Hong Kong Institute of
Certified Public Accountants
香港會計師公會

By email (response@hkex.com.hk) and by hand

31 August 2018

Our Ref.: [redacted]

Hong Kong Exchanges and Clearing Limited
10th Floor, One International Finance Centre
1 Harbour View Street, Central
Hong Kong

Dear Sirs,

Re: Consultation Paper on Backdoor Listing, Continuing Listing Criteria and other Rule Amendments

Please find attached a submission from the Hong Kong Institute of Certified Public Accountants on the above consultation paper.

Broadly speaking, we agree with need to ensure that issuers do not seek to circumvent the normal requirements for new listings by exploiting gaps in the listing rules to achieve a listing of assets "through the backdoor", or by means a "reverse takeover". In this regard, we support the aims of many of the proposed changes. However, we are also concerned that the rules should not be tightened in such a way as to restrict genuine commercial and business development activities, especially given that, with shorter business cycles, it may be more often the case, in future, that business owners have sound reasons to discontinue running an existing business line and to move progressively into new line of business for the benefit of all shareholders.

As regards some specific issues, in the context of the codification of "extreme transactions", the proposals arguably discriminate against the expansion by merger and acquisition of smaller "growth" and "new economy" companies, which may not have a principal business with an annual revenue or total asset value of at least HK$1 billion.

We have reservations whether transactions should be defined to include proposed transactions, particularly where, for example, a financially-distressed issuer is undergoing a provisional liquidation and the provisional liquidator may be looking for an investor who could potentially save the business, jobs and, possibly also, obtain a better return for minority shareholders.

We consider that further explanations, clarifications and/or definitions need to be provided in relation to terms such as "de facto control", "material disposal" and "securities brokerage business", and how these concepts will be applied.

Therefore, we support the objective of tackling shell activities to maintain the reputation of the Hong Kong market and quality of listed companies, and we go along with many of the detailed proposals. At the same time, as our responses to the relevant questions in the attached questionnaire indicate, there is room for greater clarity in certain areas and more flexibility in others.

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Should you have any questions on this submission, please feel free to contact me at the Institute.

Yours faithfully,

Peter Tisman
Director, Advocacy & Practice Development

PMT/NCL/pk

Encl.

Part B Consultation Questions

Please indicate your preference by checking the appropriate boxes. Please reply to the questions below that are raised in the Consultation Paper downloadable from the HKEX website at:
http://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/June-2018-Backdoor-and-Continuing-Listing/Consultation-Paper/cp201806.pdf

Where there is insufficient space provided for your comments, please attach additional pages.

1. 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?

   ☑ Yes

   ☐ No

   If your answer is "No", please give reasons for your views.

   Yes, in principle, subject to our comments in response to questions 2 and 3 below.

   Generally, we agree with the proposal, as codifying the assessment criteria will give more clarity to financial advisers as to the circumstances in which HKEX will consider an acquisition, or a series of acquisitions, by a listed issuer to be a reverse takeover.

2. 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?

   ☐ Yes

   ☐ No

   If your answer is "No", please give reasons for your views.

We note that there is no clear definition of "de facto control", and, therefore, extending the criterion to include this concept may entail the exercise of a substantial degree of discretion and judgement by HKEX. In addition, the concept could be confusing to a market more familiar with the broader concept of "control" or "controlling shareholder", under other areas of the listing rules. It is suggested, therefore, that a clearer definition of "de facto control", or explanation of how the concept will be determined and applied, needs to be provided; otherwise it should be its inclusion should be reconsidered.

Among the specific uncertainties raised by the proposal is the question of whether it is it sufficient for any one of the indicative factors (listed below) to be present, in order for HKEX to decide that there has been a change in de facto control, or is the presence or two, or all three, indicative factors required? Could other factors also be introduced into the mix and, if so, what factors?

(i) any substantial change in the issuer's board of directors and key management

(ii) any change in its single largest substantial shareholder

(iii) issue of restricted convertible securities

It is also suggesed that HKEX clarify the following:

(a) How to define "substantial change" in relation to factor (i) above?

(b) In relation to factor (ii) above, in some instances, the single largest substantial shareholder of a company may hold only a relatively small portion of issued share capital of the issuer (e.g., 10% or 11%) and will probably not have any effective control over the issuer. Would a change in such a shareholder be regarded as a change of de facto control?

Furthermore, in companies with dual class shares, which are now permitted to be listed, subject to conditions, the minority shareholder(s), rather than the single largest substantial shareholder, may have the effective control over the issuer.

We suggest the HKEX give more guidance on these situations, to provide greater clarity and consistency to market practitioners.

3. (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?

☑ Yes

☐ No

If your answer is “No”, please give reasons for your views.

In principle, "yes", but we consider that some further clarification of the following issues is called for:

(i) Whether transactions with independent third parties will be aggregated.

(ii) Why it is deemed necessary to extend the existing two-year period for a series of transactions to three years. We note (from footnote 11 of the consultation paper) that the Australian Securities Exchange listing rules, for example, will generally look at transactions over two years for the purposes of the shareholders' approval requirement. If the present proposal is, e.g., related to the track-record period for the Main Board listings, will the two-year period be retained for Growth Enterprise Market (GEM) issuers?

(iii) The rationale for using market capitalisation as an alternative means of calculating the percentage ratios in determining whether acquisitions are very substantial (see paragraph 47 of the consultation paper). Market capitalisation may be dependent on the state of the market as whole, or other external factors at any given time, and be outside the control of the issuer. It would appear from the proposal that HKEX could take the lower of the market capitalisation at the time of the first acquisition and that at the time of the latest acquisition, three years' later, and compare this against the aggregated considerations for acquisitions over the three-year period. But is it questionable whether this would be a like for like comparison?

It is our view that HKEX should not tighten the rules in such a way as to restrict genuine commercial and business development activities, especially given that, with shorter business cycles, it may be more frequently the case in future that business owners have sound reasons to discontinue running an existing business line and to move progressively into new line of business for the benefit of all shareholders.

(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?

☐ Yes

☑ No

If your answer is "No", please give reasons for your views.

It is not entirely clear why HKEX wishes to be able to include proposed transactions, which may or may not come to fruition, rather than only completed transactions. The RTO Rules are intended to act as a disincentive to issuers to attempt to circumvent the new listing requirements. Therefore, if HKEX feels the need to intervene even before particular transactions have taken place, other than in exceptional circumstances, this suggests that the Rules may not be achieving that objective.

In addition, if an issuer is undergoing a provisional liquidation, the provisional liquidator may receive proposals from a "white knight" to inject new assets or businesses into the issuer, which could save (part of) the business and employees' jobs and avoid the situation of the issuer being wound up. If the HKEX were to intervene at the stage of proposed transactions for issuers in financial distress, it could present an obstacle to these issuers being rescued, and result in signficant disadavantages for both employees and also shareholders, especially minority shareholders, who would potentially lose any opportunity to recover their investment. This could have a negative impact and discourage genuine rescue efforts.

4. (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?

☑ Yes

☐ No

If your answer is "No", please give reasons for your views.

(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)?

☐ Yes

☐ No

If your answer is “No”, please give reasons for your views.

See the questions raised in item (ii) of the response to question 3(a) regarding the extension of the existing two-year period to three years.

5. (a) Do you agree with the proposed changes to Rule 14.92 (proposed Rule 14.06E) as described in paragraph 56 of the Consultation Paper?

☑ Yes

☐ No

If your answer is “No”, please give reasons for your views.

We agree, in principle, with the proposal in relation to material disposals, provided that there is clarity as to what constitutes a "material disposal". Will this be determined with reference to the size test for notifiable transactions?

Regarding the three-year period, please see the questions raised in item (ii) of the response to question 3(a) regarding the extension of the existing two-year period to three years.

(b) Do you agree with the proposal to add a Note to proposed Rule 14.06E as described in paragraph 59 of the Consultation Paper?

☑ Yes

☐ No

If your answer is “No”, please give reasons for your views.

We agree, in principle, with the proposal, but we consider that the wording of the note may need to be looked at again. We refer to the concern raised in our response to question 2 (see item (ii) of that response)about treating the single largest substantial shareholder of a company, in all cases, as if he/she has control over the company, and about defining "de facto control."

6. (a) Do you agree with the proposal to add a new Rule 14.06C for “extreme transactions” as described in paragraph 62 of the Consultation Paper?

☐ Yes

☐ No

If your answer is “No”, please give reasons for your views.

We have reservations about this proposal, as the codification of a new category of transactions (i.e., "extreme transcations"), based on qualitative rather than any specific quantitative criteria, could add confusion and complexity to the market.

Were the proposal to be adopted, it should take into account the characteristics of "new economy"issuers (including e.g., biotech companies), the scale of which may not be determined solely by the size of assets or amount of revenue.

Therefore, the requirement that an issuer should have been operating a "a principal business with substantial size", which paragraph 64 of the consultation paper suggests should entail annual revenue or total asset value of at least HK$1 billion, may be too restrictive and inflexible. It also seems to discriminate against smaller listed issuers and potentially discourage their expansion by merger and acquisition, under normal business circumstances. We suggest that HKEX consider not making reference to any specific size guideline but look at individual cases on their own merits?

Therefore, if HKEX accepts that the target business meets the eligibility and suitability requirements and circumvention of the new listing requirements is not a material concern, the rules may not need to impose any specific size test on the principal business.

(b) Do you agree with the disclosure requirements for circulars of extreme transactions set out in proposed Rules 14.53A(1) and 14.69?

☑ Yes

☐ No

If your answer is "No", please give reasons for your views.

See our response to question 6(a). However, if this new category is introduced, despite the concerns that we raise, then it is logical that appropriate disclosure requirements should apply.

(c) Do you agree with the due diligence requirements for extreme transactions under proposed Rule 14.53A(2)?

☑ Yes

☐ No

If your answer is "No", please give reasons for your views.

Yes, but see our response to question 6(a).

7. (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) of the Consultation Paper?

☑ Yes

☐ No

If your answer is "No", please give reasons for your views.

Yes, in principle, we agree with the proposal.

(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) of the Consultation Paper?

☐ Yes

☐ No

If your answer is "No", please give reasons for your views.

We agree in the case of a non-financially distressed issuer. However, in a provisional liquidation involving a distressed issuer, the issuer's existing business may have significant accumulated losses. Although a "white knight" may propose to inject profitable businesses/ assets into the issuer, the enlarged group may still fail to meet the track record requirement, for perhaps one or more years, when the profits of the acquistion target are offset against the issuer's existing losses. Therefore, we suggest that, in a provisional liquidation situation, there should be greater flexibility to, e.g., look beyond the three-year track-record period, or only partially offset the legacy losses against the profits of the acquisition target, when looking at the circumstances of the enlarged group.

8. (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?

☑ Yes

☐ No

If your answer is "No", please give reasons for your views.

See the Appendix for our detailed comments

(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?

☑ Yes

☐ No

If your answer is “No”, please give reasons for your views.

Yes, subject to the Institute's detailed comments in the Appendix.

9. 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 of the Consultation Paper?

☑ Yes

☐ No

If your answer is “No”, please give reasons for your views.

10. 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?

☑ Yes

☐ No

If your answer is “No”, please give reasons for your views.

In principle, "yes", but it is suggested that, when making an assessment, HKEX should also take into account the characteristics of "new economy" companies, for which innovation and intellectual vitality may be more important than substantial asset size.

11. (a) Do you agree with the proposal to add a Note to the proposed Rule 13.24(1) as described in paragraphs 107 to 109 of the Consultation Paper?

☐ Yes

☐ No

If your answer is “No”, please give reasons for your views.

While we have no specific objection to the addition of a note, we believe that it should aim to provide clarity and as much certainty as possible. Paragraph 108 of the consultation paper, on the other hand, proposes wording that is very open ended and could create uncertainty, i.e.: ***"The Note would also specify that the Exchange will make an assessment based on the specific facts and circumstances of individual issuers. The onus is upon the issuer to demonstrate to the Exchange’s satisfaction that it is in compliance with the Rule."***

(b) Do you agree with the proposal to remove the Note to Rule 13.24 as described in paragraph 112 of the Consultation Paper?

☐ Yes

☑ No

If your answer is “No”, please give reasons for your views.

The existing Note to Rule 13.24 provides specific guidance, which is helpful. While we appreciate that it does not adequately describe all the relevant situations where an issuer may not comply with Rule 13.24, and also that an example of how the rule may be applied to a money lending business will be added, we would nevertheless suggest that additional examples and guidance be added, rather than removing the existing note. A general statement could also be included to make it clear that the test is a qualitative test .

12. 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?

☑ Yes

☐ No

If your answer is “No”, please give reasons for your views.

13. 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")?

☑ Yes

☐ No

If your answer is "No", please give reasons for your views.

14. 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?

☐ Yes

☐ No

If your answer is "No", please give reasons for your views.

If the intention is that a securities brokerage trading primarily for its own account should be regarded as a cash company, it would be clearer if this were dealt with more directly than simply by means of an amendment to Rule 14.83; even though any changes could include an amendment to that Rule. ***We suggest that HKEX provide a clear definition of a "securities brokerage business" and indicate explicitly that such businesses may be regarded as cash companies under certain situations, and what those circumstances are.***

15. 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?

☑ Yes

☐ No

If your answer is "No", please give reasons for your views.

16. 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 of the Consultation Paper)?

☑ Yes

☐ No

If your answer is "No", please give reasons for your views.

We agree with the proposal. However it is suggested that HKEX should clarify the timing of determining the 5% threshold, i.e., whether it should be based on the value at the time that the investment is made or at the end of the reporting period. It may be that a securities investment which exceeded the threshold when it was made is below the threshold at end of the reporting period, due to a reduction in its value or an increase in total asset value of the issuer; the reverse situation may also be true.

17. Do you agree with the proposal to codify the requirements set out in Listing Decision LD75-4 (as described in paragraph 137 of the Consultation Paper) for significant distribution in specie of unlisted assets into the Rules?

☑ Yes

☐ No

If your answer is "No", please give reasons for your views.

18. 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 of the Consultation Paper?

☑ Yes

☐ No

If your answer is "No", please give reasons for your views.

19. (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?

☑ Yes

☐ No

If your answer is "No", please give reasons for your views.

(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?

☑ Yes

☐ No

If your answer is "No", please give reasons for your views.

20. 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?

☑ Yes

☐ No

If your answer is “No”, please give reasons for your views.

We agree. It is suggested that HKEX should issue guidance on the alternative size tests that it may apply under different circumstances, in order to provide greater clarity and certainity.

- End -

ACCOUNTANT'S REPORT SUB-COMMITTEE'S COMMENTS ON HKEX CONSULTATION PAPER ON BACKDOOR LISTING, CONTINUING LISTING CRITERIA AND OTHER RULE AMENDMENTS

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?

(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?

Our responses:

In principle, we have no objection to the proposed Rule 14.57A and Rule 4.30 in relation to the requirements for a RTO or an extreme transaction.

We would like to bring to the attention of the HKEX that the extant relevant HKICPA pronouncements on the preparation of and reporting on pro forma financial information, namely, Accounting Guideline 7 *Preparation of Pro Forma Financial Information for Inclusion in Investment Circulars* and Hong Kong Standard on Assurance Engagement 3420 *Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus*, do not provide the relevant guidance on the preparation of pro forma financial information and the respective reporting for the purposes of the proposed new rules (for example, pro forma financial information for a three-year track record period and for the purpose of demonstrating the satisfaction of the Rule 8.05 financial requirements). It is envisaged that upon the finalisation of the proposed Listing Rules, the HKICPA would, in consultation with the Exchange, develop the appropriate new and/or revised guidance for the preparation of and reporting on such pro forma information.

In respect of the proposed Rule 4.30, it would be better to have the relevant guidance for extreme transactions or reverse takeovers involving series of transactions and/or arrangements without the cross references to Rule 4.29 (i.e. proposed Rule 4.30(4)). The wording as originally drafted may lead to some confusion. For example, a cross reference to Rule 4.29(6) may not be appropriate as Rule 4.29(6) itself includes a

reference to Rule 4.29(5), which is not applicable to the subject matter. We believe the proposed revisions below would help clarify the requirements for these extreme transactions or RTOs. The following editorial changes are proposed for the Exchange's consideration:

4.30 In the case of an extreme transaction or reverse takeover that involves a series of transactions and/or arrangements, the circular or listing document must contain pro forma income statement of all the acquisition targets in the series of acquisitions (where applicable, would include any new businesses developed by the issuer that form part of the series) for the track record period.

(1) The purpose of the pro forma income statement is for the listed issuer to provide investors with information about the financial results of all acquisition targets on an aggregated basis by combining the historical income statements of the acquisition targets as if they had been operated as a single group on an aggregated basis since the commencement of the track record period. This information will be used by the Exchange in assessing if the acquisition targets that form the series of acquisitions can meet the requirements of rule 8.05 (or rule 9.05A or 8.05B).

(2) The pro forma financial information must be published in respect of each of the financial years/periods of the track record period.

(3) The pro forma income statement must clearly state

(a) the purpose for which it has been prepared

(b) that it is prepared for illustrative purposes only; and

(c) that because of its nature, it may not give a true picture of the financial results of all acquisition targets in the series of acquisitions.

(4) The pro forma income statement must be presented in columnar format showing separately the unadjusted financial information, the pro forma adjustments and the pro forma financial information. The pro forma income statement must be prepared in a manner consistent with both the format and accounting policies adopted by the issuer in its financial statements and must identify:

(a) the basis upon which it is prepared; and

(b) the source of each item of information and adjustment.

Pro forma figures must be given no greater prominence in the document than audited figures.

(5) The unadjusted information must be derived from the acquisition targets'

accountants' reports for the track record period.

(6) Any adjustments which are made to the information referred to in rule 4.30(4) in relation to any pro forma income statement must be:

(a) clearly shown and explained;

(b) directly attributable to the series of transactions and/or arrangements concerned and not relating to future events or decisions;

(c) factually supportable; and

(d) clearly identified as to those adjustments which are expected to have a continuing effect on the acquisition targets and those which are not.

(7) The pro forma income statement must be reported on in the circular or listing document by the auditors or reporting accountants who must report that, in their opinion:

(a) the pro forma income statement has been properly compiled on the basis stated;

(b) such basis is consistent with the accounting policies of the issuer; and

(c) the adjustments are appropriate for the purposes of the pro forma income statement as disclosed pursuant to rule 4.30(1).