

Article

The New Hong Kong Backdoor Listing Rules (Part 3) – Impact on Large Scale Equity Fundraisings by Hong Kong Listed Companies and Maintenance of Listing Status

The Stock Exchange of Hong Kong Limited (the **Exchange**) has issued amendments to the Listing Rules and new guidance letters relating to backdoor 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 have discussed in Part 1 and Part 2 the implications of the New Rules on listed issuers undertaking acquisition of business/assets, and disposal of a substantial part of their existing business or assets. We now turn to how the New Rules may affect 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 3 – Large Scale Equity Fundraisings and Maintenance of Listing Status.

What is New?

In tackling evolving market practices in backdoor listing, the Exchange has adopted a multifaceted approach as reflected in the New Rules. The Exchange has clarified that:

- **Large scale equity fundraisings (Rule 14.06D):** The previous anti-avoidance guidance to prevent circumvention of the new listing requirements regarding large scale equity fundraisings is now codified; but the previous guidance on what is large scale (50 percent cash to asset ratio) is NOT codified.

Instead, equity fundraisings by issuers for cash which, for example, may (a) result in a change in control or de facto control of the issuer and (b) used to fund substantially larger businesses, be it acquisition or greenfield project, may be viewed as a means to circumvent the new listing requirements. The New Rules align the regulation on large scale equity fundraisings with the “six assessment factors” under the RTO Rules. See *The New Backdoor Listing Rules – Part 1 (Acquisitions) for discussion of the RTO Rules*.

The Exchange is also given a clear right to refuse listing approval of the securities underlying the equity fundraising, if it considers the fundraising a means to circumvent new listing requirements.

- **Sufficiency of Operations (Rule 13.24):** It is not a new requirement. What is new is this: money lending business and/or proprietary securities trading and investment are now depicted as businesses which may be of insufficient substance, save for perhaps established money lending businesses, and activities in the ordinary course of business operated by banking companies, insurance companies or SFC-licensed securities houses.
- **Cash Companies (Rules 14.82 and 14.83):** Substantial holding of cash or “short-term investments” (as opposed to “short-dated securities” previously) by issuer is not suitable for listing. This change in definition in Rule 14.82 widens the array of “unsuitable” investments, i.e. those which are easily convertible into cash (which may or may not include short-dated securities). Exempted holding is also clarified: cash and short-term investments held by members of an issuer’s group that are banking companies, insurance companies or SFC-licensed securities houses can be disregarded if the holding is not a circumvention of the rules. The Exchange may take a principle-based approach when considering the exemption.

Large Scale Equity Fundraising

As discussed in *The New Backdoor Listing Rules – Part 1 (Acquisitions)*, the rules on reverse takeover (**RTO Rules**) intend to regulate acquisition(s) that attempt to circumvent the new listing requirements. Fundraising exercises which do not involve immediate acquisition(s) are therefore not within the scope of RTO Rules.

To regulate backdoor listing through large scale issue of securities, the Exchange may exercise its power under Rule 14.06D¹ and refuse to grant listing approval for the shares to be issued if the equity issue carries the following characteristics (see Guidance Letter 105-19):

- **Size of equity fundraising.** The size of the proposed issue of shares, warrants, options or convertible securities would be very significant to the issuer and would bear little or no correlation with the needs of the issuer’s existing

principal business. As a general guidance, Rule 14.06D will *not* normally apply to an issue where the cash to asset ratio is less than 50 percent after the fundraising exercise.

What about Issue of restricted convertible securities?

Securities may have conversion restriction to avoid triggering a change in control under the Takeovers Code. Nonetheless, it might still be considered as a change in *de facto* control if upon full conversion the investor would become the controlling shareholder, or the existing controlling shareholder would cease to be a controlling shareholder. See *The New Backdoor Listing Rules – Part 1 (Acquisitions)* regarding principle based test on the meaning of change in *de facto* control.

- **Fundamental change in principal business.** Employing the cash obtained from the fundraising, the issuer would proceed to operate new business which is expected to be substantially larger than the issuer’s original business.
- **Nature and scale of issuer’s business.** Funds raised would be used largely in developing and/or acquiring a new business with little or no relation to the issuer’s existing principal business.
- **Change in control or de facto control.** The issue would result in a change in control or *de facto* control of the issuer.

The New Rules align the regulation on large scale equity fundraisings with the “six assessment factors” under the RTO Rules.

Amendments to Continuing Listing Requirements under the New Rules

We discussed in *The New Backdoor Listing Rules – Part 2 (Disposals)* the application of Rule 14.06E (Restriction on Disposal) which restricts an issuer, after a change in control or *de facto* control, from disposing of its principal business (or a material

¹ The new Rule 14.06D codifies with modification the practice set out in GL84-15.

part thereof). For cases where there is no immediate change in control or *de facto* control, the issuer must demonstrate that after such corporate action its remaining business satisfies the continuing listing requirements, in particular Rule 13.24 on sufficiency of operations.

Sufficiency of Operations (Rule 13.24). It is a continuing listing obligation of an issuer to maintain a business with a sufficient level of operations and assets of sufficient value to support operations to warrant its continued listing. It is not a new requirement but has been amended to clarify the qualitative test: if the Exchange considers that after the disposal the remaining business is **not viable and sustainable** and/or has **no substance**, the issuer will be considered to have failed to meet the Rule. Non-compliance of Rule 13.24 may lead to cancellation of the issuer's listing.

The Exchange has issued Guidance Letter 106-19 explaining its approach in applying Rule 13.24.

BUSINESS WITH MINIMAL OPERATIONS

Normally, a business with the following characteristics would be considered not viable and sustainable:

How will Rule 13.24 be applied to "Shell Activities"?

To facilitate sales of "listed shells", some listed issuers may structure their corporate actions to substantially scale down its operation through, for example, disposals of core businesses, leaving behind minimal operations. This will be caught by Rule 13.24 if the remaining business is not viable and sustainable.

Some issuers, after substantially scaling down its business, may establish or acquire a new business to purportedly comply with Rule 13.24. This will not work if the newly established business is unrelated to its original business and has no substance or otherwise not viable and sustainable.

- Minimal operations, i.e. business maintained at a very low level of operating activities and revenue – particularly if the remaining business does not generate sufficient revenue to cover corporate expense, resulting in net losses and negative operating cash flow – of which the situation is not a result of a temporary downturn.
- Insufficient assets - the Exchange emphasises that there is no intention to restrict issuers from engaging in asset-light business as the test is assessed by reference to the nature and size of the issuer's operation and the practice of the industry in which it operates.

However, assets that are not used to support issuer's operations would be disregarded. Thus a company holding significant assets but outsources its entire operations to external management companies may not meet the assets sufficiency test.

Proprietary trading and/or investment securities would also be disregarded unless the trading/investment activities are conducted by a member of the issuer's group which is a banking company, an insurance company or a SFC-licensed securities house (see further discussion below).

BUSINESS WITH NO SUBSTANCE

The prime concern here is whether the business, though not minimal, is carried on for the purpose of maintaining an issuer's listing status rather than genuinely developing such businesses. For example:

- The operating business has a very low barrier of entry, can be easily established and discontinued without significant costs and/or is asset-light.
- Reliance on a limited number of transactions or customers, and/or a single source of business (for example, referrals by a connected person or a particular employee).
- The basis for generating substantial fees/revenue from the business being unclear or questionable.

For example, if what remains with the issuer is a money lending business which is carried out with only a few employees, a high concentration of customers and a small loan portfolio comprising mainly short-term and unsecured loans, it is very likely that the business will be considered of no

substance.

However, if a member of the issuer's group is a banking company, an insurance company or a SFC-licensed securities house, the proprietary securities trading and/or investment activities carried out in the ordinary course of business by that member would not be excluded in assessing the issuer's sufficiency of operations (save in the case of securities house, this exemption is not available if such trading/investment constitutes a significant part of its business).

THE RULE 13.24 ASSESSMENT

The Exchange has emphasised that it will make ongoing assessment of the issuer's compliance with Rule 13.24 based on the issuer's periodic financial results and other disclosures, and may write to the issuer if it has any concern. The issuer should reply within a specified time period (normally three weeks). The Exchange will based on the information available to make a ruling and decide, if deem appropriate, to commence the procedure to cancel the issuer's listing.

Cash Companies (Rules 14.82 and 14.83). Under Rule 14.82, if the assets of the issuer (other than an "investment company") consist wholly or substantially of cash and/or short-term investments (i.e. securities/financial instruments that are readily realisable or convertible into cash, such as listed securities, bonds/notes with less than one year maturity, ETFs etc.), it will be regarded as not suitable for listing. In other words, if after a material disposal or a large scale fundraising, the issuer would become a cash company, it runs the risks of being considered not suitable for listing.

An exemption is provided under Rule 14.83 in that

cash and short-term investments held by members of an issuer's group that are banking companies, insurance companies or securities houses will not normally be taken into account in applying rule 14.82. However, an issuer holding excessive cash and/or securities investments cannot circumvent the New Rules by holding such assets through a member that is a licensed broker with minimal brokerage operations. The Exchange has stated explicitly that it will apply a principle based approach and consider, among others, the cash and/or short-term investments in light of the member's operating model and its cash needs for the purpose of its regulated activities, which should be substantiated by its historical track record.

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