

## Client Alert

August 2019

### SEHK publishes new rules to regulate backdoor listings and shell activities

#### Summary

On 26 July 2019, The Stock Exchange of Hong Kong Limited (SEHK) published the [Consultation Conclusions on Backdoor Listing, Continuing Listing Criteria and other Rule Amendments](#) together with three new guidance letters. SEHK adopts the amendments to the Listing Rules proposed in its [Consultation Paper](#) with modifications to reflect market responses. The rule amendments will come into effect on **1 October 2019**.

On the same day, the Securities and Futures Commission (SFC) published the [Statement on the SFC's approach to backdoor listings and shell activities](#). In deciding whether to exercise its powers of investigation under the Securities and Futures Ordinance or its powers under the Securities and Futures (Stock Market Listing) Rules to object a listing application and direct SEHK to suspend a listed issuer's shares in cases involving backdoor listings and shell activities, the SFC will take into account factors including (i) whether there are any red flags indicating concealed arrangements or understandings between the parties involved; (ii) whether the true nature or extent of the business, affairs and plans of the listed issuer/ listing applicant has been disclosed; (iii) whether there are any fundamental issues relating to the target assets or businesses; (iv) whether there are any concerns that the directors might not have fulfilled their fiduciary duties; and (v) whether sufficient due diligence has been conducted on the target assets or businesses.

#### Key Amendments to the Listing Rules

Key rule amendments are summarized below. All rule references are to the Main Board Listing Rules unless otherwise stated and the amendments apply equally to the GEM Listing Rules.

#### Part I - Amendments Relating to Reverse Takeovers (RTO)

##### A. Codifying the principle based test with modifications

Current requirements	New requirements
Guidance Letter GL 78-14 sets out the following six assessment factors which SEHK will consider in assessing whether an acquisition (or series of acquisitions) of assets would be considered an attempt by the listed issuer to achieve a listing of the assets and a means to	The six assessment factors set out in Guidance Letter GL78-14 will be codified with the following modifications (new Note 1 to Rule 14.06B): <ul style="list-style-type: none"><li>extend the current "issue of restricted convertible securities to the vendor which would provide it with de facto control of the issuer" factor to include <b>any</b> change in control (as defined in the</li></ul>

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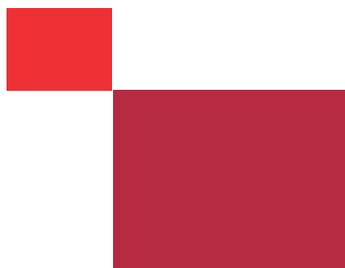
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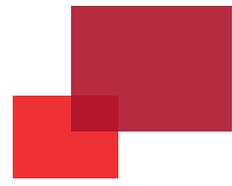
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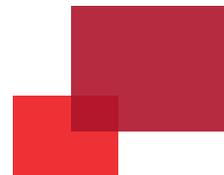




<p>circumvent the new listing requirement:</p> <ul style="list-style-type: none"> <li>(a) Size of the transaction relative to the size of the issuer;</li> <li>(b) Quality of the business to be acquired;</li> <li>(c) Nature and scale of issuer's business before the acquisition;</li> <li>(d) Any fundamental change in the listed issuer's principal business;</li> <li>(e) Other events and transactions (historical, proposed or intended) which, together with the acquisition, form a series of arrangements to circumvent the RTO rules; and</li> <li>(f) Any issue of restricted convertible securities to the vendor which would provide it with de facto control of the issuer.</li> </ul>	<p>Takeovers Code) or de facto control of the listed issuer. In assessing whether there has been any change in control or de facto control of the listed issuer, SEHK will consider:</p> <ul style="list-style-type: none"> <li>(i) any change in controlling shareholder of the listed issuer; or</li> <li>(ii) any change in the single largest substantial shareholder who is able to exercise effective control over the listed issuer as indicated by factors such as a substantial change to its board of directors and/or senior management; and</li> </ul> <ul style="list-style-type: none"> <li>• replace the current "<i>other events and transactions (historical, proposed or intended) which, together with the acquisition, form a series of arrangements to circumvent the RTO rules</i>" factor with "<i>other transactions or arrangements which, together with the acquisition or series of acquisitions, form a series of transactions or arrangements to list the acquisition targets</i>". SEHK may regard acquisitions and other transactions or arrangements as a series if they take place in a reasonable proximity (normally within 36 months) or are otherwise related. As SEHK will adopt a purposive approach, 36-month will not be a hard cut-off for the assessment period. Transactions or arrangements may include changes in control/ de facto control, acquisitions and/or disposals (<i>N.B.</i> "greenfield operations, equity fundraising and termination of businesses" as proposed in the Consultation Paper were not included).</li> </ul>
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B. Retaining the bright line tests with modification

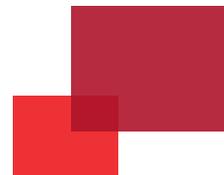
Current requirements	New requirements
<p>The bring line tests under Rule 14.06(6)(a) and (b) refer to two specific forms of RTO :</p> <ul style="list-style-type: none"> <li>(a) an acquisition or a series of acquisitions of assets constituting a very substantial</li> </ul>	<p>The bright line tests under the current Rule will be retained and renumbered as Note 2 to Rule 14.06B. The aggregation period under Rule 14.06(6)(b) will be extended from 24</p>



<p>acquisition where there is or which will result in a change in control (as defined in the Takeovers Code) of the listed issuer; or</p> <p>(b) acquisition(s) of assets from the incoming shareholder or his associate(s) within 24 months of the incoming shareholder gaining control (as defined in the Takeovers Code), which individually or together constitute a very substantial acquisition.</p>	<p>months to 36 months to align with that under the principle based test.</p>
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C. Retaining the disposal restriction with modifications

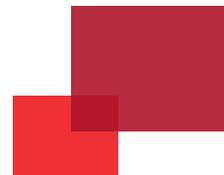
Current requirements	New requirements
<p>Rules 14.92 and 14.93 restrict a listed issuer from disposing of its existing business within 24 months after a change in control (as defined in the Takeovers Code), unless the assets acquired from the new controlling shareholder (and its associates) and any other assets acquired after the change in control can meet the track record requirement for new listing applicants under Rule 8.05 (or Rule 8.05A or 8.05B).</p> <p>These requirements complement the bright line tests and discourage a listed issuer from disposing of its original business after acquisition of the target asset with a view to circumventing the RTO rules by resequencing the transaction.</p>	<p>The disposal restriction under the current Rules will be retained and renumbered as Rule 14.60E with the following modifications:</p> <ul style="list-style-type: none"> <li>clarify that the restriction applies to disposal or distribution in specie (or a series of disposals or distributions in specie) of "all or material part" of the listed issuer's existing business as opposed to any existing business of the listed issuer. In other words, the new Rule would not restrict a new controlling shareholder from conducting a business reorganization to dispose of the listed issuer's non-performing business provided that is not all or a material part of the listed issuer's business;</li> <li>extend the restriction period from 24 months to 36 months (after a change of control) to align with that of the principle based test and the bright line tests;</li> <li>extend the restriction to a disposal at the time of the change in control. It is to capture shell creation structures where the outgoing controlling shareholder would dispose of his shareholding interest in the listed issuer to a new shareholder and at the same time buy back a material</li> </ul>



	<p>part of the listed issuer's principal business; and</p> <ul style="list-style-type: none"> <li>the carve-out from the restriction will also apply to the cases where the remaining group can meet the track record requirement for new listing applicants under Rule 8.05 (or Rule 8.05A or 8.05B).</li> </ul>
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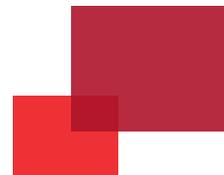
D. Codifying the "extreme very substantial acquisition" (Extreme VSA) with modifications

Current requirements	New requirements
<p>Under Guidance Letter GL 78-14, a transaction would be treated as an Extreme VSA where SEHK considers it "extreme" by reference to the criteria set out in the principle based test, but the listed issuer can demonstrate that the target business meets the eligibility and suitability for new listing requirements under Chapter 8 of the Listing Rules and that circumvention of the new listing requirements would not be a material concern. For an Extreme VSA, the listed issuer would be required to (i) prepare a transaction circular under an enhanced disclosure and vetting approach, and (ii) appoint a financial advisor to conduct due diligence with reference to Practice Note 21 of the Listing Rules. The financial adviser is required to provide a declaration to SEHK in respect of its due diligence on the extreme transaction.</p>	<p>The current Extreme VSA requirements will be codified (new Rule 14.06C), and renamed as "extreme transaction".</p> <p>Additional requirements will be imposed on the listed issuer proposing an extreme transaction:</p> <ul style="list-style-type: none"> <li>(a) the issuer 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 36 months) prior to the proposed transaction, and that the proposed transaction would not result in a change in control or de facto control; or</li> <li>(b) the issuer has been operating a principal business with substantial size which will continue after the transaction. This may apply where an investor acquired control of a listed issuers with a view to operating the underlying businesses and subsequently the listed issuer expand or diversify its businesses through a very significant acquisition. As a general guidance (<i>not</i> a rule requirement), the listed issuer should have annual revenue or total asset value of HK\$1 billion or more.</li> </ul>



E. Additional requirements for RTOs and extreme transactions

Current requirements	New requirements
<p>Under Rule 14.54, SEHK will treat a listed issuer proposing a RTO as if it were a new listing applicant. The enlarged group or the assets to be acquired must be able to meet the track record requirements under Rule 8.05 and the enlarged group must be able to meet all the other basic listing conditions set out in Chapter 8 of the Listing Rules (except Rule 8.05). This requirement also applies to extreme VSA.</p>	<p>The following additional requirements are imposed on transactions classified as RTOs and extreme transaction.</p> <p>Under the new Rules 14.54(1) and 14.06C(2), for listed issuers that comply with the sufficient operation requirement under Rule 13.24 :</p> <ul style="list-style-type: none"> <li>(i) the acquisition targets must meet the suitability for listing requirement under Rule 8.04 and the track record requirements under Rule 8.05 (or Rule 8.05A or 8.05B); and</li> <li>(ii) the enlarged group must meet all the new listing requirements set out in Chapter 8 of the Listing Rules (except Rule 8.05).</li> </ul> <p>Under the new Rule 14.54(2), for listed issuers that have failed to comply with the sufficient operation requirement Rule 13.24.;</p> <ul style="list-style-type: none"> <li>(i) the acquisition targets must meet the suitability for listing requirement under Rule 8.04, the track record requirement under Rule 8.05 (or Rule 8.05A or 8.05B) and the sufficient public interest requirement under Rule 8.07; and</li> <li>(ii) the enlarged group must meet all the new listing requirements set out in Chapter 8 of the Listing Rules (except Rule 8.05).</li> </ul>
<p>Rule 14.57 requires a listed issuer proposing a RTO to comply with the procedures and requirements for new listing applications as set out in Chapter 9 of the Listing Rules. Where the RTO involves a series of acquisitions, both the completed acquisition(s) and the proposed acquisition forming part of the RTO are subject to documentary requirements, including the production of accountants' report and pro forma financial information.</p>	<p>A new Rule 14.57A will be added to clarify for an extreme transaction or takeover RTO that involves a series of transactions and/or arrangements, the track record period of the acquisition targets normally covers the three financial years immediately prior to the issue of the circular or listing document for the latest proposed transaction of the series. Also, the listed issuer will be required to submit financial information of the acquisition targets based on accountants' reports or audited financial information to SEHK to demonstrate compliance with the track record period</p>



As these acquisitions may have taken place over a few years, the current Listing Rules do not provide guidance on how the track record of the acquisitions would be determined and the financial information to be presented.	requirement under Rule 8.05 (or Rule 8.05A or 8.05B).
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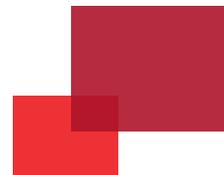
F. Codify the practice set out in Guidance Letter GL84-15 to regulate backdoor listing through large scale issue of securities with modifications

Current requirements	New requirements
Guidance Letter GL84-15 explains the circumstances under which SEHK applies the cash company rules to disallow large scale issues of securities where the fund raised would be used to start a greenfield operation which, in the opinion of SEHK, is a means to circumvent the new listing requirements and to achieve a listing of the greenfield operation.	Such practice under Guidance Letter GL84-15 will be codified with modifications (new Rule 14.06D) which clarify that this new rule is intended to apply to a large scale issue of securities for cash proposed by a listed issuer where there is, or which will result in, a change in control or de facto control of the issuer, and the proceeds are to be used to acquire and/or develop a new business that is expected to be substantially larger than the listed issuer's existing principal business. The effect of the proposal is to achieve a listing of the new business that would not have otherwise met the new listing requirements.

Part II - Amendments Relating to Continuing Listing Criteria

A. Amend Rule 13.24 sufficient operations requirement

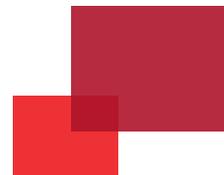
Current requirements	New requirements
<p>Rule 13.24 requires that a listed issuer must carry out a sufficient level of operations <b>or</b> have tangible assets of sufficient value and/or intangible assets for which a sufficient potential value can be demonstrated to SEHK to warrant the continued listing of the issuer's securities.</p> <p>This rule does not provide guidance on what constitutes</p>	<p>The following amendments will be made to Rule 13.24:</p> <p>(a) A listed issuer must carry out a business with a sufficient level of operations <b>and</b> have assets of sufficient value to support its operations to warrant its continued listing;</p> <p>(b) The existing note to Rule 13.24 will be replaced with a new note specifying this rule is qualitative test and SEHK may consider a listed issuer to have failed to comply with this rule in situations where,</p>



<p>"sufficient operations or assets".</p>	<p>for example, SEHK considers that the listed issuer does not have a business that has substance and/or that is viable and sustainable. Where SEHK raises concerns with a listed issuer about its compliance with this rule, the onus is on the listed issuer to provide information to address SEHK's concerns and demonstrate to the satisfaction of SEHK its compliance with this rule. ; and</p> <p>(c) Proprietary trading and/or investment in securities by a listed issuer or its subsidiaries (other than an investment company listed under Chapter 21) will normally be excluded when considering the sufficiency of the listed issuer's operation and assets under the rule. Exemptions from this exclusion will be made available to 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 Securities and Futures Ordinance.</p>
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B. Amend cash company rules under Rules 14.82 to 14.84 (Cash Company Rules)

Current requirements	New requirements
<p>Under the Cash Company Rules, where for any reason the assets of a listed issuer consist wholly or substantially of cash or short-dated securities, it will not be regarded as suitable for listing. A listed issuer that is solely or mainly engaged in the securities brokerage business is not subject to this requirement.</p> <p>The term "short-dated securities" is defined to mean securities such as bonds, bills or notes that have less than one year to maturity.</p>	<p>The following amendments will be made to the Cash Company Rules:</p> <p>(a) extend the definition of "short-dated securities" to cover investments that are easily convertible into cash and is renamed as "short-term investments".</p> <p>The term "short-term investments" will include securities that are held by the issuer for investment or trading purposes and are readily realisable or convertible into cash. Examples of short term investments include (a) bonds, bills or notes which have less than one year to maturity; (b) listed securities (whether on SEHK or otherwise) that are held for investment or trading purposes; and (c) investments in other financial instruments that are readily realizable or convertible into cash. (Note 2 to Rule 14.82)</p>



	(b) modify the exemption for securities brokerage business to 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. (Rule 14.83)
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### C. Transitional arrangements for amendments relating to continuing listing criteria

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

### Part III - Other amendments

Other proposed rule amendments relating to the revenue nature transaction exemption for listed issuers' securities trading and/or investments, significant distribution in specie of unlisted assets, and certain disclosure requirements and alternative size tests requirements for notifiable transactions and connected transactions as set out in the Consultation Paper will also be adopted with minor modifications.

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