The 10 Most Important Things To Know About Reverse Takeovers (RTOs) of HK Listed Companies

1. **What is a Reverse Takeover?**

An RTO is broadly defined as an acquisition (or series of acquisitions) of assets by a listed issuer which attempts to achieve a listing of the acquired assets while circumventing the Listing Rules' requirements for a new listing applicant.[1]

2. **Is there a specific definition of Reverse Takeover?**

No. The Listing Rules only give two specific examples of transactions that *normally* constitute an RTO.[2] These are: a listed issuer's acquisition (or series of acquisitions) of assets which constitute a very substantial acquisition ("VSA") (i.e. acquisition(s) where any percentage ratio is 100% or more):

(a) where there is or will be a change of control (i.e. 30%) of the listed issuer; or

(b) where the acquisition(s) is/are made from a person or group (or their associates) within 24 months of that person or group gaining control of the listed issuer.

3. **Are there any other circumstances that can give rise to an RTO?**

Yes. The examples at 2 above are not exhaustive, and a transaction which is in substance a backdoor listing, will be treated as an RTO notwithstanding that it does not fall within the specific examples given in the Listing Rules.[3]

4. **Does there have to be a change in control of the listed issuer for there to be an RTO?**

No. It is a common misconception that an RTO must involve a change of control of the listed issuer. The question is whether there is an attempt to achieve a listing of the business or assets acquired without having to meet the conditions for listing. Hence, a listed issuer's disposal of its existing business and acquisition of a totally new business may be regarded as an RTO even if there is no change in control.[4]

5. **What are the consequences of entering an RTO?**

This will depend on whether the RTO is considered by the Exchange to constitute an "extreme case" which is intended to circumvent the requirements for a new listing applicant.[5] If it is, the Exchange will treat the listed issuer proposing the RTO as a new listing applicant.[6] Consequently:

(a) the enlarged group or the assets to be acquired must be able to meet the financial criteria for a new listing[7];

(b) the enlarged group must meet all other basic listing conditions;

[1] Rule 14.06(6) of the Main Board Listing Rules and Rule 19.06(6) of the GEM Listing Rules.
[2] Paragraphs (a) and (b) of Rules 14.06(6) and 19.06(6) of the Main Board and GEM Rules, respectively.
[3] This was made clear in the Listing Committee's 2007 Annual Report.
[4] See the Exchange's Listing Decision 75-1 of October 2009.
[5] This treatment was set out in the Listing Committee's 2010 Annual Report.
[6] Rules 14.54 and 19.54 of the Main Board and GEM Listing Rules, respectively.
[7] As set out in Main Board Rule 8.05 and GEM Rule 11.12(A).

(c) the listed issuer must issue a listing document containing virtually all the information required for a new listing applicant and the information required for a VSA;

(d) an initial listing fee is payable; and

(e) the RTO must be conditional on shareholders' approval in general meeting.

6. **What factors will the Exchange take into account in determining whether an RTO is an "extreme case"?**

The Exchange considers:

- the size of the acquisition relative to the size of the issuer;
- the quality of the acquired business – whether it can meet the trading record requirements for a new listing, or whether it is unsuitable for listing (e.g. an early stage mineral exploration company);
- the size and type of business that the issuer was engaged in prior to the acquisition (a key question is whether it is merely a listed shell or not);
- any fundamental alteration to the issuer's principal business (e.g. the existing business would be discontinued or very immaterial to the enlarged group's operations post acquisition); and
- any other events and transactions, past or future, which, when considered alongside the acquisition, constitute a sequence of arrangements designed to circumvent the RTO Rules (e.g. a disposal of the issuer's original business simultaneous with a very substantial acquisition).

7. **What if the RTO is not an "extreme case"?**

Where the assets to be acquired can meet the minimum requirements for a new listing, and thus circumventing the Listing Rules' requirements is not a material concern, the Exchange will not insist on compliance with the requirements for new listing applicants. Likewise, if the RTO is considered to be an "extreme case", but the Exchange concludes that there is no intention to circumvent the Listings Rules, compliance with the RTO Rules is not normally required.

Instead, the Exchange will generally require:

(a) a level of disclosure in the circular to shareholders that is comparable to that required for an IPO prospectus; and

(b) a more stringent vetting process to be adopted by the Exchange.

In at least one case which was found to be "extreme", but not an attempt at circumventing the Listing Rules' listing requirements, the Exchange also required the listed issuer to appoint an adviser to perform due diligence on the target and undertake duties and obligations akin to those required of a sponsor to a new listing applicant under the Listing Rules.[8]

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[8] See Listing Decision 95-1 of July 2010.

The Exchange has said that acquisitions of new businesses or assets are more likely to be treated as new listings since enhanced disclosure is likely to be of limited use given that there will be little in the way of track record or operating history.

8. **Can the RTO Rules be circumvented by deferring disposal of the existing business until after the asset injection to the listed issuer following a change of control, thus avoiding the asset injection's classification as a VSA?**

No, the Listing Rules provide that a listed issuer cannot dispose of an existing business within 24 months of a change of control if: (a) there has been an injection of assets from the new controlling shareholder; and (b) taking into account the disposal(s), the asset injection (or series of injections) from the new controlling shareholder before and after the change in control would have resulted in a VSA, unless the assets acquired after the change of control can meet the requirements for a new listing.[9] If not, the transaction will be treated as an application for a new listing.[10]

9. **What are the RTO Rules' implications for a listed issuer proposing an RTO of mineral or petroleum assets?**

A listed issuer which acquires mineral or petroleum assets in an RTO will become a "Mineral Company" for the purposes of the Listing Rules.[11] If the Exchange regards the RTO as an "extreme case", the assets acquired or enlarged group must meet the additional criteria for listing new applicant Mineral Companies set out in Chapters 18 and 18A of the Main Board and GEM Rules, respectively, in addition to the basic listing conditions.

10. **What are the Takeovers Code implications of an RTO?**

An offer to acquire 30% or more of the voting rights of a Hong Kong listed company will trigger the obligation under Rule 26 of the Takeovers Code to make a general offer to all shareholders of the target company on the same terms in the absence of a waiver from the SFC Executive. Rule 25 further prohibits an offeror and its associates from offering favourable conditions to one or more shareholders which are not available to all the other shareholders.

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[9] See Main Board Rules 14.92 and 14.93 and GEM Rules 19.92 and 19.93 and the Listing Committee's 2008 Annual Report.

[10] See also the Exchange's Listing Decision LD7-2011.

[11] Main Board Rule 18.11 and GEM Rule 18A.11.

INTRODUCTION: RTOS VS. IPOS

Historically, reverse takeovers ("RTO"") have been used in situations where speed and certainty of outcome are more desirable than potentially larger gains. The fact that no significant regulatory review was required (and there was no prospectus requirement) meant that the timeframe for completion of an RTO was considerably shorter than that for an IPO. In addition, RTOs are not subject to the vagaries of the market, as is an IPO, and the new owners of the listed company will generally suffer less share dilution and thus have greater control. Costs can also be saved due to the lack of an underwriter. It will be much easier for the company acquiring the listed company to raise capital, as investors will have a clearly defined exit strategy through the public market.

Some of the drawbacks to RTOs are that their speed and eventual value are sometimes overestimated, and they are sometimes completed without enough regard for the uninvolved shareholders.

In many countries around the world RTOs still offer an alternative route to listing status, although there have been moves recently, notably in the United States (U.S.) and China, to tighten the regulation of RTOs following a number of accounting scandals involving Chinese companies that listed by this route. In the U.S. and Canada, reverse takeovers had been encouraged in the past, especially for small and micro-cap companies who were unlikely to be able to afford the underwriter necessary for an IPO. In the U.S., for example, it is possible to trade shares in listed shells – the investment objective being presumably to achieve a gain when there is an RTO of the shell. However, problems can arise when RTOs are under-regulated. Singapore had several high-profile reverse takeovers fall through due to concerns over profit guarantees, leading to the Singapore Stock Exchange publishing additional prescriptions for prospective RTOs including a minimum issue price for reverse takeovers and new requirements for the listed company and its financial adviser in assessing acquisitions involving profit guarantees, denounced as a gimmick during the bull run of 2007.