

ACUMINOUS

2019 FORTH ISSUE

TIGHTEN THE RULES ON BACKDOOR LISTING AND CONTINUING LISTING CRITERIA

In recent years, the Stock Exchange of Hong Kong Limited (the “Exchange”) has taken a stringent approach to deter circumvention of new listing requirements through backdoor listing and to address "shell" activities. Over the past few years the Exchange has slowly introduced various tightening measures, such as the raising of IPO minimum capitalisation requirement, widening the definition of cash companies, reducing the time frame and levels of review available for listed companies rescues, to impose stricter regulatory oversight. Forming part of a broader series of actions to curb the concerns, the Exchange published its consultation paper last year to seek market views on proposals relating to backdoor listing and continuing listing criteria. We raised concerns in response to the consultation on the potential adverse effect on listed companies carrying out normal commercial transactions should the proposals be adopted. The Exchange, on 26 July 2019, published conclusions on its consultation paper and decided to implement the consultation proposals, with related amendments to the Listing Rules to become effective on 1 October 2019. In this issue, we will go through the key changes in the Listing Rules.

Executive Summary

The Exchange suggests that the new amendments aim to enhance both the reverse takeover (RTO) rules and the continuing listing criteria, helping to address evolving market practices in backdoor listing and strengthen the regulation to address shell activities.

The new RTO rules codify the existing principle based test with modifications; modifying the bright line tests under the current Rule 14.06(6) with aggregation period from 24 months to 36 months and tightening the compliance requirements for RTOs and extreme transactions.

The new continuing listing criteria (Rule 13.24) now requires a listed company to carry out a business with both sufficient level of operations **and** (previously **or**) have assets of sufficient value to support its operations to warrant its continues listing. There will be a 12-month transitional period from the effective date for listed companies in satisfying the new continuing listing criteria.

Rules changes relating to reverse takeover (RTO) or backdoor listing

To address concerns over circumvention of the new listing requirements and “shell creation activities”, the Exchange has made the following changes to RTO related rules:

- codify the six assessment factors under the existing principle based test with modifications;

- modify the bright line tests to apply to very substantial acquisitions from a listed company’s controlling shareholder within 36 months from a change in control of the company;
- replaced the current Rules 14.92 and 14.93 with Rule 14.06E which allows the Exchange to restrict disposals (or distributions in specie) of all or a material part of the listed company’s business proposed at the time of or within 36 months after a change in control of the company unless (i) the remaining business or (ii) any asset(s) acquired from the new controlling shareholder and any other person(s), would meet the track record requirements for new listing applicants. The Exchange may also apply such restriction to a material disposal proposed at the time of or within 36 months after a change in de facto control;
- modify the Listing Rules to disallow backdoor listing through large scale issuance of new shares, where there is, or will result in, a change in control or de facto control of the listed company, and the proceeds will be applied to acquire and/or develop new business that is expected to be substantially larger than its existing principal business;
- codify the "extreme very substantial acquisition" requirements into the Listing Rules and rename this category of transaction as "extreme transactions"; and
- impose additional requirements to transactions classified as RTOs and extreme transactions which require that both the acquisition targets and the enlarged group must be

suitable for listing and the acquisition targets must meet the track record requirements for new listing applicants and the enlarged group must meet all the new listing requirements (except Rule 8.05).

During the consultation period, we raised our concerns to the Exchange regarding the proposed requirement that both the acquisition target(s) and the enlarged group must be suitable for listing (Rule 8.04) and we argued that the proposed change would effectively prohibit listed companies which fail to comply with Rule 13.24 from conducting self-rescue through acquisitions. The Exchange has now decided to include an addition note to Rule 13.24 to the effect that the requirement for the enlarged group to meet Rule 8.05 will not apply to listed companies that has failed to comply with Rule 13.24, but the acquisition targets must still meet Rule 8.04 (suitability for listing), Rule 8.05 (or Rule 8.05A or 8.05B) (track record requirements) and Rule 8.07 (sufficient public interest).

Rules changes relating to continuing listing criteria

As an alternative means to target alleged maintenance of listed shell companies, the Exchange has raised the standard for continuing listing (Rule 13.24). The new amendment requires a listed company to carry out a business with sufficient level of operations **and** (*previously or*) have assets of sufficient value to support its operations to warrant its continuing listing and the onus is upon the listed company to demonstrate to the Exchange's satisfaction that it is in compliance with the Rule. A few related changes are also summarised below:

- listed company's proprietary trading and securities investment will be excluded when considering sufficiency of operations or assets. The exception would be for those carried out by a member of the listed group that is a banking company, an insurance company, or a securities house that is mainly engaged in regulated activities under the Securities and Futures Ordinance; and
- the definition of "short-dated securities" in Rule 14.82 will extend to include investment that are easily converted into cash, such as investment in listed securities and rename it as "short-term investments" and confine the exemption under Rule 14.83 to cash and short-term investments held by banking companies, insurance companies or securities houses.

Other notable changes

The Exchange will also made other amendments to the

Listing Rules relating to securities transactions and notifiable or connected transactions which are summarised below:

- confine the revenue exemption from the notifiable transaction requirements to acquisitions or disposals of securities only if they are conducted by the members of the listed group that are subject to the supervision of prudential regulators (i.e. banking companies, insurance companies or securities houses);
- require listed companies to disclose details of each securities investment that represents 5% or more of the total assets in the annual reports;
- impose additional requirements on significant distribution in specie of unlisted assets comparable to requirements for a withdrawal of listing;
- require an announcement be made if there is (a) any subsequent change to the terms of the guarantee; or (b) the acquisition target's actual financial performance fails to meet the guarantee;
- require disclosure of the identities of the parties to a transaction in the announcements of notifiable transactions;
- require disclosure of the identities and activities of the parties to a transaction and of their ultimate beneficial owners in the announcements of connected transactions; and
- clarify that the Exchange may apply an alternative size test to assess the materiality of a transaction where the percentage ratios produce anomalous results or is inappropriate to the sphere of activity of the listed company.

Conclusion

In our view these rule changes may not be able to properly regulate the "shell" activities which the regulators seem to be unduly concerned about but the new requirements can be difficult for listed companies in Hong Kong to navigate when carrying out normal commercial transactions. Companies should consult experienced professionals when devising its business strategies and contemplating transactions as part of a plan for legitimate business expansion or diversification.

For enquiries related to this newsletter, please get in touch with the following person or your usual contacts in Asian Capital.

Catherine Wang

T (852) 2869 8861

E acuminous@asiancapital.com.hk