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Article

The New Hong Kong Backdoor Listing Rules (Part 2) – Impact on Disposals 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 2 – Disposals.

What is New?

- In order to strengthen the regulation on "shell activities", the Exchange has extended the period of restriction on disposal by issuer after a change in control from 24 months to 36 months. The restriction is not strict prohibition: the remaining group has to satisfy either the profit test, or the market capitalisation/ revenue/ cash flow test, or the market capitalisation/ revenue test set out in Chapter 8 of the Listing Rules.
- The shareholders' approval requirement for substantial distribution-in-specie is now codified.
- Issuers planning for a significant disposal of business or assets should also consider carefully whether the remaining business after disposal meets the continuing listing criteria as amended

What are "shell activities"?

"Shell companies" are listed companies that are maintained with a low level of business operations as vehicles for backdoor listings and "shell activities" which typically include:

- Disposing of all or substantially all of the listed company's original business in preparation for a subsequent change in control and injection of assets by the new controlling shareholder.
- Pursuing new businesses with low entry barriers and little commercial substance (e.g. a money lending business with only a few customers) in an attempt to maintain the shell company's listing status.

- the Securities & Futures Commission (**SFC**) statement of 26 July 2019

under the New Rules. We will discuss further in Part 3 the Rule 13.24 on Sufficiency of Operations and Rule 14.82 on Cash Companies.

In this Part 2, we will discuss the application of Rule 14.06E (Restriction of Disposal) which incorporates with amendment to the former Rule 14.92.

Restriction On Disposals

Under Rule 14.06E, there should be no disposal of all or a material part of an issuer's existing business at the time of, or within 36 months from a change in control (as defined under the Takeovers Code), unless the remaining group can satisfy either the profit test, or the market capitalisation/ revenue/ cash flow test, or the market capitalisation/ revenue test set out in Chapter 8 of the Listing Rules (failing which, the listed issuer will be treated as a new listing applicant).

Rule 14.06E further provides the Exchange with the discretion to apply the same restriction to the disposal at the time of, or within 36 months from a change in *de facto* control of the issuer, if the Exchange considers that the planned disposal forms part of "a series of transactions/ arrangements" to circumvent the listing requirements applicable to new applicants.

Change in de facto control?

As discussed in *The New Backdoor Listing Rules - Part 1 (Acquisitions)*, a new investor may be treated as gaining *de facto* control of the issuer if the new investor is able to exercise effective control over the issuer as indicated by a substantial change to its board of directors (particularly those with executive roles) and/or senior management.

The implication is that: not only the planned disposal will be subject to review but also all prior transactions (acquisitions or disposals) undertaken by the issuer within 36 months since its change in control or *de facto* control. The Exchange has explicitly stated in Guidance Letter 104-19 that it would apply this Rule to a series of arrangements that involve an issuer developing a new business through *greenfield operation* after a change in control or *de facto* control, with a view to operating the new business through the listed issuer and circumventing the new listing requirement.

Distribution in Specie

Distribution in Specie with a change in control. Rule 14.06E (Restrictions on Disposal) also applies to distribution in specie. In other words, if there is or was a change in control (as defined under Takeovers Code) concurrently with the planned distribution or within the past 36 months, the remaining assets of the issuer must satisfy the listing qualification test. In the case of a change in *de facto* control (see above "*Change in de facto control?*") in the relevant period, the Exchange may look into prior transactions and apply Rule 14.06E if it considers the distribution forms part of a series of arrangements to circumvent the new listing requirements.

Distribution in Specie amounting to a VSD. Where a listed issuer proposes a distribution in specie (other than listed securities) and the size of the assets to be distributed would amount to a very substantial disposal (i.e. any of the applicable percentage ratios is 75 percent or more), it is now required under the new Rule 14.94 that:

- The issuer must obtain prior approval of the distribution by independent shareholders in a general meeting. The issuer's controlling shareholders (or if there is no controlling shareholder, the directors (other than independent non-executive directors) and chief executive of the issuer) and their respective associates must abstain from voting in favour of the resolution. Further, the shareholders' approval for the distribution must be given by at least 75 percent of the votes attaching to any class of listed securities held by holders voting either in person or by proxy at the meeting, and the number of votes cast against the resolution is not more than 10 percent of the votes attaching to any class of listed securities held by holders permitted to vote in person or by proxy at the meeting.
- The issuer's shareholders (other than the directors (excluding independent non-executive directors), chief executive and controlling shareholders) should be offered a reasonable cash alternative or other reasonable alternative for the distributed assets.

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