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Hong Kong Law **June** 2014

Hong Kong Stock Exchange Publishes Guidance Letter on Reverse Takeover Rules

A) Introduction

The Hong Kong Stock Exchange (the **Exchange)** has published guidance letter HKEx-GL78-14, which reflects the Exchange's current practice in application of the reverse takeover (**RTO**) requirements under the Listing Rules (the **Rules**) and related administrative requirements.

B) Relevant Rules

Definition of RTO

i. Principle Based Test	
Rule 14.06(6) (GEM Rule 19.06(6))	An acquisition (or a series of acquisitions) by a listed issuer which, in the opinion of the Exchange, constitute an attempt to achieve a listing of the assets to be acquired and a means to circumvent the requirements for new applicants
ii. Bright Line Tests (specific forms of RTO)	
Rule 14.06(6)(a) (GEM Rule 19.06(6)(a))	An acquisition (or a series of acquisitions) constituting a very substantial acquisition (**VSA**) where there is or which will result in a change in control of the issuer
Rule 14.06(6)(b) (GEM Rule 19.06(6)(b))	Acquisition(s) from the incoming shareholder or his associate(s) within 24 months of the incoming shareholder gaining control, which individually or together constitute a VSA

Compliance with New Listing Requirements

Rule 14.54 (GEM Rule 19.54)	The Exchange will treat a listed issuer proposing an RTO as if it were a new listing applicant. The enlarged group or the assets to be acquired must meet: • the track record requirements for new applicants under Rule 8.05 (GEM Rule 11.12A); and • all other new listing requirements under Chapter 8 of the Rules (Chapter 11 of the GEM Rules).
Rule 14.55 (GEM Rule 19.55)	An RTO must be approved by shareholders in general meeting. Where there is a change in control, the outgoing and incoming controlling shareholders and their associates are prohibited from voting in favour of a proposed injection of assets by the incoming controlling shareholder or his associates.

Rule 14.57 (GEM Rule 19.57)	The issuer must: • comply with the procedures and requirements for new listing applications set out in Chapter 9 of the Rules (Chapter 12 of the GEM Rules); and • issue a listing document.

Disposal Restrictions

Rules 14.92 and 14.93 (GEM Rules 19.91 and 19.92)	An issuer may not dispose of its existing business within 24 months after a change in control unless the asset injection(s) from the new controlling shareholder and his associates, and any assets acquired after such change in control can meet the trading record requirement of Rule 8.05 (GEM Rule 11.12A). The Rules discourage circumvention of the bright line tests by deferring a disposal such that the assets acquired would not result in a VSA.

C) Guidance on the Application of the RTO Rules

The Listing Committee (the **Committee**) considered the RTO Rules and their application in November 2009, August 2010 and October 2013 and noted that they are anti-avoidance provisions designed to prevent circumvention of the new listing requirements.[1] Taken to the extreme, any material acquisition could be viewed as an attempt to achieve a listing of the assets to be acquired. Therefore, a balance must be struck between allowing legitimate business activities and the need to maintain market quality.

Where 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 new listing requirements. It would be treated as an RTO where the Exchange considers it "extreme", taking into account the following criteria:

- the size of transaction relative to the size of the issuer;
- the quality of the business to be acquired, i.e. whether it can meet the trading record requirements for listings or whether it is unsuitable for listing;
- the nature and scale of the issuer's business before the acquisition (e.g. whether it is a listed shell);
- 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 post-acquisition);
- other events and transactions 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 VSA); and
- any issue of Restricted Convertible Securities[2] to the vendor which would provide it with *de facto* control of the issuer.

A transaction will be treated as an extreme very substantial acquisition (**extreme VSA**) where the Exchange considers a transaction to be "extreme", but 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.

The Listing Committee decides whether the RTO Rules apply to an extreme VSA:

- Where they apply, the issuer will be treated as if it were a new listing applicant and will be subject to all applicable listing requirements for new applicants.
- Where they do not apply, the issuer will be required 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[3]. Enhanced disclosure in the transaction circular serves to provide shareholders with information about the transaction and the company's intentions.

1 See the 2009, 2010 and 2013 Listing Committee Annual Reports published on the Exchange's website at www.hkex.com.hk

2 Restricted Convertible Securities: highly dilutive convertible securities with a conversion restriction mechanism that avoids triggering a change in control under the Code on Takeovers and Mergers.

3 See Part H of this newsletter.

D) Further Guidance on the Criteria under the Principle Based Test

Whilst a combination of criteria are assessed under the principle based test, the Exchange has made the following observations based on precedents:

Fundamental change in the issuer's principal business	Where an issuer acquires a business that is entirely different from its existing business, it tends 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 normally does not consider the following as "extreme": • acquisitions for expansion; and • development of existing businesses.
Nature and scale of the issuer's business before the acquisition	Where an issuer 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).[4] 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.
Quality of the target asset or business	An acquisition of a target business unsuitable for listing will likely be considered a circumvention of the new listing requirements. Examples include: • early exploration companies; and • illegally operated businesses. Enhanced disclosure is less meaningful for acquisitions of new businesses or assets that have no track record or have yet to commence operations, particularly where the target business is completely different from that of the issuer (see LD95-4). They would more likely be treated as new listings. Examples include: • an acquisition of a patent for new technology; and • new business proposals where the infrastructure (e.g. production facilities) is under construction.
Size of transaction relative to the issuer	Where an issuer undertakes an acquisition of significant size, its existing principal business may become immaterial post-transaction, supporting the concern that the transaction may represent a means to achieve a listing of the target business. In determining whether the size of transaction is "extreme", the Exchange does not prescribe an absolute threshold and instead takes into account the following criteria: • the nature and scale of the issuer's existing business post-acquisition; and • whether the acquisition would result in a fundamental change in the issuer's business.

4 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.

Events and transactions that, together with the acquisition, form a series of arrangement to circumvent the RTO Rules	Indications that the issuer is "cleaning" its "shell" to achieve a listing of the target business include proposals involving: • an asset swap; or • disposal of the existing business to the exiting shareholder. (see LD95-2) Where an issuer acquires equity interests in a target in stages, the Exchange may aggregate the acquisitions for assessment.
Change in de facto control arising from issue of Restricted Convertible Securities	Several proposals involved the issue of Restricted Convertible Securities as consideration for proposed acquisitions. In certain cases, issuers failed to demonstrate the business rationale for the structure, which raised the question as to whether it is a means to avoid a change in control under the bright line tests. Where a proposal does not fall under the bright line tests, it may be treated as a RTO under the principle based test. In circumstances involving the issue of Restricted Convertible Securities, the Exchange would consider whether in substance, the structure serves to allow the vendor (who will hold the convertible securities) to effectively "control" the issuer. For example, the vendor would become a controlling shareholder of the issuer assuming the convertible securities were fully converted, where: • the issuer has no controlling shareholder when it proposes the acquisition; or • the existing controlling shareholder would cease to be one after the conversion. The Exchange would consider any change in *de facto* control in conjunction with the above criteria in assessing whether to treat a transaction as a RTO.

E) Documentary Requirements for VSA or RTO

Under Rule 13.52(2)(a) (GEM Rule 17.53(2)(a)), an announcement of a VSA or a RTO is subject to pre-vetting by the Exchange.

An issuer may be required to suspend trading in its shares pending the release of the acquisition announcement. In the interests of promoting a continuous market for the trading of listed securities, the suspension period should be kept as short as possible. A suspension does not relieve an issuer of its obligations under Part XIVA of the Securities and Futures Ordinance to announce inside information.

To minimize the suspension period, an issuer should provide the Exchange with relevant documents and sufficient information to make an assessment of the RTO Rules at an early stage of pre-vetting of the announcement. Examples include:

- draft financial statements / accounts of the target business over the track record period;
- where the consideration of 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, and 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 for demonstrating that such arrangements can meet the conditions set out in guidance letter HKEX-GL77-14.

F) Disclosure in Circulars

Where a transaction is treated as a RTO, the issuer is required to issue a circular that complies with the new listing requirements.

To ensure that shareholders and investors are provided with material information about the target and the future business prospects of the issuer, an issuer proposing a VSA that is not treated as a RTO should also enhance disclosure in the circular, applying the standards of disclosure for listing documents of new applicants. Key areas include:

Issuer's business plans and future prospects	The Exchange will make enquiries of, and issuers should disclose their intention to make significant changes in: • the enlarged group's business and/or arrangements for potential acquisitions or disposals of assets; • the issuer's board composition; and • the management of the target business. These should be disclosed to assist the shareholders in making a reasonable assessment about the prospects and development of the enlarged group.
Disclosure of impairment assessment	Issuers should: • conduct an impairment assessment of the target for the purpose of preparing pro forma financial statements in the circular, as provided under Hong Kong Accounting Standards 36 – Impairment of Assets; • adopt a valuation methodology that is consistent with the accounting standards and the issuer's accounting policy; and • make appropriate pro forma adjustments in accordance with the accounting standards for impairment. The 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 disclose the following: • the results of such impairment assessment in the circular; and • information about the valuation including the methodology adopted and major assumptions.

G) Disclosure in Annual Reports

Under Paragraph 32 of Appendix 16 (GEM Rule 18.41), an issuer should include in its annual report:

- a discussion and analysis of the acquired business' performance;
- the material factors underlying its results and financial position, including:
    - a discussion on trends; and
    - significant events during the financial year; and
- a discussion on any material change to the acquired business' financial position and prospects, which deviated from the disclosure in the issuer's circular.

Further guidance is set out in the Exchange's reports on "Review of Disclosure in Issuers' Annual Reports to Monitor Rule Compliance".

H) Responsibilities of Financial Advisers

Attachment 1 to the guidance letter 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[5] 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 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 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.

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:

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

    - 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.

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