

# Hong Kong Capital Markets Update

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## HKEX's consultation conclusions on the proposal relating to Backdoor Listings, Continuing Listing Criteria and Other Rule Amendments

On 26 July 2019, the Stock Exchange of Hong Kong Limited (the Exchange) published the conclusions of its consultation on [the proposal relating to backdoor listing, continuing listing criteria and other Listing Rule amendments](#). The conclusions are summarised below:

### Highlights

- Clarify the objective of the reverse takeover (RTO) Rules;
- Amend the “series of transactions and/or arrangements” factor under RTO Rules;
- Revise the additional requirements for RTOs undertaken by issuers that do not meet the Listing Rules 13.24 requirements;
- Remove the “pre-ordained” strategy on aborted transactions;
- Modify the eligibility requirements for extreme transactions; and
- Modify the proposed amendments to the current Listing Rule 13.24 (requiring issuers to maintain sufficient operations and/or assets of sufficient value) and Listing Rules 14.82 and 14.83 (restrictions on cash companies).

### Background

In recent years, there have been extensive market commentaries about the creation and trading of listed companies that carry on small scale 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. However, a number of issues relating to the transactional structure of backdoor listings were still identified.

As a result, the Exchange published a consultation paper, to seek market feedback on the proposal to consider whether the Listing Rules on backdoor listing (RTO Rules) and continuing listing criteria should be amended, on 29 June 2018 (please refer the summary of the consultation to our [Capital Markets Update Issue 2018-08](#)). The Exchange, after considering the comments from the respondents, decided to adopt the proposals in the consultation, with certain modifications detailed below.

**Appendix I** summarises a comparison between current and proposed key changes to the Listing Rules, having incorporated the modifications after consultation, relating to backdoor listing, continuing listing criteria and other rules amendments.

**Key modifications to proposals**

***Clarify the objective of the RTO Rules***

The Exchange seeks to apply the RTO Rules to address shell activities involving recent backdoor structures. In addressing shell activities, the Exchange will modify the indicative factors for assessing any change in control or de facto control as follows: (i) a change in the controlling shareholder of the issuer; or (ii) a change in the single largest substantial shareholder who is able to exercise effective control over the issuer as indicated by factors such as a substantial change to its board of directors and/or senior management.

***Amend the “series of transactions and/or arrangements” factor under RTO Rules***

To address concerns about regulatory uncertainties and the possible application of the RTO Rules to transactions in an issuer's normal course of business, the Exchange will remove references to greenfield operations, equity fund raisings and termination of businesses from the “series of transactions and/or arrangements” factor, and modify the size test, which compares the size of the new business with the original business, in assessing whether the series of transactions would give rise to a fundamental change in business in the new RTO Guidance Letter.

***Revise the additional requirements for RTOs undertaken by Listing Rule 13.24 issuers***

For an issuer that has failed to comply with Listing Rule 13.24 (requiring sufficient operations), the Exchange will remove the requirement for the enlarged group to meet Listing Rule 8.05 to address concerns that Rule 13.24 issuers with substantial losses cannot conduct RTO transactions, unless the acquisition targets have significant profit track record to cover those losses. Alternatively, the Exchange will require the acquisition targets to meet Listing Rule 8.04 (suitability for listing), Listing Rule 8.05 (or Listing Rule 8.05A or 8.05B) (track record requirements) and Listing Rule 8.07 (sufficient public interest).

***Remove the “pre-ordained” strategy on aborted transactions***

This refers to cases where the issuer aborts a transaction (the last in a series) after the Exchange's RTO ruling. The Exchange may impose additional requirements on the completed transactions if it considers them to form a pre-ordained strategy to circumvent the new listing requirements. In light of market's concerns that it would be unfair to presume the aborted transaction to be part of a “pre-ordained” strategy, the Exchange will not adopt this approach.

***Modify the eligibility requirements for extreme transactions***

To address concerns that the proposed eligibility requirements would prejudice against smaller issuers, the Exchange will modify requirements such that an issuer may use the extreme transaction category if it 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 three years) prior to the proposed transaction, and that the proposed transaction would not result in a change in control or de facto control.

***Modify the proposed amendments to the current Listing Rule 13.24 (requiring issuers to maintain sufficient operations and/or assets of sufficient value) and Listing Rules 14.82 and 14.83 (restrictions on cash companies)***

To address concerns in relation to the proposed amendments to the current Listing Rules 13.24, 14.82 and 14.83, the Exchange will:

- Modify the Note to Listing Rule 13.24 to clarify that the onus is upon the issuer to provide information for the Exchange's assessment on its compliance with Listing Rule 13.24 (rather than to demonstrate that it is in compliance with the Rule as set out in the proposal).
- Amend the Listing Rule to also exempt trading and/or investment in securities by a member of an issuer's group that is a banking company, an insurance company or a securities house that is mainly engaged in regulated activities under the SFO. The Exchange will also amend the Listing Rule to clarify that the Listing Rule would apply to an issuer's “proprietary” trading and/or investment in securities.
- Amend the proposed Note to Listing Rule 14.82 to clarify the purpose of the Listing Rule and that the scope of short-term investments includes securities that are held by the issuer for investment or trading purposes and are readily realisable or convertible into cash. Reference about the issuer's intention is removed.

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- Amend the Listing Rule to also exempt cash and short-term investments held by a member of an issuer's group that is a banking company, an insurance company or a securities house that is subject to supervision by other regulatory authorities. The exemption will not apply to an issuer that operates a securities house where the Exchange has concerns that the issuer is holding cash and short-term investments through the member to circumvent Listing Rule 14.82. Consequential changes to Listing Rule 8.05C will also be made.

### **Effective date**

The Listing Rule amendments will take effect from 1 October 2019. A transitional period of 12 months from the effective date of the Rule amendments will apply to listed issuers that do not comply with the new Listing Rules 13.24 or 14.82 strictly as a result of the Listing Rule amendments. To avoid doubt, the transitional arrangement will not apply to issuers that do not comply with the current requirements under Listing Rule 13.24 or 14.82, or become non-compliant with the new Listing Rules 13.24 or 14.82 after the effective date of the Rule amendments.

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

The following is a comparison between current and proposed key changes to the Listing Rules, having incorporated the modifications after consultation, relating to backdoor listing, continuing listing criteria and other rules amendments.

Topic	Current Listing Rules	Proposed Changes to Listing Rules (for consultation)	Proposed Changes to Listing Rules (modifications after consultation)
<b>Part I: Backdoor Listing</b>			
<b>Amend the RTO Rules - Principle based test</b>	GL78-14 sets out six assessment criteria for principles-based test.	<p>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:</p> <ul style="list-style-type: none"> <li>(a) Extend the current criterion “issue of restricted convertible securities” to include any change in control or de facto control of the issuer; and</li> <li>(b) clarify the “series of arrangements” criterion to include transactions and/or arrangements (normally within 36 months) that are in reasonable proximity.</li> </ul>	<p>Adopted with modifications.</p> <p>Modify the indicative factors for assessing any change in control or de facto control as follows: (i) a change in controlling shareholder of the issuer; or (ii) a change in the single largest substantial shareholder who is able to exercise effective control over the issuer as indicated by factors such as a substantial change to its board of directors and/or senior management.</p> <p>Remove references to greenfield operations, equity fund raisings and termination of businesses from the “series of transactions and/or arrangements” factor, and modify the size test that compares the size of the new business with the original business in assessing whether the series of transactions would give rise to a fundamental change in business in the new RTO Guidance Letter.</p> <p>Remove “pre-ordained” strategy on aborted transactions.</p>
<b>Amend the RTO Rules - Bright line tests</b>	MB Rule 14.06 / GEM Rule 19.06 set out the bright line tests - RTO rules are applicable to very substantial acquisitions (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.	Adopted.
<b>Disposal restriction</b>	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.	Adopted.

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

Topic	Current Listing Rules	Proposed Changes to Listing Rules (for consultation)	(modifications after consultation)
<b>Prohibition of backdoor listings through large scale securities issuance</b>	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.	Adopted with modifications.  Modify proposed MB Rule 14.06D / GEM Rule 19.06D to clarify that it applies to equity fundraisings that involve a change in control or de facto control of the issuer.
<b>Tighten the compliance requirements for RTOs and extreme transactions</b>	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 the same requirements under GEM Rule 19.54.	<p>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:</p> <ul style="list-style-type: none"> <li>(a) operate a principal business of substantial size; or</li> <li>(b) 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.</li> </ul> <p>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 cases where the listed issuer does 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.</p> <p>A new requirement will be added in MB Rule 14.57A / GEM Rule 19.57A) to require a listed issuer, in the case an 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.</p>	<p>Adopted with modifications.  Modify requirements (b) such that an issuer may use the extreme transaction category if it 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 three years) prior to the proposed transaction, and that the proposed transaction would not result in a change in control or de facto control.</p> <p>Remove the requirement for an issuer that has failed to comply with Listing Rule 13.24 (requiring sufficient operations) for the enlarged group to meet Listing Rule 8.05 and require the acquisition targets to meet Listing Rule 8.04 (suitability for listing), Listing Rule 8.05 (or Listing Rule 8.05A or 8.05B) (track record requirements) and Listing Rule 8.07 (sufficient public interest).</p>

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

Topic	Current Listing Rules	Proposed Changes to Listing Rules (for consultation)	(modifications after consultation)
<b>Part II: Continuing Listing</b>			
<b>Amendments to the requirements on “sufficiency of operations”</b>	<p>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 with a sufficient potential value to warrant the continued listing.</p>	<p>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 <b>and</b> assets of sufficient value to support its operations to warrant the continued listing.</p> <p>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.</p>	<p>Adopted with modifications.</p> <p>Modify the Note to Listing Rule 13.24 to clarify that the onus is upon the issuer to provide information for the Exchange's assessment on its compliance with Listing Rule 13.24.</p> <p>Amend the Listing Rule to also exempt trading and/or investment in securities by a member of an issuer's group that is a banking company; an insurance company; or a securities house that is mainly engaged in regulated activities under the SFO.</p> <p>Amend the Listing Rule to clarify that the Listing Rule would apply to an issuer's “proprietary” trading and/or investment in securities.</p>
<b>Amendments to the requirements on “cash companies”</b>	<p>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.</p> <p>Under MB Rule 14.83 / GEM Rule 19.83, securities brokerage companies are not subject to MB Rule 14.82 / GEM Rule 19.82.</p>	<p>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).</p> <p>The exemption for securities brokerage companies under MB Rule 14.83 / GEM Rule 19.83 will be amended to apply only to client assets.</p>	<p>Adopted with modifications.</p> <p>Amend the proposed Note to Listing Rule 14.82 to clarify the purpose of the Listing Rule and that the scope of short-term investments includes securities that are held by the issuer for investment or trading purposes and are readily realisable or convertible into cash. Reference about the issuer's intention is removed.</p> <p>Amend the Listing Rule to also exempt cash and short-term investments held by a member of an issuer's group that is a banking company, an insurance company or a securities house, but this exemption will not apply to an issuer that operates a securities house where the Exchange has concerns that the issuer is holding cash and short-term investments through the member to circumvent Listing Rule 14.82. Consequential changes to Listing Rule 8.05C will also be made.</p>
<b>Part III: Other Proposed Rule Amendments</b>			
<b>Securities transactions</b>	<p>Under MB Rule 14.04 / GEM Rule 19.04, there is no specific guidance on whether purchases and sales of securities can qualify for revenue exemptions from notifiable transaction requirements.</p>	<p>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).</p> <p>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.</p>	<p>Adopted with modifications.</p> <p>Modify the Listing Rule to clarify that in the case of a member which is a securities house, the exemption will be available only if such member is mainly engaged in regulated activities under the SFO.</p> <p>Modify the proposed Listing Rule to clarify that the proposed Listing Rule is an additional disclosure requirement and the 5% threshold is based on the issuer's investments in each investee company at the end of the reporting period.</p>