HKEx's Latest Rule Amendments to Crack Down on Backdoor Listing and Shell Activities

Skadden

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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorney or call your regular Skadden contact.

Christopher W. Betts
Partner / Hong Kong
852.3740.4827
christopher.betts@skadden.com

Paloma Wang
Partner / Hong Kong
852.3740.6888
paloma.wang@skadden.com

Antony Dapiran
Of Counsel / Hong Kong
852.3740.4762
antony.dapiran@skadden.com

Four Times Square
New York, NY 10036
212.735.3000

42/F, Edinburgh Tower, The Landmark
15 Queen's Road Central, Hong Kong
Hong Kong
852.3740.4700

On 26 July 2019, The Stock Exchange of Hong Kong Limited (**HKEx**) published conclusions to its consultation paper regarding backdoor listings, continuing listing criteria and other related Listing Rule amendments. The corresponding amendments to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (**Listing Rules**) will come into effect on 1 October 2019.

The amendments largely codify existing guidance set out in guidance letters and listing decisions issued by HKEx in recent years as part of their broader efforts to reduce the ability of listed companies to be used as tools for "backdoor" listings and restrict the creation of "shell" companies (*i.e.*, companies that do not have a substantial business but maintain their listing status with a view to being purchased by buyers who wish to go public but are unable or unwilling to go through the listing application process to seek a listing status).

The fundamental position that an acquisition by a listed company of a target larger than itself within close proximity of a change of control will be treated as a reverse takeover (**RTO**) necessitating a new listing application remains unchanged, albeit with some new modifications.

The notable amendments to the Listing Rules to combat backdoor listings and shell creation activities are summarized below.

Amendments Relating to Backdoor Listings

Modification of the Definition of RTO. Listing Rule 14.06 sets out a principle-based test and a bright-line test to determine whether a transaction constitutes an RTO. The tests have been modified as follows:

Principle-Based Test:

- The six assessment criteria that HKEx will take into account when applying the principle-based test previously set out in HKEx guidance letter GL78-14 will now be codified into Rule 14.06;
- The previous assessment criteria relating to the "issue of restricted convertible securities providing de facto control" will be broadened to "any change in control (as defined in the Takeovers Code) or de facto control of the issuer (other than at the level of its subsidiaries)";
- Two additional factors in assessing whether a change in control or de facto control has occurred will be incorporated into Rule 14.06, namely, (i) any change in control of the controlling shareholder of the listed company, and (ii) any change in the single largest substantial shareholder who is able to exercise effective control over the listed company, as indicated by factors such as a substantial change to its board of directors and/or senior management; and
- In assessing whether "a series of transactions and/or arrangements" constitutes an RTO, Rule 14.06 will now be broadened to include acquisitions, disposals and/or a change in control or de facto control that take place in reasonable proximity (normally within 36 months) or are otherwise related.

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Bright-Line Test:

- This test has been amended to now capture very substantial acquisition(s) of assets from a controlling shareholder and/or its associates within 36 months of a change of control (compared to the existing 24 months). The bright-line test will also be supplemented to restrict disposals (or distributions in specie) of all or a material part of a listed company's business within 36 months after a change in control or de facto control — thus limiting the ability of an incoming controlling shareholder from restructuring any material existing businesses out of a listed company.

Backdoor Listings Through Large-Scale Issue of Securities. A new Listing Rule will be adopted to prevent large-scale issues of securities for cash, where there is (or the issue will result in) a change of control or de facto control of the issuer, and the proceeds will be applied to acquire and/or develop new business. HKEx views these transactions as tantamount to a backdoor listing and had previously set out its guidance on such transactions in HKEx guidance letter GL85-14. HKEx has also published a new guidance letter, GL105-19, setting out two examples to illustrate the situations where HKEx considers the new rule to apply.

Codification of "Extreme Very Substantial Acquisition" Requirements With Modifications. The current "extreme very substantial acquisition" requirements in guidance letter GL78-14 will be codified into the Listing Rules, with such transactions renamed "extreme transactions". Additional eligibility criteria will also be imposed on listed companies entering into "extreme transactions": Companies entering into extreme transactions must either (i) operate an existing principal business of a substantial size (being a business with revenues or total assets in excess of HK$1 billion) or (ii) have been under the long-term (normally not less than 36 months) control or de facto control of the same large business enterprise (which HKEx did not define), and the transaction will not result in a change in control or de facto control.

Tightening of the Compliance Requirements for RTOs and "Extreme Transactions". The Listing Rules have been modified to require:

- that the acquisition targets in an RTO or an extreme transaction be suitable for listing pursuant to Listing Rule 8.04 and meet the track record requirements of Listing Rule 8.05;
- the enlarged group to meet all the new listing requirements set out in Chapter 8 of the Listing Rules, except the track record requirements of Rule 8.05; and
- the acquisition target(s) of a company that has failed to comply with the sufficiency of assets requirement in Listing Rule 13.24 to meet the requirement under Listing Rule 8.07 that HKEx must be satisfied that there will be sufficient public interest in the company and any securities for which listing is sought.

Significantly, the Listing Rules will now also require listed companies conducting extreme transactions to appoint a financial advisor who must conduct a due diligence process similar to that for an initial public offering and for them to give the same declaration to HKEx as that given by a listing sponsor, including that the target meets the new listing requirements.

HKEx has also published a new guidance letter, GL104-19, on the application of the revised RTO rules described above.

Amendments Relating to Continuing Listing Criteria for Listed Issuers

Sufficiency of Operations and Assets. Listing Rule 13.24 will be amended to require a company to carry out a business with a sufficient level of operations *and* have assets of sufficient value to warrant its continuing listing (not sufficient operations *or* assets set out in the current rule). Proprietary securities trading and/or investment activities (other than a Chapter 21 company) will be excluded when considering whether Rule 13.24 is met (except for those carried out by a banking company, insurance company or securities house that is mainly engaged in regulated activities under the Securities and Futures Ordinance). HKEx has also published a new guidance letter, GL106-19, on the purpose behind and the general approach relating to its application of the amended rule.

Cash Companies. Listing Rule 14.82 (commonly known as the "cash company rule") states that companies whose assets consist substantially (which HKEx has interpreted to be more than 50%) of cash or short-dated securities after a transaction will be considered unsuitable for listing. HKEx has extended the definition of "short-dated securities" to cover investments that are easily convertible to cash (*e.g.*, investment in listed securities; bonds, bills or notes that have less than one year to maturity) and has renamed them "short-term investments". The exemption from the "cash company rule" under Listing Rule 14.83 is confined to cash and short-term investments held by members of a listed company's group that are banking companies, insurance companies or securities houses.

Transitional Arrangements. In order to minimize the impact of the rule amendments, a transitional period of 12 months will apply to companies that do not comply with the new Rule 13.24 or Rule 14.82 at the time the amendments come into effect. The transitional arrangements will not apply to companies that do not comply with the current Rule 13.24 or Rule 14.82 requirements or become noncompliant with them after the new rules come into effect.

Significance of the Amendments

The rule amendments are a continuation of HKEx's efforts to plug the loopholes for backdoor listings and the creation of listed shells. Given the broad scope of the revised rules, any transactions that may result in significant changes to a listed company's shareholding structure and underlying businesses will need to be carefully structured to avoid being caught by the expanded definition of an RTO.

The ability of listed companies to circumvent the new listing requirements by building up a new business through a series of smaller acquisitions or acquiring a new business and then disposing of its original business, and by large-scale capital raisings where new shares are issued for cash that is then used to develop new businesses, are now also further restricted.

The goal of HKEx is, of course, to make the process of structuring around these rules so challenging and time-consuming that companies instead opt to simply list their businesses via a new listing application. In some cases, this may indeed become the most attractive option. For companies that do not meet the new listing criteria (and, where necessary, are able to wait out the new 36-month aggregation period), there will be little choice but to structure transactions to comply with or fall outside the new rules.

Associate **Johanna Yau** assisted in the preparation of this alert.