

Hong Kong Capital Markets Update

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HKEX's consultation on Backdoor Listing, Continuing Listing Criteria and Other Rule Amendments

The Hong Kong Stock Exchange's (the Exchange) recent [consultation on Backdoor Listing, Continuing Listing Criteria and other rule amendments](#) is set to end on 31 August 2018.

The purpose of the consultation paper is to seek the market's views on the proposed Listing Rules amendments, which aim to address concerns over backdoor listings and other activities related to shell companies.

This Capital Markets Update provides an overview of the proposed Listing Rules amendments.

Highlights

- Codify the principle-based test set out in Guidance Letter GL78-14 (RTO Guidance) into the Listing Rules, with modifications to two assessment criteria (change in control/de facto control and series of transactions and/or arrangements);
- Modify the bright line tests to apply reverse takeover (RTO) rules on very substantial acquisitions (VSAs) from controlling shareholder within 36 (instead of 24) months from a change in control;
- Add a new rule to codify, with modifications, the practice set out in Guidance Letter GL84-15 to regulate backdoor listings through large-scale issue of securities;
- Tighten the compliance requirements for RTOs and extreme transactions (e.g. pro forma financial information of all acquisition targets that are part of the series to be included in the listing document or circular);
- Amend Listing Rules to require a listed issuer to carry out a business with a sufficient level of operations **and** assets of sufficient value to warrant its continued listing;
- Amend the definition "short-dated securities" in the Cash Company Rules to include investments that are easily convertible into cash (e.g. investments in listed securities); and
- Amend the revenue exemption from the notifiable transaction requirements to be available only for purchases and sales of securities conducted by members of the issuer group that are subject to the supervision of prudential regulators.

Background

In recent years, there have been extensive market commentaries about the creation and trading of listed companies that carry on small scale of operations, and whose market capitalisations are disproportionate to the sizes and prospects of their businesses. These shell creation activities invite speculative trading and can lead to opportunities for market manipulation, insider trading and unnecessary market volatility, undermining investor confidence and overall market quality.

In response, the Exchange has conducted a number of reviews of the existing Listing Rules and adopted practices in order to improve the regulation of backdoor listings and shell activities. For example, the

Exchange issued the RTO Guidance in May 2014 to apply a principle-based approach¹, in addition to the bright line tests² under the current RTO rules, to regulate backdoor listing activities. However, a number of issues relating to the transactional structure of backdoor listings were still identified. This includes concerns over new investors acquiring de facto control of an issuer and subsequently using it as a listing platform to acquire new businesses and circumvent the new listing requirements, issuers breaking up acquisitions into a series of smaller acquisitions, or acquiring a new business that does not meet new listing requirements and, subsequently, disposing its original businesses. As a result, the Exchange considers there is a need to formalise its guidance into the Listing Rules as well as implement amendments to address the identified issues.

Key proposals

(I) Proposals relating to backdoor listings

Amend the RTO Rules – Principle-based test

The principle-based test will be codified into the Listing Rules, with modifications to the following two assessment criteria:

- extend the current criterion “issue of restricted convertible securities” to include any change in control or de facto control of the listed issuer. Indicative factors of a change in de facto control include:
 - i) substantial change in board / key management;
 - ii) change in single largest substantial shareholder; and
 - iii) issue of restricted convertible securities.
- clarify the “series of transactions and/or arrangements” criterion to include transactions and/or arrangements that are in reasonable proximity (normally within 36 months) or are otherwise related. This may include changes in control/ de facto control, acquisitions, disposals or termination of the original businesses, and in some circumstances, greenfield operations or equity fundraisings related to acquisitions of new lines of businesses. The entire series of transactions and/or arrangements would be treated as if it were one transaction. Consequently, a disposal may trigger a RTO ruling on a previously completed acquisition in the same series, or a number of smaller acquisitions may form a RTO.

Amend the RTO Rules – Bright line tests

The bright line tests under the current Listing Rules will be retained and modified to apply RTO rules to VSAs from the controlling shareholder within 36 months (instead of 24 months) from a change in control³.

Disposal restriction

Disposal restriction prevents any material disposal (or distribution in specie) at the time of or within 36 months after a change in control³ of the listed issuer, unless the remaining business, or any assets acquired after the change in control, can meet the new listing requirements. The Exchange may also apply this disposal restriction to a material disposal proposed at the time of or within 36 months after a change in the single largest substantial shareholder of the listed issuer.

¹ GL78-14 sets out the following six assessment criteria under the principle-based approach:

- (i) the size of transaction relative to the size of issuer;
- (ii) the quality of business to be acquired – whether it can meet the trading record requirements for listings, or whether it is unsuitable for listing (e.g. an early stage exploration company);
- (iii) the nature and scale of the issuer’s business before the acquisition (e.g. whether it is a listed shell);
- (iv) any fundamental change in the issuer’s principal business (e.g. the existing business would be discontinued or very immaterial to the enlarged group’s operations after the acquisition);
- (v) other events and transactions (historical, proposed or intended) which, together with the acquisition, form a series of arrangements to circumvent the RTO rules (e.g. a disposal of the issuer’s original business simultaneously with a very substantial acquisition); and
- (vi) any issue of restricted convertible securities to vendor which would provide it with de facto control of the issuer.

² Under the current bright line tests, a transaction will be considered as a RTO if it meets any of the criteria below:

- (i) the acquisition or series of acquisitions constitutes a very substantial acquisition resulting in a change of control of the listed company; or
- (ii) after the incoming shareholder or his associates gain control of the listed company, within 24 months, any acquisition or series of acquisitions from the incoming shareholder which, either individually or together constitute a VSA.

³ As defined under the section “Definitions” of the Takeovers Code

Prohibition of backdoor listings through large-scale securities issuance

The Exchange will add a new rule to disallow backdoor listings through the large-scale issuance of securities for cash, where proceeds will be applied to acquire and/or develop new business that is expected to be substantially larger than the issuer's existing principal business. In addition to greenfield operations, the proposed rule will also apply where proceeds are used to develop a new business through future acquisitions.

Tighten the compliance requirements for RTOs and extreme transactions

The following proposals aim to discourage the use of shell companies for backdoor listings and to ensure that acquisition targets are suitable for listing:

- the acquisition targets must be suitable for listing⁴ and meet the trading record requirements⁵ for new applicants. The enlarged group must meet all the new listing requirements (except the trading record requirements⁵). For listed issuers that do not comply with the continuing listing requirements⁶, each of the acquisition targets and the enlarged group must comply with all the new listing requirements;
- codify the "extreme VSAs" category set out in the RTO Guidance and rename it as "extreme transactions". Shell companies do not fall under this category and accordingly, the listed issuer must either:
 - i) operate a principal business of substantial size; or
 - ii) have been under the long-term control of a large business enterprise and the acquisition forms part of a business restructuring with no change in control.
- where an RTO or an extreme transaction involves a series of transactions and/or arrangements, listed issuers are required to include in the listing document or circular the pro forma income statement (GEM: pro forma cash flow statement) for the three (GEM: two) most recent financial years (with reference to the latest proposed transactions) of all acquisition targets and any new business developed that are part of the series.

(II) Proposals relating to continuing listing criteria

Amendments to the requirements on "sufficiency of operations"

A listed issuer will be required to carry out a business with a sufficient level of operations and assets of sufficient value to warrant its continued listing. This excludes any securities trading and/or investment activities unless it is an investment company as defined by Chapter 21 of the MB Listing Rules. A listed issuer without a substantial business that is viable and sustainable will not be able to meet this rule.

Amendments to the requirements on "cash companies"

The definition of "short-dated securities" in the Cash Company Rules will be amended to include investments that are easily convertible into cash (e.g. investments in listed securities). The exemption for securities brokerage companies will only apply to clients' assets.

Proposed transitional arrangements

There will be a 12-month transitional period for issuers that do not meet the amended continuing listing criteria. No transitional period for the proposed amendments to the RTO rules, however, if issuers conduct transactions with a view to re-comply with the new Listing Rules, the Exchange would take this into account with the objective of facilitating their re-compliance.

(III) Other proposed Listing Rules amendments

Securities Transactions

The Exchange confines the revenue exemption from the notifiable transaction requirements to purchases and sales of securities only if they are conducted by members of the issuer group that are subject to the supervision of prudential regulators (i.e. banking companies, insurance companies, or securities houses). A

⁴ MB Rule 8.04 / GEM Rule 11.06

⁵ MB Rule 8.05 (or MB Rule 8.05A or 8.05B) / GEM Rule 11.12A (or 11.14)

⁶ MB Rule 13.24 / GEM Rule 17.26

specific requirement for listed issuers to disclose in their annual reports details of each securities investment that represents five per cent or more of their total assets will also be added.

Significant distribution in specie of unlisted assets

Additional requirements on distribution in specie⁷ that is equivalent in size to a very substantial disposal will be codified. This will be comparable to requirements for a withdrawal of listing.

Other matters relating to notifiable and connected transactions

Amendments will be made to the Listing Rules to make it clear that where any calculation of the percentage ratios produces an anomalous result or is inappropriate to the sphere of activity of the listed issuer, the Exchange (or the issuer) may apply an alternative size test that it considers appropriate to assess the materiality of a notifiable or connected transaction.

The following additional disclosure requirements relating to notifiable and connected transactions will be added:

- in respect of guarantee of financial performance:
 - (i) disclosure on the outcome of any guarantee on the financial performance of an acquisition target that is subject to the notifiable or connected transaction requirements in the next annual report; and
 - (ii) disclosure by way of an announcement if:
 - (a) there is any subsequent change to the guarantee; or
 - (b) the actual financial performance of the target acquired fails to meet the guarantee;
- disclosure on the identities of the parties to a transaction in the announcements and circulars of notifiable transactions; and
- disclosure on the identities and activities of the parties to the transaction and of their ultimate beneficial owners in the announcements of connected transactions.

If you have any questions about the matters discussed in this publication, please feel free to contact the following capital markets partners and directors.

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⁷ Please refer to Listing Decision LD75-4

Appendix I – Overview of Proposed Key Changes to the Listing Rules

The following is a comparison between current and the proposed key changes to Listing Rules relating to Backdoor Listing, Continuing Listing Criteria and other rule amendments.

Topic	Current Listing Rules	Proposed Changes to Listing Rules
Part I: Backdoor Listing		
Amend the RTO Rules - Principle based test	GL78-14 sets out six assessment criteria for principle based test	- The six criteria set out in GL78-14 will be codified in MB Rule 14.06B / GEM Rule 19.06B, with modifications to two assessment criteria: - extend the current criterion “issue of restricted convertible securities” to include any change in control or de facto control of the issuer; and - clarify the “series of arrangements” criterion to include transactions and/or arrangements (normally within 36 months) that are in reasonable proximity
Amend the RTO Rules - Bright line tests	MB Rule 14.06 / GEM Rule 19.06 set out the bright line tests - RTO rules are applicable to VSAs from the controlling shareholder within 24 months from a change in control	Extend the aggregation period of the bright line tests from 24 months to 36 months
Disposal restriction	MB Rule 14.92 / GEM Rule 19.91 set out disposal restrictions on listed issuers for disposals of its business for a 24-month period after a change in control, unless the assets acquired fulfil the new listing requirements	The existing rule will be replaced by MB Rule 14.06E / GEM Rule 19.06E - disposal restrictions will apply to material disposals (or distribution in specie) of business for a 36-month period from a change in control, unless the remaining business, or any assets acquired fulfil the new listing requirements
Prohibition of backdoor listings through large scale securities issuance	GL84-15 provides guidance on the Exchange’s view to disallow backdoor listings through large scale issues of securities for cash where the proceeds will be applied to greenfield operations	The guidance set out in GL84-15 will be codified into MB Rule 14.06D / GEM Rule 19.06D to disallow backdoor listings through large scale issues of securities for cash where the proceeds will be applied to acquire and/or develop new business that is expected to be substantially larger than the listed issuer’s existing principal business
Tighten the compliance requirements for RTOs and extreme transactions	- GL78-14 sets out the criteria to be eligible for “extreme VSAs” - MB Rule 14.54 requires the enlarged group or the assets to be acquired must meet the track record requirement of MB Rule 8.05 and the enlarged group to meet all the other basic listing conditions set out in Chapter 8. There are same requirements under GEM Rule 19.54	- The extreme VSAs set out in GL78-14 will be codified into MB Rule 14.06C / GEM Rule 19.06C and renamed as “extreme transactions”. “Shell companies” are not eligible for this category and accordingly, the listed issuer must either: - operate a principal business of substantial size; or - have been under the long-term control of a large business enterprise and the acquisition forms part of a business restructuring with no change of control - Requiring the acquisition targets must meet both the requirements of MB Rule 8.04 (suitability for listing) and MB Rule 8.05 (the track record requirements) and the enlarged group to meet all the new listing requirements (except MB Rule 8.05). In case where the listed issuer do not comply with MB Rule 13.24, each of the acquisition targets and the enlarged group must comply with all the new listing requirements. The corresponding GEM Rule 19.54 will also be amended to align with the MB Rule - A new requirement will be added in MB Rule 14.57A / GEM Rule 19.57A) to require a listed issuer, in the case of a RTO or extreme transaction involves a series of transactions and/or arrangements, to include in the listing document or circular the pro forma income statement (GEM: pro forma cash flow statement) for the most recent three (GEM: two) financial years (with reference to the latest proposed transaction) of all acquisition targets and any new business developed that are part of the series

Appendix I – Overview of Proposed Key Changes to the Listing Rules (continued)

Topic	Current Listing Rules	Proposed Changes to Listing Rules
Part II: Continuing Listing		
Amendments to the requirements on “sufficiency of operations”	MB Rule 13.24 / GEM Rule 17.26 require a listed issuer to carry out a business with a sufficient level of operations or have tangible assets of sufficient value and/or intangible assets for which a sufficient potential value to warrant the continued listing	The existing Listing Rule (MB Rule 13.24 / GEM Rule 17.26) will be amended to require a listed issuer to carry out a business with a sufficient level of operations and assets of sufficient value to support its operations to warrant the continued listing A new requirement will also be added in MB Rule 13.24 / GEM Rule 17.26 to exclude trading and/or investment in securities (other than those of MB Rule Chapter 21 investment company) when considering the above criteria for continued listing
Amendments to the requirements on “cash companies”	- Under MB Rule 14.82 / GEM Rule 19.82, a listed issuer whose assets consist wholly or substantially of cash or short-dated securities and/or short-term investments will not be regarded as suitable for listing - Under MB Rule 14.83 / GEM Rule 19.83, securities brokerage companies are not subject to MB Rule 14.82 / GEM Rule 19.82	- The definition of “short-dated securities” under MB Rule 14.82 / GEM Rule 19.82 will be amended to include investments that are easily convertible into cash (e.g. investments in listed securities) - The exemption for securities brokerage companies under MB Rule 14.83 / GEM Rule 19.83 will be amended to apply only to client’s assets
Part III: Other Proposed Rule Amendments		
Securities transactions	Under MB Rule 14.04 / GEM Rule 19.04, there are no specific guidance on whether purchases and sales securities can qualify for revenue exemption from notifiable transaction requirements	The revenue exemption from the notifiable transaction requirements will only be available to purchases and sales of securities if they are conducted by members of an issuer group that are subject to the supervision of prudential regulators (i.e. bank companies, insurance companies or securities house) An additional requirement will be added in MB Rule Appendix 16(32) / GEM Rule 18.41 requiring listed issuers to disclose details of each securities investment that represents 5% or more of their total assets in their annual report