MAYER | BROWN

27 September 2019

Article

The New Hong Kong Backdoor Listing Rules (Part 1) – Impact on Acquisitions by Hong Kong Listed Companies

The Stock Exchange of Hong Kong Limited (the **Exchange**) has issued amendments to the Listing Rules and new guidance letters relating to back-door listing and continuing listing criteria (together the "**New Rules**"), which take effect on 1 October 2019. While the New Rules are meant to address evolving market practices in backdoor listing and to regulate shell activities, they may also affect business expansion or diversification particularly those involving important strategic moves pursued by listed issuers.

We will discuss in three parts the implications of the New Rules on listed issuers: first, on acquisition of business or assets; second, on disposal of a substantial part of an issuer's existing business or assets; and third, on large scale equity fundraisings and maintenance of listing status.

All "Rule" references herein are to the Main Board listing rules, and the "Consultation Conclusion" means the Consultation Conclusion released by the Exchange in July 2019 relating to Backdoor Listing, Continuing Listing Criteria and other Rule Amendments.

This is Part 1– Acquisitions.

Why regulate backdoor listing?

Backdoor listings involve transactions or arrangements that are structured to achieve a listing of assets while circumventing the requirements that apply to a new listing applicant, including: (i) initial listing criteria under the Listing Rules, such as suitability for listing and financial eligibility criteria; and (ii) obligations such as disclosure and due diligence requirements. As such, backdoor listings are often associated with assets of lower quality or with suitability issues, which can undermine the integrity and quality of the market, and may affect investor confidence and the market's reputation.

What is New?

- The existing "six assessment factors" found in the Exchange's Guidance Letter are codified (with minor modifications) into the New Rules as reverse takeover (RTO) principle based test when assessing if acquisitions or "a series of transactions", coupled with a change of control of the listed company, are backdoor listing.
- "A series of acquisitions" spanning a 36-month period will be caught (instead of the previous 24).
- "Greenfield operation" will not count towards the "series of acquisitions" factor in the RTO principle based test.
- Substantial acquisition(s) by a listed company having a controlling shareholder for a long period of time (at least 36 months) are less likely

to be considered backdoor listing but they can be Extreme Transactions.

The Revised Rules on Reverse Takeover (RTO Rules)

The New Rules set out two alternative tests: (a) RTO bright line test and (b) RTO principle based test.

RTO Bright Line Test: (1) a very substantial acquisition (**VSA**) resulting in a change in control (as defined under Takeovers Code); and (2) an acquisition or a series of acquisitions of assets (which individually or together constitute a VSA) from the new controlling shareholder and/or its associates at the time of, or within 36 months of the change in control.

Proposed acquisitions not amounting to a VSA may still be caught by the RTO Rules, based on the RTO principle based test.

RTO Principle Based Test: The Exchange will assess if acquisition(s) are in circumvention of the new listing requirements of the Listing Rules by looking at the following six assessment factors:

1. **Size of acquisition substantial compared to issuer's existing business**. If the issuer's existing business, given its nature and scale, would become immaterial after an acquisition (or a series of acquisitions), then it would be likely viewed as a backdoor listing of the target business.
2. **Fundamental change in issuer's principal business**. A target business, which is substantially larger and is completely different from the issuer's existing business, constitutes a fundamental change of the issuer's principal business. It is another factor towards backdoor-listing the target business. An expansion into upstream or downstream business segments, or a mature business seeking to diversify its operations and income stream, may be less suspicious if it is part of the issuer's business strategy.
3. **Nature and scale of issuer's business before acquisition**. The Exchange looks here for signs of "shell activities" *before* the acquisition (or a series of acquisitions). For instance, if the issuer has been winding down its original business before the proposed acquisition and is now moving into a new business that can be easily discontinued (e.g. trading or money lending business). We will discuss "*shell activities*" in further details in *The New Backdoor Listing Rules – Part 2 (Disposals)*.
4. **Quality of acquisition targets**. If the target business is not eligible or suitable for listing (e.g. insufficient track record), it is more likely to be considered for circumvention of the new listing requirements.
5. **Change in control or de facto control**. A change in control of the issuer which makes an acquisition (or a series of acquisitions) would be another likely factor viewed as a backdoor listing of the target business.

   "Control" means 30 percent or more of the voting rights under the Takeovers Code. Issuance of convertible securities (e.g. convertible bonds), however, may not be viewed as change in "Control" under the Takeovers Code if there is no actual change in voting rights until the exercise of the convertible securities.

RTO – anti-avoidance provisions for backdoor listing

An RTO, in essence, is an acquisition or a series of acquisitions, which in the opinion of the Exchange, constitutes an attempt to achieve a listing of the acquisition targets (including assets acquired or to be acquired) and a means to circumvent the requirements for new listing applicants set out in Chapter 8 of the Listing Rules (in other words, an attempt to achieve a backdoor listing).

Once considered an RTO, the transaction(s) will be treated as a new listing application. All the acquisition targets in the acquisition(s) must *as a whole* meet the suitability for listing requirement and the new listing track record requirement; *and* the enlarged group must meet all new listing requirements under Chapter 8 of the Listing Rules (except Rule 8.05).

Further guidance on the application of RTO Rules is set out in the Exchange's Guidance letter 104-19.

Under the New Rules, the Exchange would also assess whether there is a change in '*de facto*' control, e.g. the seller of the target business taking up the issuer's convertible securities may still be seen as gaining control of the issuer if, for example, it is able to exercise effective control over the issuer by a substantial change to the issuer's board of directors (particularly those with executive roles) and/or senior management.

6. **Acquisition forms a part of a series of transactions/arrangements to list the acquisition targets**. A few points to note here:
   - » As a general rule, the Exchange may regard transactions and arrangements as a part of a series if they take place in reasonable proximity to each other (normally within a 36-month period) or are otherwise related. Transactions or arrangements may include change in control or *de facto* control, acquisitions, disposals or completed transaction of any of the aforesaid.
   - » "Greenfield operations" is removed from this "series of transactions and/or arrangements" factor to address concerns about possible application of the RTO Rules to issuers' transactions in the normal course of business.
   - » Acquisitions forming part of a series that are related will be aggregated for the purpose of size calculation.
   - » The 36-month RTO assessment period may be extended on a case-by-case basis. The key is if there is a clear nexus between the transactions or where there are specific concerns about circumvention of the RTO Rules. For example, in an acquisition of new business, the issuer is further granted an option to purchase another business from the vendor exercisable more than three years from completion of the first acquisition- such option would likely be included in the assessment.

Acquisitions that are "related"?

It is clarified in the Consultation Conclusion that RTO aggregation will normally apply to acquisitions that are related, i.e. they would bear some relationship to each other, for example:

- acquisitions that are part of a similar line of business.
- acquisitions of interests in the same company or group of companies in stages.
- acquisitions of businesses from the same or related party.

Absent indication of an attempt to achieve backdoor listing, acquisitions of multiple businesses from different parties would not normally be aggregated.

Extreme Transactions

If, by reference to the above "six assessment factors", an acquisition or a series of acquisitions, which individually or together with other transactions or arrangements, has the effect of achieving a listing of the acquisition targets, but the issuer can demonstrate that it is not an attempt to circumvent the new

Is there ramification if the seller of the acquisition target, or the issuer, apply to the Exchange for a ruling that certain proposed acquisition is not an RTO?

The answer is yes. If (a) the Exchange rules a certain proposed acquisition together with formerly completed acquisitions (as a series) are RTO and (b) the parties then decide to terminate the proposed acquisition, the Exchange confirms that it would not under such circumstances impose the RTO Rules on those formerly completed acquisitions. The "pre-ordained" strategy approach as originally proposed is now scrapped.

However, an RTO ruling does imply a concern of backdoor listing and the Exchange may require issuer to include a negative statement in the termination announcement regarding the plans and intention in relation to possible future transactions/arrangements.

Extreme Transactions - Compliance Requirements

As an extreme transaction has the effect of achieving a listing of the acquisition targets, the Exchange considers it necessary for the issuer to provide information to a standard comparable to a new listing application.

As such, the issuer is required to (a) issue a circular following the VSA content requirements; and (b) appoint a financial adviser to perform due diligence on the acquisition targets who must submit to the Exchange a declaration in prescribed form confirming, amongst others, that save as disclosed in the circular there are no other material issues relating to the extreme transaction which should be disclosed.

listing requirements, the proposed acquisition (or series of acquisitions) may, subject to the satisfaction of either of the following additional requirements, be classified as an "extreme transaction" under Rule 14.06C:

- The issuer has been under the control or *de facto* control of the same person or group of persons for a long period (normally not less than 36 months) prior to the proposed transaction, and the transaction would not result in a change in control or *de facto* control of the issuer; or
- The issuer has been operating a principal business of substantial size, which will continue after the transaction. As a general guidance, this may include an issuer with annual revenue or total asset value of HK$1 billion or more based on the latest published financial statements.

Contact Us

For enquiries related to this article, please contact the following or your usual contact at our firm.

Jeckle Chiu
Partner
T: +852 2843 2245
E: jeckle.chiu@mayerbrown.com

Jacqueline Chiu
Partner
T: +852 2843 2447
E: jacqueline.chiu@mayerbrown.com