

HKEX GUIDANCE LETTER
HKEX-GL105-19 (October 2019)

Subject	Guidance on Large Scale Issues of Securities
Listing Rules	Main Board Rule 14.06D GEM Rule 19.06D

Important note: *This letter does not override the Listing Rules and is not a substitute for advice from qualified professional advisers. If there is any conflict or inconsistency between this letter and the Listing Rules, the Listing Rules prevail. You may consult the Listing Department on a confidential basis for an interpretation of the Listing Rules, or this letter.*

I. Background and Purpose

1. This letter provides guidance on the application of Rule 14.06D to large scale issues of securities by listed issuers.
2. In recent years the prevalence of backdoor listings has resulted in a substantial increase in the value of listing status, leading to extensive activities related to investors acquiring control of listed issuers for their listing platforms (rather than the underlying businesses) for backdoor listing. In particular, there were some issuers proposing large scale issues of securities to new investors with an intention to use the injected funds to start new businesses unrelated to the issuers' original businesses. The investors would be in effect listing, through the listed issuers, new businesses that would not have otherwise met the new listing requirements. In December 2015, the Exchange issued Guidance Letter GL84-15 on the application of the cash company Rules¹ to restrict these large scale issues of securities.
3. As part of the recent Rule amendments (effective on 1 October 2019) to address backdoor listings and shell activities, the Exchange codified the practices set out in Guidance Letter GL84-15 into Rule 14.06D. This guidance letter supersedes GL84-15.
4. All Rule references in this letter are to the Main Board Listing Rules. As GEM Rule 19.06D is the same as Main Board Rule 14.06D, the guidance set out in this letter also applies to GEM issuers.

¹ Rules 14.82 to 14.84

II. Relevant Rule

5. Rule 14.06D state that:

“Where a listed issuer proposes a large scale issue of new securities (including any shares, warrants, options or convertible securities) for cash to acquire and/or develop a new business, which, in the opinion of the Exchange, is a means to circumvent the new listing requirements and to achieve a listing of that new business, the Exchange may refuse to grant listing approval for the shares to be issued.

Note: This rule is an anti-avoidance provision to prevent circumvention of the new listing requirements. It 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 (by reference to the factor set out in Note 1(e) to rule 14.06B), and the proceeds are to be used to acquire and/or develop a new business that is expected to be substantially larger than the 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.”

III. Guidance

6. Rule 14.06D is an anti-avoidance provision designed to prevent circumvention of new listing requirements through large scale equity fundraisings. When applying this Rule, the Exchange’s approach is targeted towards large scale equity fundraisings that are made to facilitate investors in acquiring controls of the issuers for listing of new businesses that would not have otherwise met the new listing requirements.

Application of Rule 14.06D

7. Rule 14.06D is a purposive test and is assessed based on all relevant facts and circumstances of the issuer. This assessment is not simply based on the size of the equity fundraising proposed by the issuer, but also other factors including the nature and scale of the issuer’s business and its financial position before the fundraising, its business plans and the intended use of proceeds, and whether there is, or will be, any change in control or de facto control of the issuer².

² In making the assessment, the Exchange will consider whether there is any change in the controlling shareholder of the issuer, or any change in the single largest substantial shareholder who is able to exercise effective control over the issuer as indicated by factors such as a substantial change in its board and/or senior management. Where the case involves an issue of restricted convertible securities to the investor, the Exchange will consider whether in substance, the issue serves to allow the investor to effectively “control” the issuer. Please refer to Note 1(e) to Rule 14.06B and paragraphs 19 to 25 of Guidance Letter GL104-19 for details.

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8. In general, an equity fundraising with the following characteristics would normally be caught under Rule 14.06D:
- (a) The size of the fundraising would be very significant to the issuer and would bear little or no correlation with the needs of the issuer's existing principal business.
 - (b) Funds raised would be used largely in developing and/or acquiring a new business with little or no relation to the issuer's existing principal business. This would include circumstances where the issuer has started the new business shortly before the proposed fundraising (e.g. obtained a money lending license or acquired a small size money lending company).
 - (c) Employing the cash obtained from the fundraising, the issuer would proceed to operate the new business which is expected to be substantially larger than the original business.
 - (d) The investor would obtain control or de facto control of the issuer through the subscription of securities in the issuer. The effect is that the investor would obtain a listing platform for listing the new business. This is a circumvention of the new listing requirements as the lack of a track record would render such business unsuitable for listing.

Two examples are set out in Part IV below.

Other points to note

9. Rule 14.06D is not intended to restrict fundraising activities of issuers for legitimate business expansions or diversifications. As general guidance, the Rule will not normally apply to an issue of securities if, taking into account the proceeds from the issue³, less than half of the issuer's assets would consist of cash as a result of the fundraising. Nevertheless, if the Exchange considers that any fundraising, acquisition or other corporate action of the issuer in the future together with the current fundraising are a means to list a new business that is not suitable for listing or otherwise circumvent the new listing requirements, the Exchange may exercise its discretion under Rule 2.04 to impose additional requirements or conditions on such future arrangement(s).
10. Further, the Exchange acknowledges that issuers engaging in asset-light businesses (for example, technology companies in the new economy sector) may have a cash to asset ratio exceeding 50% after fundraising activities. As set out in paragraph 7 above, the Exchange will consider all factors in totality when determining whether an issuer's proposed equity fundraisings is an attempt to circumvent the new listing requirements. The assessment is not simply an analysis of the cash to asset ratio of the issuer.

³ These include any proceeds that are intended to be used for specific purposes (whether by way of legally binding agreements or other commitments)

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11. For the avoidance of doubt, the Exchange may apply the RTO Rule 14.06B when issuers use the funds raised for acquisitions of new businesses. This may be the case where an equity fundraising was not caught under Rule 14.06D (e.g. there was no change in control or de facto control of the issuer as a result of the fundraising) but the subsequent acquisition using the funds raised constitutes an attempt to circumvent the new listing requirements under the principle based test of Rule 14.06B.

Consultation with the Exchange

12. Listed issuers who intend to undertake large scale equity fundraisings are encouraged to contact the Exchange at the earliest possible opportunity to seek guidance on the application of Rule 14.06D in individual cases.

IV. Examples

13. In each of the following two examples, the Exchange considers that Rule 14.06D would apply to the proposed issue of securities.

Example 1

14. Company A is principally engaged in the garment business. It recorded revenue of about HK\$60 million and a net loss of about HK\$20 million in the latest financial year, and its total assets value was about HK\$100 million.
15. *The proposed subscriptions:* Company A signed subscription agreements to raise a total of HK\$400 million by issuing restricted convertible bonds⁴ to subscribers:
 - Upon completion, over 85% of the company's assets would consist of cash. The proceeds from the subscriptions would be mostly used to develop a new mobile game business.
 - Assuming full conversion of the bonds, the conversion shares would represent about 4 times of the company's existing issued shares, and the major subscriber would hold more than 60% of the company's shares as enlarged by the conversion shares.

The major subscriber is an entrepreneur.

⁴ Convertible bonds with a restriction from conversion to avoid triggering a change in control under the Code on Takeovers and Mergers.

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16. Immediately after signing the subscription agreements, Company A completed an acquisition of a newly set up company engaged in distributing and marketing mobile games. Taking this into account, Company A's cash would represent 65% of its total assets upon completion of the subscriptions.
17. *The Exchange's analysis:* The Exchange considers that Rule 14.06D would apply to the proposed subscriptions for the following reasons:
 - (a) Under the proposal, the subscription amount is significant to the company and the cash level would be 65% of the company's total assets upon completion. The company's assets would comprise substantially of cash.
 - (b) The subscriptions would be a means to list a new business which is unsuitable for listing:
 - The company has been engaging in the garment business since listing. It acquired a company engaged in the mobile game business only after it signed the subscription agreements.
 - The subscription amount is significant to the company. It has no correlation, and is completely disproportionate, to the company's existing garment business. The proceeds would be used to develop and operate a new mobile game business that would be significant relative to the existing business after the subscription.
 - The company would in effect be a listed vehicle for the subscriber (who would acquire a de facto control of the company using the restricted convertible bonds) to develop and operate a new mobile game business which has no track record and does not meet the new listing requirements.

Example 2

18. Company B is principally engaged in the business of manufacturing toys. It recorded revenue of about HK\$200 million and a loss of HK\$38 million in the latest financial year, and its total assets value was about HK\$500 million.
19. Two months earlier, Company B obtained a money lender licence in Hong Kong and commenced a money lending business.
20. *The proposed subscriptions:* Company B signed subscription agreements to raise HK\$1 billion by issuing shares to subscribers:
 - Upon completion, about 75% of its total assets would consist of cash. The proceeds from the subscriptions would be mostly used to develop the money lending business. In particular, Company B signed loan agreements to provide financial assistance of a total amount of HK\$900 million to several independent third parties. These agreements were subject to completion of the subscriptions.

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- The subscribers would hold about 55% of Company B's shares as enlarged by the new shares.

The major subscriber is a money lending company.

21. *The Exchange's analysis:* The Exchange considers that Rule 14.06D would apply to the proposed subscriptions for the following reasons:

- (a) The subscription amount is significant to the company and the cash level would be 75% of the company's total assets upon completion. Company B's assets would comprise substantially of cash.
- (b) The subscriptions would be a means to list a new business which is unsuitable for listing:
 - Company B has been engaging in manufacturing toys. The money lending business commenced shortly before the subscriptions were agreed and is a new business of Company B.
 - The subscription amount is significant to Company B. It has no correlation, and is completely disproportionate, to Company B's original toy business. The proceeds would be used to develop and operate the money lending business that would be significant relative to the existing business after the subscription.
 - Company B would in effect be a listed vehicle for the subscribers (who would become controlling shareholders of Company B) to develop and operate the new money lending business that has no track record and does not meet the new listing requirements.

22. Whilst Company B has signed legally binding agreements (i.e. the loan agreements) to ensure that a substantial part of the subscription proceeds would be used shortly after completion of the subscriptions, this does not address the concern about backdoor listing of a new business to circumvention of new listing requirements. These proceeds would be counted for the purpose of calculating the cash to assets ratio of the issuer under Rule 14.06D.