HKEX LISTING DECISION
HKEX-LD109-2017 (published in June 2017) (updated in October 2019 (amendments to the reverse takeover Rules))

Parties	Company A – a Main Board issuer Mr. X and Mr. Y – directors of Company A
Issue	Whether Company A would be required to aggregate the proposed acquisition with a previous acquisition, and whether these acquisitions would constitute a reverse takeover
Listing Rules	Main Board Rule ~~14.06(6)~~14.06B
Decision	The acquisitions were aggregated and they constituted an extreme VSA

FACTS[1]

1. Company A was principally engaged in the manufacturing and sale of certain food products for many years.

2. About two years ago, Mr. X ceased to be the controlling shareholder of Company A but remained as a director of Company A. A few months ago, Mr. Y acquired about 20% interest in Company A and was appointed as a director of Company A. It was disclosed that Mr. Y had experience in the internet gaming industry.

Previous acquisition

3. About 20 months ago, Company A announced a major transaction to acquire a company engaging in video gaming business (**First Target**) from independent third parties for cash consideration (**First Acquisition**). The First Acquisition had been completed.

Proposed transactions

4. Company A proposed the following transactions:

   - Acquisition of another company engaging in video gaming business (**Proposed Target**) from independent third parties for cash consideration (**Proposed Acquisition**). Based on its size tests, the Proposed Acquisition would, on its own, constitute a major transaction.

[1] Time reference is the time to date of the decision.

- Disposal of its food business (**Proposed Disposal**) to Mr. X. The Proposed Disposal would constitute a very substantial disposal.

5. There was an issue whether the Proposed Acquisition, together with the First Acquisition and the Proposed Disposal, formed a series of transactions to achieve a listing of the acquisition targets and constituted a reverse takeover under Rule 14.06(6).

6. Company A was of the view that the reverse takeover Rule should not apply. It submitted that:

   - The Proposed Acquisition and the First Acquisition should not be aggregated as they were separate transactions involving different counterparties. The targets had distinct businesses operated in different countries. They were owned and managed by different parties before the acquisitions.

   - Video gaming business had been one of the principal activities of Company A after the completion of the First Acquisition a year ago. The Proposed Acquisition was an expansion of the company's video gaming business. The Proposed Disposal would enable the company to divest its loss-making food business and re-allocate its resources to the video gaming business.

   - The First Target was able to meet the minimum profit requirement under Rule 8.05(1)(a). Its results, when combined with those of the Proposed Target, would still exceed the profit requirement.

APPLICABLE LISTING RULES

7. Rule 14.06(6) defines a "reverse takeover" 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 or arrangement or series of transactions or arrangements which constitute, an attempt to achieve a listing of the assets to be acquired and a means to circumvent the requirements for new applicants set out in Chapter 8 of the Exchange Listing Rules*…". This is a principle based test.

8. Rule 14.54 states that *"The Exchange will treat a listed issuer proposing a reverse takeover as if it were a new listing applicant. The enlarged group or the assets to be acquired must be able to meet the requirements of rule 8.05 and the enlarged group must be able to meet all the other basic conditions set out in Chapter 8 of the Exchange Listing Rules. …"*

9. The Exchange Guidance Letter (HKEX-GL78-14) on reverse takeovers (**RTO**) explains that Rule 14.06(6) is an anti-avoidance provision designed to prevent circumvention of the new listing requirements. Paragraphs 7 to 9 of the guidance letter states that:-

"7. If a transaction falls outside the bright line tests, the Exchange will apply the principle based test to assess whether the acquisition constitutes an attempt to achieve a listing of the assets to be acquired and a means to circumvent the requirements for new listing. The transaction would be treated as a RTO under the principle based test if the Exchange considers it is an 'extreme' case taking into account the following criteria:

- *the size of transaction relative to the size of the issuer;*
- *the quality of the business to be acquired—whether it can meet the trading record requirements for listings, or whether it is unsuitable for listing (e.g. an early stage exploration company);*
- *the nature and scale of the issuer's business before the acquisition (e.g. whether it is a listed shell);*
- *any fundamental change in the issuer's principal business (e.g. the existing business would be discontinued or very immaterial to the enlarged group's operations after the acquisition);*
- *other events and transactions (historical, proposed or intended) which, together with the acquisition, form a series of arrangements to circumvent the RTO Rules (e.g. a disposal of the issuer's original business simultaneously with a very substantial acquisition); and*
- *any issue of Restricted Convertible Securities[2] to the vendor which would provide it with de facto control of the issuer.*

8. A transaction would be treated as an extreme very substantial acquisition (extreme VSA) where the Exchange considers it "extreme" by reference to the criteria set out in paragraph 7, but the assets to be acquired can meet the minimum profit requirement under Rule 8.05 (the positive cash flow requirement under GEM Rule 11.12A) and circumvention of new listing requirements would not be a material concern. Extreme VSAs are presented to the Listing Committee for its decision.

[2] **Restricted Convertible Securities** are highly dilutive convertible securities with a conversion restriction mechanism (e.g. restriction from conversion that would cause the securities holder to hold 30% interest or higher) to avoid triggering a change of control under the Code on Takeovers and Mergers.

9. *Where the Committee resolves that the RTO Rules will apply, the issuer will be treated as if it were a new listing applicant and will be subject to all applicable listing requirements for new applicants (see paragraph 4). Where the Committee resolves that the RTO Rules will not apply to an extreme VSA, the issuer will be required to prepare a transaction circular under an enhanced disclosure and vetting approach, and to appoint a financial adviser to conduct due diligence on the acquisition. …"*

(The reverse takeover Rules were amended on 1 October 2019. See Note 1 below.)

ANALYSIS

10. In this case, the Exchange applied the principle based test to assess whether the acquisitions would constitute a RTO under Rule 14.06(6). When applying the principle based test, the Exchange would consider the criteria set out in Guidance Letter GL78-14 to assess whether, taking the criteria together, an acquisition or a series of acquisitions would constitute an attempt to achieve a listing of the assets acquired and to be acquired and a means to circumvent the Exchange's new listing requirements.

11. When making the assessment, the Exchange had considered the following:

    a. As set out in Rule 14.06(6), the principle based test may apply to a series of acquisitions that constitutes an attempt to achieve a listing of the acquisition targets. The Rule does not prescribe a fixed time period for aggregating a series of acquisitions for the purpose of the principle based test. The assessment of a series of acquisitions is made based on the circumstances of individual cases.

       In this case, Company A entered into the Proposed Acquisition just over 12 months after the completion of the First Acquisition, and the acquisition targets were both engaged in video gaming business. The Exchange considered that the First Acquisition and the Proposed Acquisition (together the **Acquisitions**) constituted a series of acquisitions and should be aggregated for the purpose of the RTO Rule because they were made within a short period, and together would lead to a substantial involvement by Company A in a new video gaming business which was completely different form its principal business in the manufacturing and sale of food products.

    b. Company A would cease to operate its existing food business after the Proposed Disposal. The Acquisitions together with the Proposed

Disposal would effect a complete change of Company A's principal business. They formed a series of transactions to list the video gaming businesses of the targets.

12. Given the above, the Acquisitions were an extreme case by reference to the criteria set out in the RTO guidance letter. Nevertheless, Company A had provided information and the latest three year financial results relating to the acquisition targets to demonstrate that the acquisition targets could meet the profit requirement under Rule 8.05 and there was no material concern about circumvention of new listing requirements. The Exchange considered that the Acquisitions could fall into the situation of an extreme VSA under the RTO guidance letter.

CONCLUSION

13. The Exchange decided to require aggregation of the Acquisitions and treat them as an extreme VSA. Accordingly, the due diligence and enhanced disclosure requirements for extreme VSAs as set out in the RTO guidance letter applied to the Acquisitions.

Notes

1 The reverse takeover Rules were amended with effect from 1 October 2019.

- *Under the new Rule 14.06B (which incorporates former Rule 14.06(6) with certain modifications):*

  - *A "reverse takeover" is defined as an acquisition or series of acquisitions 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 constitutes, an attempt to achieve a listing of the acquisition targets and a means to circumvent the requirements for new applicants as set out in Chapter 8 of the Listing Rules.*

  - *Note 1 to Rule 14.06B sets out the factors that the Exchange will normally consider in assessing whether the acquisition or series of acquisitions is a reverse takeover, including:*
    a) the size of the acquisition or series of acquisitions relative to the size of the issuer;
    b) a fundamental change in the issuer's principal business;
    c) the nature and scale of the issuer's business before the acquisition or series of acquisitions;
    d) the quality of the acquisition targets;

e) a change in control (as defined in the Takeovers Code) or de facto control of the listed issuer (other than at the level of the subsidiaries); and/or

f) 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.

As set out in Note 1(f) to Rule 14.06B, the Exchange may regard acquisitions and other transactions or arrangements as a series if they take place in a reasonable proximity to each other (which normally refers to a period of 36 months or less) or are otherwise related.

- *Note 2 to Rule 14.06B contains two specific forms of reverse takeovers involving a change in control (as defined in the Takeovers Code) of the listed issuer (other than at the level of the subsidiaries) and an acquisition or a series of acquisitions of assets from the new controlling shareholder and/or its associates at the time of, or within 36 months from, the change in control.*

- *Rule 14.54 (as amended) requires that in the case of a reverse takeover, the acquisition targets must meet the requirements of Rule 8.04 and Rule 8.05 (or Rule 8.05A or 8.05B), and the enlarged group must meet all the new listing requirements in Chapter 8 of the Rules (except Rule 8.05). Where the reverse takeover is proposed by an issuer that does not meet Rule 13.24, the acquisition targets must also meet the requirement of Rule 8.07.*

- *The Exchange also added a new Rule 14.06C to (i) codify the "extreme VSAs" requirements in Guidance Letter GL78-14 and rename this category of transactions as "extreme transactions"; and (ii) impose additional eligibility criteria on the issuer that may use this transaction category.*

  Under Rule 14.06C, an "extreme transaction" is defined as an acquisition or a series of acquisitions of assets by a listed issuer, which individually or together with other transactions or arrangements, may, by reference to the factors set out in Note 1 to Rule 14.06B, have the effect of achieving a listing of the acquisition targets, but where the issuer can demonstrate to the satisfaction of the Exchange that it is not an attempt to circumvent the requirements for new applicants set out in Chapter 8 of the Listing Rules and that:

  (1) (a) the issuer must have been under the control or de facto control of the same person(s) for a long period (normally not less than 36 months) and the transaction will not result in a change in control or de facto control of the issuer; or (b) the issuer must operate a

principal business of substantial size, which will continue after the transaction; and

(2) the acquisition targets meet the requirements of Rule 8.04 and Rule 8.05 (or Rule 8.05A or 8.05B) and the enlarged group meets all the new listing requirements set out in Chapter 8 of the Listing Rules (except Rule 8.05).

2 In this case, the Rule amendments would not change the analysis, except the assessment of whether the Acquisitions would qualify as an extreme transaction.

Under Rule 14.06C, an issuer proposing to use the extreme transaction category must satisfy one of the additional eligibility criteria set out in Rule 14.06C(1). However, the facts of this case indicated that there was a change in de facto control of Company A within the last 36 months and Company A would cease to operate its existing food business after the transactions. Should the amended Rules apply, Company A would not meet the additional eligibility criteria under Rule 14.06C(1). Accordingly, the Acquisitions would be classified as a reverse takeover (and not an extreme transaction).