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BACKDOOR LISTING IN HONG KONG

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A private company goes public without undertaking the traditional route of listing its shares on a stock exchange by way of a new listing application

Introduction

Backdoor listing usually refers to transactions and arrangements through which a private company goes public without undertaking the traditional route of listing its shares on a stock exchange by way of a new listing application.

While backdoor listing may be the result of a legitimate commercial transaction, for example a merger between a public company and a private company driven by their business synergy, it is commonly associated with companies with questionable suitability for listing because the process may be relied on to circumvent the requirements imposed on a new applicant by The Stock Exchange of Hong Kong Limited (the "**Exchange**").

A private company can effect a backdoor listing by merging with or acquiring an existing listed company. A backdoor listing may also be achieved through a large-scale issuance of securities by a listed company to a private company. This would dilute the shareholding of its existing shareholders of the listed company and allow the private company to gain control of the listed company and, thus, benefit from its access to the capital markets. Oftentimes, such transaction is driven by the value of the target's listing status as opposed to its underlying business. Such arrangements opened up the market for the creation and sale of "shell companies", i.e., companies without active business operations or significant assets which are listed for the purpose of being acquired by a private corporation.

Backdoor listing vs new listing

In the past, backdoor listing was considered an attractive alternative means for achieving a stock exchange listing because its process was generally shorter and cheaper than that of a new listing. Not only did it offer time and cost benefits, it also offered a higher probability of successful listing for certain companies. This was because the previous regulatory framework for backdoor listing was less established than that of a new listing and a company which obtains a listing status through backdoor listing would be subject to less scrutiny than one which does so via a new listing. From the market's perspective, however, this is the main drawback of backdoor listing.

The weak regulatory framework of backdoor listing means that private companies listing through backdoor listing may not meet the listing criteria as set out in the rules of the Exchange, which is designed to safeguard the quality of the companies listed on the Exchange. Allowing companies which are not suitable for listing to go public via backdoor listing undermines the integrity and reputation of stock markets and weakens investors' confidence. Further, backdoor listing may invite speculative trading and lead to opportunities for market misconducts such as insider trading and market manipulation.

The Exchange's stance on backdoor listing

Backdoor listing in Hong Kong is primarily governed by the reverse takeover rules (the "**Reverse Takeover Rules**") contained in Chapter 14 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "**MB Listing Rules**") and Chapter 19 of the Rules Governing the Listing of Securities on GEM (the "**GEM Listing Rules**"). Over the years, the Exchange had conducted a number of reviews of its rules and adopted practices with a view to improving the regulation of backdoor listings and shell activities. However, there had still been an increase in the number of market activities in relation to the trading and creation of shell companies in recent years. The growing prevalence of backdoor listing in Hong Kong has attracted considerable adverse publicity and regulatory attention and has led to the tightening of the Reverse Takeover Rules.

The Reverse Takeover Rules have been revised to further restrict undesirable backdoor listings and shell activities. The revised Reverse Takeover Rules came into effect on 1 October 2019, a summary of which is set out below.

Definition of "reverse takeover"

The Reverse Takeover Rules contain two types of tests for determining whether a transaction constitutes a reverse takeover: (i) the principle-based test and (ii) the bright-line tests.

(i) Principle-based test

Pursuant to Rule 14.06B, reverse takeover is defined as "an acquisition or a series of acquisitions of assets by a listed issuer which, in the opinion of the Exchange, constitutes, or is part of a transaction and/or arrangement or series of transactions and/or arrangements which constitute, an attempt to achieve a listing of the acquisition targets and a means to circumvent the requirements for new applicants set out in Chapter 8 of the MB Listing Rules".

Following this definition, multiple acquisitions can together constitute a reverse takeover. Rule 14.04(2A) has been added to clarify that "acquisition targets" cover both assets acquired and assets to be acquired, thereby making it clear that completed and proposed acquisitions can together constitute a reverse takeover. Whether such acquisitions constitute a reverse takeover is in the Exchange's discretion.

The six assessment factors which the Exchange considers when applying the principal-based tests, which were originally contained in Guidance Letter GL78-14, have been codified into the MB Listing Rules. These are:

1) The <u>size of the acquisition</u> relative to the size of the issuer.

An acquisition may be viewed as a means to achieve a listing of the target business if it is of such significant size that the issuer's existing principal business becomes immaterial after the acquisition. There is no threshold for determining whether a transaction is of "significant" size. The Exchange will consider the other assessment factors when making such determination.

2) Whether the acquisition results in a **fundamental change in the issuer's principal business**.

A transaction is also more likely to be considered a reverse takeover if the business of the acquisition target is completely different from and substantially larger than the issuer's existing business. However, given that the Reverse Takeover Rules are not intended to restrict legitimate business activities of issuers, transactions which are part of the issuer's strategy to, for example, expand or diversify its existing business will not be considered as a reverse takeover.

3) The **nature and scale of the issuer's business** before the acquisition.

The smaller the scale of the issuer's existing business, the more likely its existing business will become immaterial after an acquisition. Therefore, a significant acquisition made by an issuer whose existing business is small is more likely to be considered a reverse takeover.

4) The **quality of the acquisition targets**.

If the acquisition target does not meet the eligibility and suitability requirements imposed on new listing applicants, the transaction may be considered a means to circumvent the MB Listing Rules. This is particularly the case where the business of the acquisition target is completely different from the issuer's existing business.

5) Whether the acquisition results in a **change in control or de facto control** of the issuer.

In considering whether the transaction would result in a change in control or de facto control of the issuer, the Exchange will consider whether there would be (a) a change in the controlling shareholder of the issuer or (b) a change in the single largest substantial shareholder who is able to exercise effective control over the issuer.

Non-exhaustive indications of a change in the single largest substantial shareholder who is able to exercise effective control over the issuer include a substantial change to the issuer's board of directors and/or senior management. In assessing whether the transaction would result in such changes, the Exchange will consider changes made to both the personnel and the executive functions of the existing directors of the issuer.

This does not generally apply to render a transaction a reverse takeover if:

(a) the new substantial (and not controlling) shareholder is a passive investor in the issuer; or

(b) there are changes in the issuer's board of directors and/or senior management but not its controlling or single largest substantial shareholder.

Where the transaction involves an issuance of convertible securities of the issuer with conversion restrictions to avoid triggering a change in control under the Code on Takeovers and Mergers and Share Buy-backs to a vendor, the Exchange will consider whether such issuance is in substance a means to allow the vendor to effectively control the issuer.

6) Whether other transactions or arrangements, together with the acquisition or series of acquisitions in concern, form a **series of transactions or arrangements to list the acquisition targets**.

Transactions or arrangements taking place in reasonable proximity or are otherwise related may be considered as a collective attempt to list the acquisition targets. Such transactions or arrangements may include change in control or de facto control, acquisitions or disposals of businesses.

This assessment factor is generally considered alongside the other assessment factors such as the size of the transactions relative to that of the issuer and whether the transactions would lead to a fundamental change in the issuer's principal business.

Transactions which take place within a 36-month period are generally considered to be in reasonable proximity. However, where there is a clear nexus between two or more transactions and/or arrangements, they may still collectively constitute a reverse takeover even if their occurrence is over 36-months apart.

(ii) Bright line tests

Note 2 to Rule 14.06B sets out transactions which would generally be considered reverse takeovers. These are:

1) A <u>very substantial acquisition</u> which results in a <u>change in control</u> of the listed issuer.

A series of acquisitions may collectively constitute a very substantial transaction if they are all completed within a 12-month period or are otherwise related. Pursuant to Rule 14.23, factors which the Exchange considers when consider whether certain transactions should be aggregated include whether the transactions:

a) are entered into by the listed issuer with the same party or with parties connected or otherwise associated with one another;

b) involve the acquisition or disposal of securities or an interest in one particular company or group of companies;

c) involve the acquisition or disposal of parts of one asset; or

d) together lead to substantial involvement by the listed issuer in a business activity which did not previously form part of the listed issuer's principal business activities.

2) A **very substantial acquisition** from a person or a group of persons or any of his/their associates **within 36 months of such person(s) gaining control** of the listed issuer.

The Exchange has broadened the application of this test by increasing the time period between the very substantial acquisition and the change in control from 24 months to 36 months. The new test restricts disposals (or distributions in specie) of all or a material part of the issuer's business proposed or occurred at the time of or within 36 months after a change in control or de facto control of the issuer. This covers very substantial acquisitions from an issuer's controlling shareholder within 36 months from a change in control of the issuer.

Backdoor listing through large-scale issue of securities

Guidance Letter GL84-15 has been codified into Rule 14.06D to give the Exchange the power to refuse to grant listing approval for a large-scale issue of securities for cash to acquire and/or develop a new business if the Exchange considers the transaction a means to circumvent the new listing requirements and to achieve a listing of the new business. This is a purposive test and the Exchange will consider all relevant facts and circumstances of the issuer when considering whether a large-scale issue of securities constitute backdoor listing.

This anti-avoidance provision prevents circumvention of the listing requirements applicable to new listing applicants under the

MB Listing Rules through large-scale equity fundraisings. It is not intended to restrict genuine fundraising activities for legitimate business expansions or diversifications. Instead, it is designed to target large-scale issue of securities which results in a change in control or de facto control of the issuer and large-scale issue of securities, the proceeds of which are used to acquire and/or develop a new business that is substantially larger than the issuer's existing principal business.

Generally speaking, a large-scale issue of securities would not constitute backdoor listing if, taking into account the proceeds from the issue, less than half of the issuer's assets would consist of cash as a result of the fundraising. However, this is not a strict rule and the Exchange will consider all relevant factors in totality when determining whether a large-scale issue of securities constitute an attempt to circumvent the new listing requirements.

Restriction on material disposals

Pursuant to Rule 14.06E, a listed issuer must not carry out a material disposal or distribution in specie of, or a series of material disposals or distributions in specie of, its existing business at the time of, or within 36 months from, a change in control of the issuer unless the remaining business or the assets acquired by the issuer can meet the new listing track record requirements under Rule 8.05 (or Rule 8.05A or 8.05B). If these requirements cannot be met, the transaction will be treated as a new listing application.

The Exchange also has discretion to apply the above restriction to material disposals or distributions in specie of the listed issuer's business at the time of, or within 36 months from, a change of de facto control of the issuer if the Exchange considers that such transaction may form part of a series of arrangements to circumvent the new listing requirements.

Reverse takeovers vs extreme transactions

A transaction meeting either the principle-based test or the bright-line tests outlined above would constitute a reverse takeover. An issuer proposing a reverse takeover will be treated as if it were a new listing applicant.

However, where an acquisition or a series of acquisitions may, by reference to the assessment factors under the principle-based test, have the effect of achieving a listing of the acquisition targets but the issuer can demonstrate to the satisfaction of the Exchange that the transactions do not constitute an attempt to circumvent the new listing requirements, the transactions may be classified as an "extreme transaction" under Rule 14.06C. These transactions are allowed, albeit subject to additional requirements.

A transaction or a series of transactions may constitute an extreme transaction if:

(i) the issuer has been under the control or de facto control of a person or group of persons for a long period of generally not less than 36 months and the transaction would not result in a change in control or de facto control of the issuer; or

(ii) the issuer has been operating a principal business of a substantial size, which will continue after the transaction.

As a general guidance, this may include an issuer with annual revenue or total asset value of HK$1 billion or more based on the latest published financial statements. When assessing the size of the issuer, the Exchange will also consider its financial position, the nature and operation model of the business as well as its future business plans.

For such transaction to constitute an extreme transaction, the acquisition targets have to meet the suitability requirement under Rule 8.04 and the new listing track record requirements under Rule 8.05 (or Rule 8.05A or 8.05B) and the enlarged group has to meet all the new listing requirements set out in Chapter 8 of the MB Listing Rules except the new listing track record requirements under Rule 8.05.

Compliance requirements for extreme transactions

As mentioned above, the acquisition targets must meet both the suitability requirement and the new listing track record requirements and the enlarged group must meet all the new listing requirements other than the track record requirement. The issuer must provide sufficient information to the Exchange to demonstrate that these requirements are met. This may be in the form of a draft circular containing all material information.

Further, pursuant to Rule 14.53A, to undertake an extreme transaction, the issuer must (i) comply with the requirements for very substantial acquisitions set out in Rules 14.48 to 14.53 (including the requirement to obtain shareholders' approval in a general meeting) and (ii) appoint a financial adviser to perform due diligence on the acquisition targets and provide the declaration in the form set out in Appendix 29 to the MB Listing Rules.

The Exchange may rule that the transaction constitutes a reverse takeover if:

(i) an issuer fails to provide sufficient information to demonstrate that the requirements are met;

(ii) the financial adviser cannot provide the declaration;

(iii) additional information indicate that the acquisition target cannot meet the suitability requirement and the new listing track record requirements; or

(iv) where there are any other concerns about circumvention of the new listing requirements.

Requirements for reverse takeovers

Where an issuer proposes to undertake a reverse takeover, the issuer will be treated as if it were a new listing applicant. The additional requirements are as follows:

(i) the acquisition targets must meet the suitability requirement and the new listing track record requirements and the enlarged group must meet all the new listing requirements except the new listing track record requirements;

(ii) if the listed issuer fails 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 of its securities, the Exchange must be satisfied that there will be sufficient public interest in the business of the acquisition target and the enlarged group;

(iii) the listed issuer must comply with the notification and announcement requirements for all transactions set out in Rules 14.34 to 14.37; and

(iv) the shareholders must have approved the transaction in a general meeting.

If the Exchange is aware of information suggesting that the transaction is a means to avoid any new listing requirement, it may require the issuer to demonstrate that the acquisition targets meet all the new listing requirements set out in Chapter 8 of the MB Listing Rules.

Where the acquisition targets fail to meet the new listing track record requirement due to a change in their ownership and management solely as a result of the acquisition by the issuer, the Exchange may consider granting a waiver from strict compliance with the new listing track record requirements.

Requirements for reverse takeovers and extreme transactions that involve a series of transactions and/or arrangements

Where a reverse takeover or an extreme transaction involves a series of transactions and/or arrangements, the track record requirement must be met by the entire series of transactions. The issuer must provide sufficient information to the Exchange to demonstrate that the acquisition targets can meet the track record requirement. The track record period for a series of transactions shall be referenced to the latest proposed transaction and covers the three financial years immediately prior to the issue of circular for that transaction.

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