THE LAW SOCIETY OF HONG KONG 香港律師會

CONSULTATION PAPER ON BACKDOOR LISTING, CONTINUING LISTING CRITERIA AND OTHER RULE AMENDMENTS

The Law Society's Submissions

The Stock Exchange of Hong Kong Limited (the "Exchange") has issued a consultation paper on "Backdoor Listing, Continuing Listing Criteria and Other Rule Amendments" on 29 June 2018 ("Consultation Paper"). The Law Society makes the following submissions on the consultation questions posed.

Q1 *Do you agree with the proposal to codify the assessment criteria under the principle based test in a Note to the proposed Rule 14.06B? If not, why?*

Law Society's response:

Agree.

We support tightening up back door listings. However, we emphasise that the proposed Listing Rules must not be applied to hinder or significantly increase the costs of legitimate business activities. We note that the Exchange has made various statements in the Consultation Paper to the same effect. Our concern is to ensure that this emphasis on not hindering legitimate business will not be overlooked by over-zealous application of the letter of the Rules by the frontline of the Exchange.

Q2 *Do you agree with the proposal to extend the current criterion "issue of restricted convertible securities" in the principle based test to include any change in control or de facto control of issuers? If not, why?*

Law Society's response:

Agree.

Note 1 to Rule 14.06D - the Rule should also apply to a large scale issue of

restricted convertible securities.

Re Note 2 of Rule 14.06D, the test should not be how much cash the issuer has immediately after the issue, but whether the issuer can show that the cash has been raised for a genuine and legitimate committed purpose (for example, the cash will be applied to pay for an asset or discharge a liability under a binding agreement that would not otherwise trigger RTO considerations).

Q3 *(a) As regards the "series of arrangements" criterion, do you agree with the proposal to include transactions and arrangements that take place in reasonable proximity or are otherwise related and normally within a three-year period? If not, why?*

Law Society's response:

In principle, yes but see comments below.

The "series of arrangements" test is a factor to consider under the principle based test. The principle based test applies to situations where the transactions have been conducted "to circumvent the requirements of new applicants" under the Listing Rules.

Back door listing concerns arise only where the transactions constitute a circumvention. The "series of arrangements" test is not to be taken as operating in isolation to trigger a back door listing. The examples in Appendix II however suggest that the test may be applied to trigger a back door listing even though there may be no circumvention.

By way of illustration, Example 4 in Appendix II basically suggests that disposal of the original business of an issuer per se will trigger reverse takeover ("RTO") considerations. This is not correct because the original business of the issuer may over time deteriorate and the business may be disposed due to its limited prospects. As long as this is not preordained (e.g. the disposal is made because the original business cannot be profitably continued due to a change in circumstances, such as environmental concerns over coal-fired plants due to pollution regulations, a trade war, the losing of patent rights, or the development of new technology), such disposal should not trigger new listing considerations.

(b) Do you agree with the proposal to amend the RTO Rule 14.06B to clarify that a series of acquisitions may include proposed and/or completed acquisitions? If not, why?

Law Society's response:

Agree.

Q4 *(a) Do you agree with the proposal to retain the bright line tests under Rules 14.06(6)(a) and (b) in a Note to the proposed Rule 14.06B? If not, why?*

Law Society's response:

Agree.

(b) Do you agree with the proposal to extend the aggregation period from 24 months to 36 months under the bright line test currently set out in Rule 14.06(6)(b)? If not, why?

Law Society's response:

Agree.

Q5 *(a) Do you agree with the proposed changes to Rule 14.92 (proposed Rule 14.06E) as described in paragraph 56? If not, why?*

Law Society's response:

Agree.

(b) Do you agree with the proposal to add a Note to proposed Rule 14.06E as described in paragraph 59? If not, why?

Law Society's response:

Agree.

Q6 *(a) Do you agree with the proposal to add a new Rule 14.06C for "extreme transactions" as described in paragraph 62? If not, why?*

Law Society's response:

Whilst we support the codification of GL78-14, the new "extreme

transaction" qualification requirement that an issuer must have "*been operating a principal business of a substantial size (e.g. annual revenue or total asset value of HK$1 billion or more), which will continue after the transaction*" (the **new pre-condition**) seems unnecessarily restrictive.

A transaction is potentially an "extreme transaction" where it is considered an "extreme" case by reference to the RTO assessment criteria (codified in Rule 14.06B) including, *inter alia*, (a) the scale of the issuer's business before the acquisition and (b) change in issuer's principal business. It is unnecessary or overly restrictive to impose additional requirements for issuers to have an annual revenue or total asset of HKD1 billion before it can put forward a substantial acquisition.

On the other hand, a critical difference between a RTO and an extreme transaction is that a transaction can only qualify as an "extreme transaction" where "***the issuer can demonstrate to the satisfaction of the Exchange that it is not an attempt to circumvent the requirements for new applications set out in Chapter 8***". This, together with the Rule 14.06C(2) requirement that the acquisition targets must meet the criteria in Rule 8.04 and Rule 8.05, should already empower the Exchange to ensure that a transaction will only qualify as an "extreme transaction" where circumvention of the new listing requirements is not of major concern (as opposed to the case of a RTO).

For issuers that have already established this critical difference, denying them the opportunity to have their proposed transaction considered by the Listing Committee just because their principal business is not considered to be "*substantial*" enough would be overly restrictive and may place undue restrictions on their legitimate business activities.

If the intention is to discourage acquisition of "listed shells", the concern would be better addressed through a robust enforcement of Rule 13.24 (and the enhanced delisting regime), rather than imposition of a "substantial size" pre-condition in 14.06C, which may not always be an accurate indicator of "shell" characteristics (e.g. failure to meet the HK$1 billion annual revenue threshold can be due to various valid reasons, rather than the issuer being a "listed shell"). In any event, the proposed Rule 14.54(2) (which requires Rule 13.24 issuers proposing a RTO to demonstrate that both the acquisition targets and enlarged group would meet all the new listing requirements) should already be a powerful tool for discouraging backdoor listings through "listed shells".

If, however, the Exchange decides that the size of the turnover should be stipulated, it should be done on the basis of a note to Rule 14.06C. It should also be stated flexibly so that if the revenue falls below the threshold amount, that will be a factor to be taken into account.

(b) Do you agree with the disclosure requirements for circulars of extreme transactions set out in proposed Rules 14.53A(1) and 14.69? If not, why?

Law Society's response:

Agree.

(c) Do you agree with the due diligence requirements for extreme transactions under proposed Rule 14.53A(2)? If not, why?

Law Society's response:

Agree.

Q7 *(a) Do you agree with the proposal to amend Rule 14.54 and to add Rule 14.06C(2) as described in paragraph 69(i)? If not, why?*

Law Society's response:

Agree, but as RTO / extreme transaction can apply on account of a series of transactions (proposed or completed), rather than requiring each acquisition target (see Note to Rule 14.54(1), and Rule 14.54(2) and 14.06C(2)) to meet the new listing requirements, it should be the acquisition targets as a whole. In particular, we believe that it should be logical for the combined track record of all acquisition targets in the series to be looked into when determining if the acquisitions targets can meet Rule 8.05, as opposed to just the proposed acquisition.

(b) Do you agree with the proposal to amend Rule 14.54 to impose additional requirements on RTOs proposed by Rule 13.24 issuers as described in paragraph 69(ii)? If not, why?

Law Society's response:

See our answer to Q7(a) above.

Q8 *(a) Do you agree with the proposed Rule 14.57A to clarify the track record requirements for extreme transactions and RTOs that involve a series*

of transactions and/or arrangements? If not, why?

Law Society's response:

Agree, but paragraph 76 of the Consultation Paper makes it clear that the track record period may date back from a disposal transaction, as a series of transactions (both acquisitions and disposals) may be involved.

Rule 14.57A however only refers to "acquisitions" and it should be changed to refer also to disposals (if that be the latest transaction triggering the RTO).

(b) Do you agree with the proposed Rule 4.30 that sets out the requirements for preparing pro forma income statement of all the acquisition targets in the entire series of acquisitions (where applicable, would include any new business developed by the issuer that forms part of the series) for the track record period? If not, why?

Law Society's response:

Agree.

Q9 Do you agree with the proposal to add a new Rule 14.06D to codify, with modification, the practice under Guidance Letter GL84-15 as described in paragraph 81? If not, why?

Law Society's response:

Agree, but see our answer to Q2 above.

Q10 Do you agree with the proposal to require issuers to have a business with a sufficient level of operations and assets of sufficient value to support its operations to warrant the continued listing of the issuer's securities? If not, why?

Law Society's response:

Agree.

Q11 Do you agree with (a) the proposal to add a Note to the proposed Rule 13.24(1) as described in paragraphs 107 to 109; and (b) the proposal to remove the Note to Rule 13.24 as described in paragraph 112? If not, why?

Law Society's response:

Agree.

Q12 *Do you agree with the proposal to exclude an issuer's securities trading and/or investment activities (other than a Chapter 21 company) when considering the sufficiency of the issuer's operations and assets under Rule 13.24? If not, why?*

Law Society's response:

Agree. Note 29 to the Consultation Paper (about players in the financial industry) should be set out in the Note to Rule 13.24.

Q13 *Do you agree with the proposal to extend the definition of short-dated securities in the cash company Rules to cover investments that are easily convertible into cash ("short-term investments")? If not, why?*

Law Society's response:

Agree. This will close a loophole. However, the Exchange would have to expect and deal with submissions regarding the application of this Rule flexibly. For example, the exclusion of "advances to third parties" is quite wide and the exclusion of trade receivables is not enough. Third party debt can arise in all sorts of circumstances, including hedging and other transactions (and such debts cannot be described as trade receivables).

Q14 *Do you agree with the proposal that the exemption under Rule 14.83 shall only be confined to clients' assets relating to the issuer's securities brokerage business? If not, why?*

Law Society's response:

Agree.

Q15 *Do you agree with the proposal to confine the revenue exemption to purchases and sales of securities only if they are conducted by banking companies, insurance companies and securities houses within the listed issuers' group? If not, why?*

Law Society's response:

We agree with the principle but there must be clear guidance given regarding how the Exchange will aggregate transactions. Different securities may be bought and sold over a period of time with different parties on-market and will such transactions be aggregated?

Q16 *Do you agree with the proposal to require issuers to disclose in their annual reports details of each securities investment that represents 5% or more of their total assets (as described in paragraph 134 above)? If not, why?*

Law Society's response:

Disagree. If it is intended to give investors useful information, it should be a qualitative discussion in the "Management Discussion and Analysis" section about asset/investment performance including the top 5 contributors during the financial year, rather than taking only a snap shot at the end of the year based only on total assets.

Q17 *Do you agree with the proposal to codify the requirements set out in Listing Decision LD75-4 (as described in paragraph 137 above) for significant distribution in specie of unlisted assets into the Rules? If not, why?*

Law Society's response:

Agree.

Q18 *Do you agree with the proposal to require disclosure on any subsequent change and the outcome of any financial performance guarantee of a target acquired by the issuer in a notifiable or connected transaction as set out in paragraph 140? If not, why?*

Law Society's response:

Disagree.

If we follow this logic, it should apply to any transaction, for example, price adjustments after closing, disputes and legal actions after closing of an acquisition involving independent third parties. Rather, we think the positon should be governed by the general obligation to disclose enough information as will appraise investors and the market about the position of the company.

Q19 *(a) Do you agree with the proposal to require disclosure on the identity of the parties to a transaction in the announcements and circulars of notifiable transactions? If not, why?*

Law Society's response:

No comment.

(b) Do you agree with the proposal to require the 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 not, why?

Law Society's response:

Agree.

Q20 *Do you agree with the proposal that if any calculation of the percentage ratios produces an anomalous result or is inappropriate to the sphere of activities of the issuer, the Exchange (or the issuer) may apply an alternative size test that it considers appropriate to assess the materiality of a transaction under Chapter 14 or 14A? If not, why?*

Law Society's response:

Agree.

The Law Society of Hong Kong
22 August 2018