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HKEX proposes listing rule changes to crack down on backdoor listing

The Hong Kong Stock Exchange (HKEX) has published a [consultation paper on backdoor listing, continuing listing criteria and other rule amendments](#). The proposals do not contain major surprises, many of which are already set out in guidance letters and listing decisions issued in the last few years, and therefore the proposed amendments can be viewed largely as an exercise to codify the previous guidance, with limited tightening and fine-tuning. The consultation will close on 31 August 2018 and the Securities and Futures Commission (SFC) has [expressed support](#) for the proposals.

This latest consultation paper forms part of a broader series of actions taken by the regulators in Hong Kong to address their concerns over “backdoor” listing activities and the creation of “shell” companies (i.e., listed companies which do not have a substantial business but maintain their listing status to be purchased by buyers which wish to go public but are unable or unwilling to go through the “front door” to seek a listing status).

We have already seen several major changes to the listing rules in the last 12 months to address these concerns, including:

- reforms aimed at curbing highly dilutive capital raising activities (see [our alert](#) and note the related rule amendments took effect on [3 July 2018](#));
- introducing a more robust delisting mechanism which allows the HKEX to delist an issuer with prolonged suspensions (note the related rule amendments will take effect on [1 August 2018](#)); and
- tightening the GEM new listing requirements to curb sharp share price movements of GEM shares shortly after their trading debut (note the related rule amendments took effect on [15 February 2018](#)).

In this alert, we summarise the notable features in the proposed rule changes.

Proposals relating to the existing reverse takeover rules

The current rules relating to reverse takeovers (RTOs) are set out in MB Rule 14.06. They comprise the principle-based test and the bright-line test. The RTO rules are anti-avoidance provisions designed to prevent the circumvention of the requirements for new listings. The HKEX published guidance letter GL78-14 in 2014 which provides guidance on the application of the RTO rules and, particularly, the principle-based test. Under this test, the HKEX takes into account six criteria in deciding whether a proposed transaction or series of transactions would be considered an attempt by the issuer to achieve a listing of the assets to be acquired and to circumvent the new listing requirements. The HKEX treats a listed issuer proposing an RTO transaction as a new listing applicant.

In the new consultation paper, it is proposed that:

- The HKEX will retain the principle-based test in the RTO rules and codify the six assessment criteria, with the following minor modifications and clarifications:
 - a. “a series of transactions” may include completed or proposed transactions/arrangements if they are within reasonable proximity of each other or are otherwise related, and a series of transactions will be treated as if it were one transaction;
 - b. the last transaction does not need to be an acquisition of assets to trigger the RTO rules – a disposal could also form part of a series of transactions. Appendix II of the consultation paper illustrates this concept with examples; and
 - c. the HKEX notes it will not normally consider a transaction or arrangement outside a **three-year period** as part of a series and warns the market that if an issuer aborts the latest proposed transaction in the series (e.g., after the Listing Committee makes a RTO ruling on the series), the HKEX may impose additional requirements on the issuer by requiring it to engage a financial adviser to conduct due diligence and make enhanced disclosures on its completed acquisitions in the series. Separately, the SFC may take regulatory action (including suspending trading) under the Securities and Futures Ordinance and the Securities and Futures (Stock Market Listing) Rules.
- The HKEX will retain the bright-line test, with the following modifications:
 - a. the aggregation period for acquisitions of assets will be extended from 24 months to 36 months; and
 - b. there will be a restriction on any material disposal of an issuer’s existing business at the time of or within 36 months after a change in control, unless: (i) the remaining business; or (ii) the assets acquired from the new controlling shareholder (and its associates) and third parties would meet the IPO financial listing qualification requirements in MB Rule 8.05/8.05A/8.05B.

Proposal to codify the approach to “extreme VSAs” in GL78-14, with modifications

An “extreme VSA” is an acquisition or series of acquisitions of assets which have the effect of achieving a listing of the acquisition target(s), but where the issuer can demonstrate to the satisfaction of the HKEX that it is not an attempt to circumvent the requirements for new listings. Extreme VSAs are subject to requirements in addition to those applicable to simple VSAs (very substantial acquisitions), including enhanced disclosure and the appointment of a financial adviser to perform diligence on the assets which are the subject of the acquisition.

In the new consultation paper, it is proposed that:

- “Extreme VSAs” will be renamed as “extreme transactions” in the Listing Rules.
- New qualification requirements will be imposed on listed issuers who conduct extreme transactions, including that:
 - a. the issuer must have been operating a “principal business with substantial size” which will continue after the transaction. The HKEX notes that “substantial size” normally means a business with an annual revenue or total asset value of HK\$1 billion or more, which must exclude any revenue or assets not attributable to the principal business (such as significant investments or surplus cash); or

- b. the issuer must have been under the control of a large business enterprise for a long period (normally not less than three years) and the transaction forms part of a business restructuring of the group and would not result in a change in control.

Proposals relating to the continuing listing criteria

The new consultation paper makes certain proposals relating to the requirement for sufficient operations/assets (currently MB Rule 13.24), including:

- An issuer having a sufficient level of operations or assets of sufficient value to support the issuer's operations to warrant its continued listing are currently alternative criteria under the current Listing Rules. The HKEX proposes to turn these alternative criteria into a double-limb test, which means an issuer has to satisfy both tests.
- It is proposed that an issuer must exclude its trading and investment in securities when considering the sufficiency of its operations and assets under Rule 13.24 (unless it is a Chapter 21 investment company).

The HKEX has also published a guidance letter ([GL96-18](#)) on listed issuers' suitability for continued listing. The guidance contained in this letter is fairly similar to the suitability for listing criteria for new listing applicants.

Other notable proposals

- Changes to the revenue nature transaction exemption (MB Chapter 14)
Confine the availability of the revenue nature transaction exemption from the notifiable transaction requirements to securities trading only if such trading is conducted by members of the issuer group that are under the supervision of prudential regulators (i.e. banking companies, insurance companies, or securities houses).
- New annual report disclosure requirement
Introduce a new annual report disclosure requirement for issuers to disclose details of each securities investment that represents 5% or more of their total assets.

Please refer to the [consultation paper](#) for more details and other proposals. The consultation period will run until 31 August 2018.

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