions would apply to funds raised to be used to develop a new business through future acquisitions, rather than only greenfield operations (as in the Guidance Letter GL84-15).

A Note to the proposed new Listing Rule provides that the rule is not intended to restrict fundraising activities of listed issuers generally; and will not usually apply to an issue of securities if, taking into account the proceeds from the issue, less than half of the issuer's assets would comprise of cash as a result of the fundraising (except where there are specific concerns regarding circumvention of the rule).

Guidance Letter GL84-15, which explains the intent and operation of the provision, will be retained.

## 4. Proposals relating to Continuing Listing Criteria

### 4.1 Continuing Listing Criteria - Current Listing Rules

#### 1) Current Listing Rule on sufficiency of operations

Under Listing Rule 13.24, 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 Hong Kong Stock Exchange to warrant the continued listing of its securities.

Although Listing Rule 13.24 does not offer guidance as to what is considered "sufficient operations or assets", in practice, an issuer is required to demonstrate that it carries out a viable and sustainable business.

According to Listing Decision LD35-2012, Listing Rule 13.24 is intended to maintain overall market quality, and where issuers do not satisfy this rule, public investors are not provided with information about issuers' business plans and prospects. The Stock Exchange would suspend trading in an issuer's securities under Listing Rule 6.01(3) for the protection of investors and the maintenance of an orderly market where the issuer does not meet the Listing Rule 13.24 requirement.

Significant demand for shell companies in recent years has resulted in "shell cleansing" activities where issuers dispose of their main businesses and only very small operations remain in order to satisfy the continuing listing obligations. Recently, the Stock Exchange has adopted a robust approach in applying Listing Rule 13.24 to issuers with very low levels of operations, with several listing decisions being published. The Stock Exchange is of the opinion that an issuer should carry out a business of sufficient size to justify its listing.

#### 2) Current Listing Rule on suitability for continued listing

Pursuant to Listing Rules 8.04 and 6.01(4), issuers (new applicants as well as listed issuers) and their businesses must be suitable for listing in the opinion of the Hong Kong Stock Exchange.

The Stock Exchange issued Guidance Letter GL96-18 on 29 June 2018 on listed issuers' suitability for continued listing. According to the Guidance Letter, an example of a circumstance where the Stock Exchange may raise concerns on the suitability for listing of an issuer or its business is where issuers have ceased or disposed of their original business and carry on new businesses, and have business models which have shell-like characteristics and give rise to concerns whether they are carried out to maintain a listing status and are suitable for listing.

### 4.2 Requirements in Other Markets

Other markets such as the UK and Australia have rules similar to Hong Kong's Listing Rule 13.24 on sufficiency of operations. However, in some markets in Asia (including Singapore and Shanghai), issuers are subject to quantitative continuing listing

requirements and may be delisted if they continue to incur losses for several years or their assets are below a specified level.

Hong Kong's rule on suitability for continued listing is in line with other markets.

#### 4.3 Issues and Findings

The Stock Exchange states in the Consultation Paper that the growing demand for shell companies has resulted in an increase in shell creation and maintenance activities, such as disposals or termination of an issuer's main business, and carrying on businesses with a very low level of operations to satisfy the continuing listing obligations, which gives rise to concerns relating to the suitability of listing of such businesses.

In order to address such concerns, the Hong Kong Stock Exchange has applied the current Listing Rules on continuing listing requirements, and it considers that such Listing Rules are largely adequate.

The Stock Exchange considers that quantitative continuing listing requirements are an arbitrary measure of the "quality" of listed issuers and are likely to have a wide implication on issuers, and thus does not propose to introduce such requirements.

#### 4.4 Proposals – Amendments to Listing Rule 13.24

The Stock Exchange proposes to amend Listing Rule 13.24 so that an issuer is required to carry out a business with a sufficient level of operations and have assets of sufficient value to support its operations to warrant its continued listing.

It further proposes to amend the Note to Listing Rule 32.4. Under the proposed amendments to the Note, the Hong Kong Stock Exchange clarifies the position that the rule is a qualitative test. The Stock Exchange may consider an issuer to not comply with the rule where, for example, it considers that the issuer does not have a business that has substance and/or that is viable and sustainable. For example, when determining whether a money lending business is a business of substance, the Stock Exchange may take into account factors including the business model, operating scale and history, source of funding, size and diversity of customer base, loan portfolio and internal control systems of the money lending business of the issuer. The onus is on the issuer to demonstrate its compliance with the rule to the Stock Exchange's satisfaction. Where an

issuer is not operating a business of substance, the issuer's suitability for continued listing under Listing Rule 6.01(4) may be questioned.

According to the Consultation Paper, issuers with substantial operating assets which undergo a temporary reduction or suspension of operations as a result of market conditions or business strategies would not breach the rule merely as a result of its temporary circumstances.

It is proposed to remove the current Note which specifies characteristics of issuers unable to comply with the rule, as the current Note fails to sufficiently explain all situations where an issuer is considered to have not complied with the proposed Listing Rule 13.24.

The Stock Exchange also proposes to exclude an issuer's trading and/or investment in securities (other than an investment company listed under Chapter 21) when determining whether the issuer can satisfy the sufficiency of operations and assets requirement under Listing Rule 13.24. There has been commentary in the market suggesting that some issuers are engaging in securities trading or investment in order to maintain their listing status (as opposed to operating a business of substance), because such investments can be easily liquidated where an investor obtains control of the issuer. Listings of issuers engaged in trading and/or investment in securities are governed by Chapter 20 (authorised collective investment schemes) and Chapter 21 (non-authorised collective investment schemes). The Stock Exchange does not consider listed issuers to be primarily engaged in trading and/or investment in securities as their principal business unless they are listed under Chapters 20 and 21 and are subject to applicable SFC regulation on collective investment schemes or investment companies.

## 5. Cash companies

### 5.1 Current Listing Rules

Under the Cash Company Rules, i.e. Listing Rules 14.82 to 14.84, listed issuers will not be considered as suitable for listing where for any reason their assets consist wholly or substantially of cash or short-dated securities. Short-dated securities are securities such as bonds, bills or notes with less than one year to maturity. The Cash Company Rules do not apply to Chapter 21 investment companies or issuers solely or mainly engaged in the securities brokerage business. The rules are intended to prevent speculative trading in securities of companies with no substantive business.

The Listing Rules do not prescribe a threshold on the amount of cash to fall under the Cash Company Rules, however the amount is normally expected to be much greater than half of the issuer's total assets. The Stock Exchange also takes into account the nature of the issuer's business as well as its business model when making a determination.

As provided in Guidance Letter GL84-15, the Cash Company Rules are being applied where investors inject substantial amounts of cash into issuers to operate new businesses which are expected to be substantially larger than the original business and the investors are in effect listing, through the listed company, new businesses which would not have otherwise satisfied the new listing requirements

## 5.2 Issue

Certain issuers have disposed of their main businesses and converted a substantial amount of the cash proceeds into highly liquid assets, for example listed securities or short-term loans, in order to reduce their cash levels so as to not fall within the Cash Company Rules. These assets are not caught by the Listing Rules' definition of short-dated securities.

## 5.3 Proposals – Amendments to the Cash Company Rules

### 1) *Amendment to Listing Rule 14.82*

The Hong Kong Stock Exchange proposes to amend the definition of short-dated securities in Listing Rule 14.82 to include investments that are easily convertible into cash, referred to under the proposed amendments as "short-term investments".

Pursuant to a proposed Note to the Listing Rule, the Hong Kong Stock Exchange will take into account the issuer's intention in holding the assets, as well as the marketability or liquidity of the assets, when assessing whether an issuer's assets are short-term investments. Examples of short term investments under the proposed Note are:

- a) bonds, bills or notes which have less than one year to maturity or which are intended to be held for less than one year;
- b) securities listed on the Stock Exchange or other stock exchanges that are available for sale;
- c) investments that are readily realisable or convertible to cash; and

- d) advances to third parties which are repayable within one year (excluding trade receivables arising from the issuer's ordinary and usual course of business).

In determining whether an issuer falls under Listing Rule 14.82, the Hong Kong Stock Exchange will usually consider the value of the issuer's cash and short-term investments relative to its total assets, the nature of the issuer's business, as well as its level of operations and financial position. According to the Consultation Paper, where the holding assets of an issuer are, in the Stock Exchange's opinion, a method of circumventing the Cash Company Rules, the Stock Exchange will include such assets as short-term investments. On the other hand, near cash assets used in the ordinary and usual course of business will not be included as short-term investments.

### 2) *Amendment to Listing Rule 14.83*

Currently, a listed issuer which is solely or mainly engaged in the securities brokerage business is not subject to Listing Rule 14.82. It is proposed to restrict the exemption to assets held on behalf of its clients relating to such brokerage business.

## 5.4 Transitional Arrangements

A transitional period of 12 months from the effective date of the amendments is proposed for Listing Rules 13.24, 14.82 and 14.84.

## 6. Other proposed Listing Rule amendments

### 6.1 Proposals relating to securities transactions

#### 1) Confine the revenue exemption for securities transactions

Pursuant to Listing Rule 14.04(1)(g), any transaction of a revenue nature in the ordinary and usual course of business of the issuer is exempt from the Chapter 14 notifiable transaction requirements.

In order to strengthen investor protection and prevent shell activities, it is proposed to limit this exemption to acquisitions and disposals of securities only where they are carried out by members of the issuer group that are subject to the supervision of prudential regulators (i.e. banking companies, insurance companies, or securities houses) as one of the principal activities and in the ordinary and usual course of business of the issuer.

## 2) Require disclosure of significant investments in annual reports

Issuers must disclose significant investments held, their performance during the financial year and their future prospects in their annual reports (Paragraph 32(4) of Appendix 16 to the Listing Rules).

A new requirement for issuers to disclose a breakdown of their significant investments, including any investment with a value of 5% of the issuer's total assets, is proposed. Proposed specific disclosure requirements include:

- a) details of each investment, including the name and principal businesses of the underlying company, the number or percentage of shares held and the investment costs;
- b) the fair value of each investment as at the year-end date and its size relative to the issuer's total assets;
- c) the performance of each investment during the year, including any realised and unrealised gain or loss as well as any dividends received; and
- d) a discussion of the issuer's investment strategy for these significant investments.

## **6.2 Proposal relating to distribution in specie of unlisted assets**

According to Listing Decision LD75-4, an issuer's distribution of a significant portion of its business in specie, relative to its remaining operations, is tantamount to a delisting of the assets to be distributed, and thus, shareholders should be afforded the same level of protection as for delistings. The Stock Exchange proposes to add a new Listing Rule 14.94 which codifies the requirements for a significant distribution in specie of unlisted assets set out in Listing Decision LD75-4.

Under the proposed new Listing Rule, where a listed issuer proposes a distribution of assets (excluding listed securities) and such disposal would constitute a very substantial disposal based on the percentage ratio calculations:

- a) prior approval by independent shareholders in a general meeting is required – approval by at least 75% of the votes attaching to any class of listed securities, and the number of votes cast against the resolution being not more than 10% of the

votes attaching to any class of listed securities. Controlling shareholders (or where there is no controlling shareholder, the directors (excluding independent non-executive directors (**INEDs**)) and the chief executive) and their respective associates must abstain from voting in favour of the resolution; and

- b) the issuer's shareholders (apart from the directors (excluding INEDs), chief executive and controlling shareholders) should be offered a reasonable cash alternative or other reasonable alternative for the distributed assets.

## **6.3 Proposals relating to notifiable or connected transactions**

### 1) Disclosure on the outcome of a financial performance guarantee of a target acquired by the issuer in a notifiable or connected transaction

Under Listing Rule 14A.63, listed issuers must disclose specified information in an announcement and in their next annual report where actual performance fails to meet the guarantee given by a connected person. The current Listing Rules do not cover disclosure requirements relating to performance guarantees given by independent parties.

The Stock Exchange proposes to amend the Listing Rules in relation to notifiable transactions and connected transactions to require an issuer to disclose by way of an announcement any subsequent change to a guarantee's terms (with reasons), and whether the INEDs consider that such change is fair and reasonable and in the interests of the shareholders as a whole. Further, where actual performance fails to meet the guarantee, the issuer must make specified disclosures in an announcement (currently only required for a connected transaction). The issuer must also disclose whether the actual performance of the company or business acquired meets the guarantee in its next annual report.

### 2) Disclosure on the identities of the parties to a transaction

Disclosure requirements for notifiable and connected transaction announcements are set out in Listing Rules 14.58 and 14A.68, respectively.

It is proposed that the identities of parties to a notifiable transaction must be disclosed in the announcements and circulars of such transactions.

Currently, in relation to connected transactions, the identity and activities of the parties to the transaction and of their ultimate beneficial owner(s) must be disclosed in circulars (Listing Rule 14A.70). It is proposed that this requirement should also apply to announcements of connected transactions, including transactions exempt from circular and shareholder's approval requirements.

### 3) Alternative size tests requirements

The size of a notifiable or connected transaction must be classified using the percentage ratios specified in Listing Rule 14.07. However, such ratios may not be indicative of the issuer's current financial position as they are usually based on the latest published financial position.

Under Listing Rule 14.20, where any of the calculations of the percentage ratios produces an anomalous result or is inappropriate to the sphere of activity of the issuer, the Hong Kong Stock Exchange may disregard the calculation and substitute other relevant indicators of size, including industry specific tests. The issuer is required to provide alternative tests which it considers appropriate for the Stock Exchange's consideration.

It is proposed to amend this Listing Rule to clarify the position that where any calculation of the percentage ratios produces an anomalous result or is inappropriate to the sphere of activity of the issuer, the Hong Kong Stock Exchange (or the issuer with the Stock Exchange's consent) may apply other size test(s) that the Stock Exchange considers appropriate.

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