



Hong Kong

January 2016

HKEX TARGETS BACKDOOR LISTINGS IN APPLICATION OF CASH COMPANY RULES TO LARGE SCALE FUNDRAISINGS

Background

The Stock Exchange of Hong Kong Limited (the Exchange) has published Guidance Letter 84-15¹ on the application of the Listing Rules' cash company provisions to large scale fundraisings.

The move follows an upsurge in the number of large scale fundraisings proposed by listed companies in the wake of a stricter reverse takeover regime under the Listing Rules. In many cases, the proposed fundraisings involved the injection of substantial amounts of cash into listed companies by investors who would acquire control of the companies. The cash raised in the fundraisings would then be invested into new businesses and the companies' original businesses would be marginalised. The Exchange's concern is that, in some cases, these activities constitute attempted backdoor listings of new businesses which do not meet the requirements for a new listing, for example because they lack the requisite track record. The investor's equity subscription is essentially a means to acquire a listed company. The Listing Rules' reverse takeover provisions do not apply because there is no asset acquisition by the listed company.

Under the Guidance Letter, where the Exchange considers that: (i) a proposed subscription will render a listed issuer a cash company under the Listing Rules; and (ii) the subscription is being used to list a new business which is unsuitable for listing, it will evaluate the listed issuer's business against the requirements for a new listing.

The Exchange encourages listed companies planning large scale fundraisings to consult the Exchange at the earliest opportunity to seek guidance on the application of the cash company provisions.

The Cash Company Rules

The rules on cash companies (the **Cash Company Rules**) are set out in Rules 14.82 to 14.84 of the Main Board Listing Rules and Rules 19.82 to 19.84 of the GEM Listing Rules. These define a cash company as a company whose assets consist wholly or substantially of cash or short-dated securities.² Cash companies are not considered to be suitable for listing and if an existing listed company becomes a cash company, trading in its securities will be suspended. If the company subsequently has a business which is suitable for listing, it can apply to the Exchange to lift the trading suspension and the Exchange will treat that application as an application for a new listing. This requires the company to satisfy all the requirements for a new listing and to publish a full listing document.

The Listing Rules do not specify a quantitative threshold for determining whether a company's assets consist *substantially* of cash. The Exchange considers a number of factors in addition to the company's cash to assets ratio, including the background facts and circumstances of the company's business, operation, and financial position, when assessing whether a company is a cash company or not.

¹ HKEx Guidance Letter HKEx-GL84-15 of December 2015.

² Short-dated securities are defined as securities such as bonds, bills or notes which have less than 1 year to maturity.

Application of the Cash Company Rules to Large Scale Fundraisings

The Exchange has assessed the application of the Cash Company Rules to proposed large scale fundraisings with some or all of the following characteristics:

- a) the scale of the fundraising would be very substantial and bear little or no relation to the needs of the company's existing principal business;
- b) the funds raised would be invested in largely greenfield operations of new businesses that have little or no relation to the company's existing principal business. The new businesses were sometimes the same as, or similar to, the business of the investor(s). In some instances, companies claimed to have started the new businesses prior to the proposed fundraising;
- c) the investor(s) would obtain control (or de facto control) of the company and would intend to manage the new businesses. In most cases, a significant proportion of the existing directors would resign and be replaced by new directors nominated by the investor(s); and
- d) the company would use the cash raised from the fundraising in new businesses which are expected to be significantly larger than the original business.

The Exchange concluded that these proposed fundraisings would result in the companies' assets consisting substantially of cash upon completion. The facts of individual cases suggested that the investors were seeking to list, through the listed company, new businesses which would not have otherwise met the new listing requirements due to their lacking the requisite track record.

Cash company concerns cannot be addressed by providing details of future business plans and/or signing agreements to commit the use of the cash proceeds. The cash company assessment under the Listing Rules is based on the company's cash balance resulting from the fundraising and the situation as at the date of completion of the fundraising. A company cannot rely on the future intended use of proceeds, whether under a legally binding agreement or not, to reduce its cash level on completion of the fundraising. Once the Exchange considers that the company's assets consist substantially of cash, the Exchange is required to evaluate the business plans (including the intended use of proceeds) as if it were a new listing application.

According to the Guidance Letter, the Exchange's application of the Cash Company Rules will not affect companies' equity fundraisings for legitimate business expansions. The expression "*wholly or substantially*" in Rule 14.82 should be interpreted as meaning "*in the main*" or "*as of the greater part*". Where less than half of a company's assets are cash after a fundraising, it will not normally be regarded as having assets consisting wholly or substantially of cash. However, where the Exchange considers that a future fundraising, acquisition or other action of the company, together with the current fundraising, are a means to list new businesses that are not suitable for listing or otherwise circumvent the new listing requirements, the Exchange will impose additional requirements or conditions on such future arrangements.

Consultation with the Exchange

Rule 13.52(2)(c) requires announcements related to cash companies to be pre-vetted by the Exchange. Listed companies that are planning large scale fundraising are encouraged to contact the Exchange at the earliest opportunity to seek guidance regarding the application of the Cash Company Rules.

Application of the Cash Company Rules: Examples

The guidance letter sets out two examples of situations in which the Exchange considers that the listed company, if it were to proceed with the proposed fundraising, would become a cash company and its business plans would be evaluated against the new listing requirements under Rule 14.84.

Example 1

Company A is principally engaged in the garment business. In the previous financial year, it had revenue of approximately HK\$60 million and a net loss of approximately HK\$20 million. Its total assets are valued at approximately HK\$100 million.

The proposed subscription

Company A signed subscription agreements to raise a total of HK\$400 million through the issue of restricted convertible bonds³ to subscribers:

³ Convertible bonds with a restriction from conversion to avoid triggering a change of control under the Code on Takeovers and Mergers.

- Upon completion, over 85% of the company's assets would consist of cash. The majority of the proceeds would be used to develop a new mobile game business (greenfield operation).
- If the bonds were fully converted, the conversion shares would represent about four times the company's existing issued shares, and the major subscriber (an entrepreneur) would hold more than 60% of the company's shares.
- The subscriber, who would acquire de facto control of the company through the restricted convertible bonds, is effectively using the listed company to develop and operate the new mobile game business, which does not satisfy the requirements for a new listing because it has no previous track record.

Example 2

Following the signing of the subscription agreements, Company A acquired a newly set-up company engaging in distributing and marketing mobile games. This acquisition reduced Company A's cash level to 65% of its total assets upon completion of the subscriptions.

The Exchange's analysis

The Exchange considers that the proposed subscriptions would result in Company A becoming a cash company and its business plans would be assessed against the requirements for a new listing on the basis that:

- i) The subscription amount is significant to the company and on completion of the subscriptions, its cash level would be 65% of the company's total assets. The company's assets would thus consist substantially of cash on completion.
- ii) The subscriptions would achieve a listing of a new business which is unsuitable for listing:
 - The company has been involved in the garment industry since listing. The acquisition of the company engaged in the mobile game business only occurred after the signing of the subscription agreements;
 - The subscription amount is significant yet disproportionate and unrelated to the needs of the company's existing garment business. The subscription amount would be used to develop and operate a new business that would be significant relative to the existing business after the subscription.

Company B is principally engaged in manufacturing toys. Its total assets are valued at approximately HK\$500 million.

Two months ago, Company B obtained a money lender licence in Hong Kong and launched a money lending business.

The proposed subscription

Company B signed subscription agreements to raise HK\$1 billion through the issue of shares to subscribers:

- Upon completion, roughly 75% of the company's assets would consist of cash. The majority of the proceeds would be used to develop the money lending business. Furthermore, Company B signed loan agreements worth a total of HK\$900 million to several independent third parties. These agreements were conditional on the completion of the subscriptions.
- The subscribers would hold approximately 55% of the company's shares.
- The major subscriber is a money lending company.

The Exchange's analysis

The Exchange considers that Company B would become a cash company if the proposed subscriptions took place since:

- i) The subscription amount is significant to the company and on completion of the subscriptions, its cash level would be 75% of the company's total assets. The company's assets would thus consist substantially of cash on completion.
- ii) The subscriptions would achieve a listing of a new business which is unsuitable for listing:

- The company's business is toy manufacture. The money lending business is a new business for Company B which commenced shortly before the signing of the subscription agreements;
- The subscription amount is significant yet disproportionate and unrelated to the needs of the company's original toy manufacturing business. The subscription amount would be used to develop and operate the new money lending business that would be significant relative to the original business after the subscription.
- The subscriber, who would become the controlling shareholder, is effectively using the listed company to develop and operate the new money lending business, which does not satisfy the requirements for a new listing because it has no previous track record.

Although the loan agreements ensured that a substantial part of the subscription proceeds would be used shortly after the subscriptions, this does not address the cash company concern. Once a company is considered to be a cash company, the Exchange will evaluate the business plans (i.e. with the proposed use of proceeds) as if it were an application for listing from a new applicant.

CHARLTONS

Best Boutique Firm 2015

Asian Legal Business Awards

This newsletter is for information purposes only.

Its contents do not constitute legal advice and it should not be regarded as a substitute for detailed advice in individual cases.

Transmission of this information is not intended to create and receipt does not constitute a lawyer-client relationship between Charltons and the user or browser.

Charltons is not responsible for any third party content which can be accessed through the website.

If you do not wish to receive this newsletter please let us know by emailing us at unsubscribe@charltonslaw.com

Hong Kong Office

Dominion Centre

12th Floor

43-59 Queen's Road East

Hong Kong

Tel: + (852) 2905 7888

Fax: + (852) 2854 9596

www.charltonslaw.com