

▶ Listing PRC Companies in Hong Kong



September 2014

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www.charltonslaw.com

Introduction

- ❖ Historically – 2 models for PRC companies to list on the Exchange:
 - Directly via an H share listing
 - Indirectly via a red chip listing
- ❖ H share companies are enterprises incorporated as joint stock limited companies in the PRC which have received CSRC approval to list in Hong Kong.
- ❖ Red chip companies are enterprises that are incorporated outside of the PRC (normally in Hong Kong, the Cayman Islands or Bermuda), are controlled by PRC entities or individuals and conduct most of their business in the PRC.
- ❖ For the purpose of quoting statistics, the Exchange uses the terms:
 - “Red chip” to refer to overseas incorporated entities controlled by PRC government entities; and
 - “Non-H share Mainland private enterprises” to refer to overseas incorporated entities controlled by PRC individuals.
- ❖ Of the **1,711** listed companies on the Exchange at the end of July 2014, **851** were Mainland enterprises, including **195** H-share companies, **130** red-chip companies and **526** Mainland private enterprises.
- ❖ Together, Mainland enterprises accounted for **57.6%** of the market capitalisation and **70.1%** of the equity turnover of all listings on the Exchange (as at end July 2014).

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Introduction (Cont'd)

- ❖ Hong Kong Exchange: world's 6th largest (2nd in Asia after Japan) by market capitalisation.
- ❖ IPO market: ranked 2nd in the world in IPO funds raised (after New York) in 2013. HK ranked in top 5 for last 12 years.
- ❖ 110 new listings in 2013, raised HKD 166.5 billion (up **85%** from 2012).

2014

- ❖ According to Ernst & Young, 2013 marked end of 2-year decline in IPO activity.
- ❖ 2014 expected to be record year for IPOs globally.
- ❖ First 7 months of 2014 – 76 new listings (up from 33 in same period in 2013) raised HK\$105,972 mln (increase of 137% over same period in 2013).
- ❖ Majority of new issuers are SMEs.

China Market: Impact on HK

- ▶ Beijing resumed processing of IPO applications in January 2014 following 15-month freeze on IPOs in attempt to prop up Shanghai market, the world's worst performing market in 2012.
- ▶ Aim of IPO resumption = to create funding alternative to bank lending as government seeks to halt build-up in bad loans.
- ▶ Shanghai's disappointing performance in 1st half 2014 prevented CSRC fast-tracking listing approvals due to fear of causing fall in stock prices.
- ▶ Approx. 600 listing applications currently waiting for CSRC approval.

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Introduction (Cont'd)

- ❖ On 19 August 2014, CSRC approved 11 new listings: 5 on the Shanghai Stock Exchange, 5 on Shenzhen's Nasdaq-style ChiNext market, and 1 on Shenzhen's SME board.
- ❖ New listings expected to drag markets down as retail investors shun existing stocks to chase first-day gains on newly listed stocks: almost all recent IPOs have seen share prices rise the 1st day trading limit of 44%.
- ❖ CSRC has limited approvals to smaller listings to avoid massive fundraisings which would drain liquidity from the market.
- ❖ Hong Kong Exchange benefits as cash-strapped companies switch listing plans to HKEx.
- ❖ While China's IPO pipeline remains blocked, Chinese companies are seeking HK listings: particularly real estate and financial services companies such as city commercial banks.
- ❖ Companies reported to be planning an HKEx listing include BAIC Motor (potentially the largest listing by a Chinese carmaker), China General Nuclear Power Group, Bank of Shanghai, Shengjing Bank and China Railway Materials Co Ltd.
- ❖ Launch of Shanghai-Hong Kong Stock Connect scheduled for Oct. 2014 – expected to add liquidity and widen investor base in HK stock market, adding further momentum to the market.
- ❖ Ernst & Young predicting HK\$99.3 billion of IPOs in 2nd half of 2014 and HKEx to rank 3rd for IPO fundraising in 2014 (after the NYSE and Nasdaq).
- ❖ High valuations for tech stocks in US have prompted new Chinese listings on NYSE and NASDAQ including online retailer JD.com Inc., and Alibaba (due to list in September).

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Benefits of listing

- ▶ access to international funds
- ▶ active post-listing trading & a separate Hang Seng Chinese Enterprise Index
- ▶ interest and confidence of international investors
- ▶ enhanced profile and reputation
- ▶ more transparent management

Hong Kong's markets

- ▶ **Main Board** – caters for established companies able to meet its profit or other financial standards.
- ▶ **Growth Enterprise Market (“GEM”)** – caters for smaller growth companies, has lower admission criteria and acts as a stepping stone to the Main Board.
 - ❖ The post-listing obligations of GEM companies are now broadly similar to those of Main Board listed companies. The principal difference in the ongoing obligations of Main Board and GEM companies is that quarterly reporting is a **Listing Rule requirement for GEM** companies whilst for **Main Board** issuers it is still a **Recommended Best Practice** only (under the Corporate Governance Code).

Applicable HK laws and non-statutory codes

- ▶ Rules Governing the Listing of Securities on The Exchange of Hong Kong Limited (the “Listing Rules”)
- ▶ Listing Rules have modifications and additional requirements for H share issuers (MB Chapter 19A GEM Chapter 25)
- ▶ Companies Ordinance
- ▶ Securities & Futures Ordinance
- ▶ Code on Takeovers and Mergers and Code on Share Buybacks
- ▶ Additional requirements of Chapter 19 of the Main Board Rules (Chapter 24 of the GEM Rules) (Red chip companies and non-H share Mainland private enterprises)

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PRC Regulatory Requirements for H Share Issuers

- ❖ **The China Securities Regulatory Commission (the “CSRC”)** = responsible authority for overseeing overseas listing of Chinese enterprises.
- ❖ CSRC’s Guidelines for Supervising the Application Documents and Examination Procedures for the Overseas Stock Issuance and Listing of Joint Stock Companies (**Guidelines**) came into effect 1 January 2013.
- ❖ Guidelines removed financial requirements for H share listings – previously under **“4-5-6 Requirements”**, listing applicants were required to:
 - have RMB 400 million of net assets;
 - raise US50 million of funds; and
 - have after-tax profit of more than RMB 60 million
- ❖ Under new Guidelines, Chinese joint stock companies listing overseas must satisfy CSRC that they meet listing requirements of overseas stock exchange.

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PRC Regulatory Requirements for H Share Issuers (Cont'd)

- ❖ 4-5-6 Requirements previously meant that majority of H share companies were large state-owned enterprises.
- ❖ New Guidelines provide Chinese SMEs with alternative route to domestic IPO.
- ❖ New Guidelines also simplified application process – e.g. removed requirement for submission of documentation to CSRC 3 months before submission of overseas listing application.
- ❖ New Guidelines aimed at easing fundraising pressure on PRC exchanges and promoting development of Chinese SMEs.

B shares conversion to H shares

- China Int'l Marine Containers Group: the first PRC B share company to convert its B-share listing into H-share listing by way of introduction in December 2012.
- Listing by introduction is a means of listing shares already in issue on another stock exchange where no marketing arrangements are required because the shares are already widely held. As only existing shares are listed by introduction, no additional funds are raised.
- An introduction will only be permitted in exceptional circumstances if there has been a marketing of the securities in Hong Kong within the 6 months prior to the proposed introduction where the marketing was made conditional on listing being granted for those securities.(LR 7.15);
- Guidance Letter GL53-13 which provides guidance to issuers seeking to list by way of introduction on arrangements to facilitate liquidity of issuers' securities to meet demand on the Hong Kong market during the initial period after listing;
- Listing Decision HKEx-LD52-2013 provides a detailed explanation for its decision to allow an un-named company (Company A) listed on a PRC stock exchange to convert its entire B shares into H shares to be listed on the Exchange by way of introduction.

Regulation of Red Chip Listings Circular 10 – the M & A Rules

- ❖ The Provisions on the Takeover of Domestic Enterprises by Foreign Investors (the “**M&A Rules**” or “**Circular 10**”) jointly issued by Ministry of Commerce (“**MOFCOM**”) and 6 other governmental departments came into effect on 8 Sept 2006.
- ❖ Since Circular 10 came into force, there have been virtually no approvals for restructurings of Chinese companies into offshore holding companies.
- ❖ Use of offshore SPV to achieve offshore listing of Chinese company is effectively prevented, as Central MOFCOM approval is always required for:
 - ▶ establishment of offshore SPV to achieve overseas listing where offshore company is directly or indirectly controlled by a Chinese company or Chinese individuals; and
 - ▶ the offshore SPV’s acquisition of the affiliated Chinese company.
- ❖ CSRC approval also required for overseas listing of SPV holding China assets.

Circular 10 – the M & A Rules (Cont'd)

- ❖ Parties to an acquisition must declare whether they are affiliated - if parties are under common control, identities of the ultimate controlling parties must be disclosed to approving authorities.
- ❖ Use of trusts/or other arrangements to avoid this requirement is expressly prohibited (Article 15).
- ❖ Listing price of SPV's shares on overseas exchange may not be less than the valuation of the onshore equity interest as determined by a PRC asset valuation company.
- ❖ Proceeds of offshore listing, as well as dividends and proceeds of changes in the capital of domestic shareholders must be repatriated to China within 6 months / 180 days

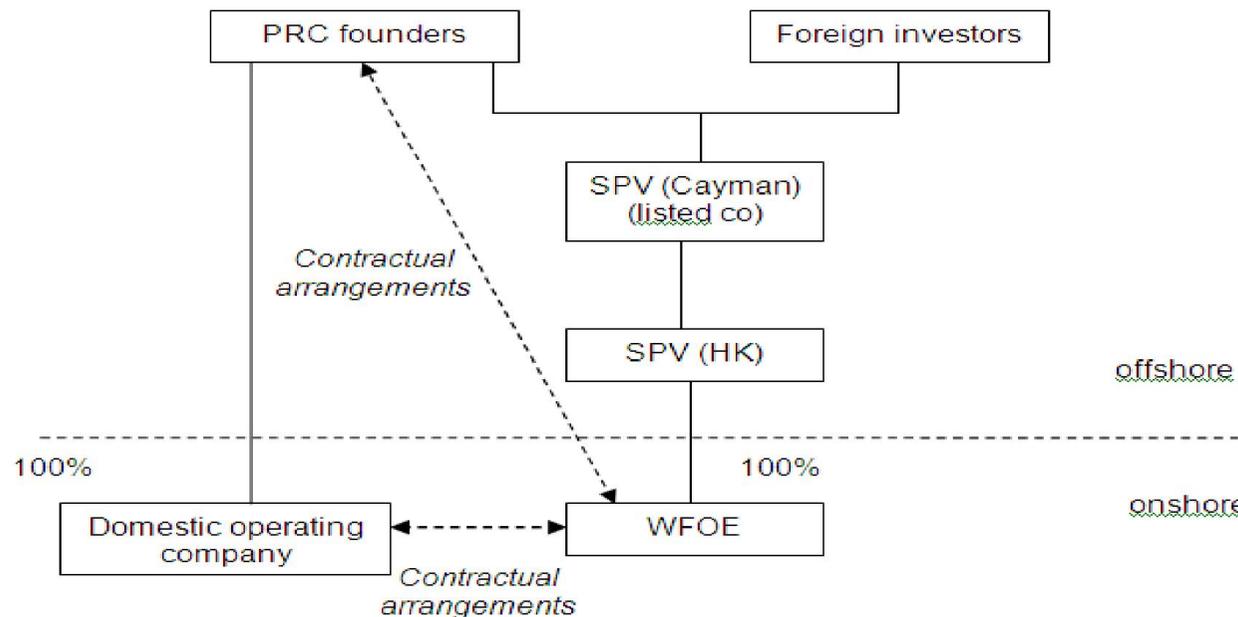
Circular 10 – the M & A Rules (Cont'd)

The listing of China Zhongsheng Resources Holdings in 2012

- ▶ Originally a PRC company, transformed into a Sino-foreign enterprise and then a WFOE;
- ▶ Only commenced red-chip restructuring after the implementation of Circular 10;
- ▶ Approvals of provincial bureau of commerce were granted at various stages;
- ▶ Seen as a circumvention of Circular 10;
- ▶ Remains to be seen whether it was a change of MOFCOM's policy or a mere exception.

VIE structures

A typical VIE structure is illustrated in the following diagram :



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Typical contents of contractual arrangements between domestic company and the WFOE

❖ Exclusive Service Agreement

- The WFOE provides exclusive consultancy, management and technology services to the OPCOs in return for a fee → shifting profit from OPCOs to the WFOE

❖ Call Option Agreement

- The WFOE is granted the option to acquire all or portion of the equity interest of the OPCOs at the lowest permitted price

❖ Equity Pledge Agreement

- The PRC shareholder will enter a registered pledge for all its equity interests in the OPCOs in favour of the WFOE to secure due performance of the contractual obligations

❖ Loan Agreement

- The WFOE will grant a loan to the PRC shareholder for capitalising the OPCOs

❖ Voting rights agreement / Power of attorney

- The PRC shareholder irrevocably grants the WFOE all its shareholder rights (incl. voting rights)

Risks involved

- ❖ Regulatory risk of structure being declared invalid by PRC authorities:
 - ▶ failure to obtain required foreign investment approvals could lead to PRC authorities requiring structure to be unwound; or
 - ▶ VIE structures could be declared to be subject to requirement for MOFCOM approval under M&A Rules.
- ❖ Risk that contractual arrangements will be unenforceable or insufficient to retain control over VIE.
- ❖ As regards future regulatory changes, PRC legal advisers usually include in their legal opinion that on the basis of the principle of non-retrospectivity of laws, the status of existing VIE structures A contractual arrangements should not be affected if there is any change in future.
- ❖ Restrictions on use of structure for specific industries:
 - * In relation to value added telecommunications businesses, a circular issued by the PRC Ministry of Information Industry in 2006, requires certain key assets, including trademarks and domain names, to be held by the company with the value added telecommunications service provider licence or its shareholders.
 - * Notice of general administration of press and publication → foreign investors are not allowed to control or participate in a domestic online gaming business by setting up a joint venture company and/or through contractual arrangements.

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Risks involved (Cont'd)

- ❖ The measures on security review system of M&A of Chinese enterprises by foreign investors (Sept 2011)
 - Foreign investors are prohibited from adopting indirect or contractual arrangements to avoid national security review procedures

- ❖ Public policy – Buddha Steel was required to withdraw its listing application
 - The withdrawal might be more an indicator that the regulatory authorities are tightening control on foreign investment in certain core industries than a disapproval of VIE structure

2011 CSRC report

- ❖ An internal CSRC report disclosed in Sept 2011 (apparently advocating prior MOFCOM approval of VIE structures)
 - Raised concerns about national security (particularly regarding internet industry and asset-heavy industries)
 - Suggested that all VIE structures should obtain CSRC approval
 - Desirability of PRC companies in emerging industries listing onshore
 - Possible negative impact of prohibiting VIE structures addressed e.g. restriction of fund raising activities by companies unable to list on domestic exchanges
 - No official confirmation on the genuineness of the report

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Risks involved (Cont'd)

Case study: Wal-Mart's acquisition of Yihaodian

- ❖ MOFCOM approved the acquisition of Niu Hai (Yihaodian) by Wal-Mart.
- ❖ To safeguard the restricted area of business, MOFCOM imposed the following conditions:
 - the acquisition should be confined to the direct sales business;
 - without prior approval for engaging in value-added telecommunications (VATS) business, Niu Hai should not provide internet services to other parties; and
 - Wal-Mart was not allowed to use VIE to engage in VATS business then operated by Yihaodian.
- ❖ The most direct reference to VIE by Chinese authorities so far.
- ❖ However, the decision is not considered an indicator of any policy change towards VIE structure.

Risks involved (Cont'd)

- ❖ Since 1999, more than 200 Chinese companies listed in the US used the VIE structure.
- ❖ Primarily internet and education companies subject to restrictions on foreign investment.

The Alipay Scandal

In 2011, Alibaba Chairman, Jack Ma, transferred ownership of Alipay, the company's payment arm, out of a VIE to a structure he controlled personally, allegedly without majority approval of Alibaba's shareholders (i.e. of Yahoo and Japan's Softbank). Mr. Ma claimed the transfer was necessary because Alipay could not obtain an operational licence if held by foreigners. Settlement reached between 3 companies that if Alipay went public, it would pay Alibaba between US\$2 billion and US\$6 billion.

Mitigating the Risks

- ❖ Alibaba's blockbuster IPO reported to be targeting a September 16 trading debut. Expected to raise over US\$20 billion, making it the largest ever IPO in the US, and possibly in the world.
- ❖ Alibaba still operates under a VIE structure. However, has mitigated investors' risks by holding most of its assets in the foreign-owned part of its business. Alibaba's PRC operating companies hold only 7.5% of the group's assets and generate 11.9% of its revenue.
- ❖ Seen as significantly reducing risk of abuse by the PRC operating companies' shareholders.

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Risks involved (Cont'd)

- ❖ Also mitigates other problems such as deferred taxes and foreign exchange controls;
- ❖ Comparison of amount of business conducted in PRC **OPCOS** under Alibaba & Baidu VIE structures with that of New Oriental, listed on NYSE in 2006:

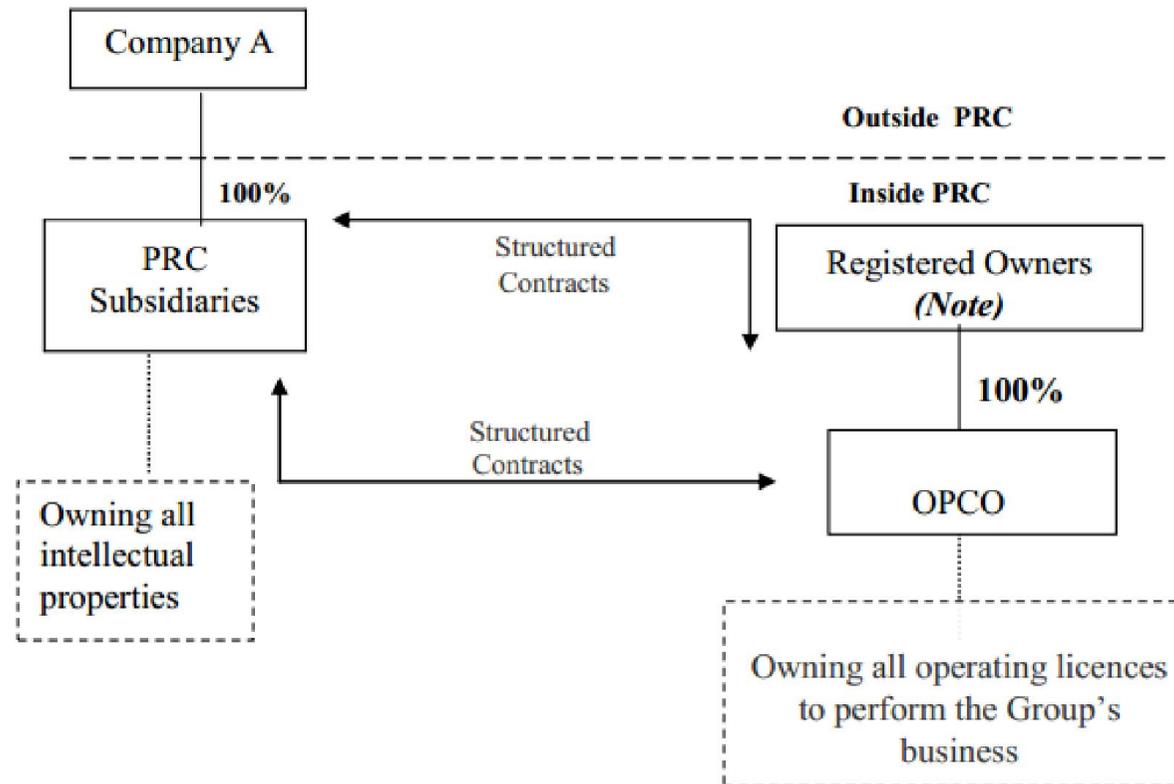
	<u>ALIBABA</u>	<u>BAIDU</u>	<u>NEW ORIENTAL</u>
<u>% of revenue in OPCOS</u>	11.9%	28.3%	99.1%
<u>% of assets in OPCOS</u>	7.5%	10.1%	65.5%
<u>Net income in OPCOS</u>	0%	0%	151.5%

Source: Paul Gillis, China Accounting Blog, "Alibaba sets the VIE gold standard"

- ❖ Minimise risks by (i) diversifying shareholdings in Chinese OPCOS so that no single shareholder, or related shareholders, have control; and (ii) ensuring controllers of PRC OPCOS get greater returns from stakes in offshore cos than from PRC OPCOS (thus less likely to sever VIE structure);
- ❖ Risk of China authorities declaring structure illegal – thought harm to Chinese economy makes this unlikely.

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Listing decision 43-3



The Registered Owners were controlling shareholders of Company A

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Listing decision 43-3

- ❖ Listing Decision 43-3 on VIE structures first issued in 2005 – updated several times, most recently in April 2014.
- ❖ HKSE generally allows listing of applicants using a VIE structure provided:
 - it is satisfied as to reasons for the use of structured contracts; and
 - listing applicant complies with requirements of the listing decision.
- ❖ A disclosure-based approach is adopted in considering listing applications involving VIE.
- ❖ VIE structures normally accepted only for restricted businesses. Where VIE structure used for an unrestricted business, case is referred to Listing Committee.
- ❖ HKSE will not consider an applicant unsuitable for listing if all relevant PRC laws and regulations have been complied with.
- ❖ Appropriate regulatory assurance should be obtained from the relevant regulatory authorities.
- ❖ In the absence of regulatory assurance, PRC legal opinion must include a statement to the effect that all possible actions or steps have been taken to enable it to reach its legal conclusions.

Listing decision 43-3

- ❖ PRC legal opinion must confirm that structured contracts would not be deemed as “concealing illegal intentions with a lawful form” and thus void under PRC contract law.
- ❖ Listing applicants in restricted businesses must demonstrate that they have taken all reasonable steps to comply with applicable PRC rules (other than foreign ownership restriction).
- ❖ Where PRC laws/regulations specifically prohibit foreign investors using contractual arrangements to gain control of or operate a foreign restricted business (e.g. on-line gaming business), PRC legal opinion must:
 - a) confirm that:
 - ▶ the use of structured contracts does not breach the relevant laws/regulations;
 - ▶ the structured contracts will not be deemed invalid or ineffective under those laws/regulations; and
 - b) be supported by appropriate regulatory assurance, where possible, to demonstrate the legality of the structured contracts.

Listing decision 43-3

- ❖ Requirements for an applicant using VIE and its sponsor:
 - provide reasons for the use of structured contracts in its business operation
 - unwind the structured contracts as soon as the law allows the business to be operated without them. OPCOs' shareholders must undertake to return to the listing applicant any consideration received if the applicant acquires OPCO shares when structured contracts are unwound
 - ensure the structured contracts:
 - include a POA by OPCOs' PRC shareholders granting listco's directors (and successors) power to exercise all shareholders' rights
 - * contain dispute resolution clauses which:
 - i. provide for arbitration and that remedies over the shares, land or assets, injunctive relief or winding up order of the domestic operating company may be awarded;
 - ii. give the courts of competent jurisdictions (HK, the applicant's place of incorporation, the place of incorporation of the domestic company, the location of the domestic company's principal assets) the power to grant interim remedies in support of the arbitration pending formation of the arbitral tribunal; and
 - iii. encompass dealing with OPCOs' assets and not only the right to manage its business and the right to revenue.

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Listing decision 43-3

- ❖ Prospectus disclosure requirements:
 - detailed discussion about the OPCOs' registered shareholders and a confirmation that appropriate arrangements have been made to protect the applicant's interests;
 - arrangements to address the potential conflicts of interest between the applicant and OPCOs' registered shareholders;
 - reasons why the directors believe that each of the contractual arrangements is enforceable under PRC laws and regulations;
 - the economic risks the applicant bears as the primary beneficiary of the OPCOs;
 - whether the applicant has encountered any interference from any PRC governing bodies; and
 - the limitations in exercising the option to acquire ownership in the OPCO with a separate risk factor explaining the limitations.

Listing decision 43-3

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- the limitations in exercising the option to acquire ownership in the OPCO with a separate risk factor explaining the limitations.

PRC Property Issues

- ▶ Many issues relating to titles of PRC properties remain unresolved;
- ▶ Potential PRC listing applicants may face difficulties in evidencing their ownership due to uncertainty in the application process for the land use right certificate and/or building ownership certificate;

Exchange's guidance letter (HKEx-GL19-10)

- ▶ For infrastructure project companies and property companies, the relevant title certificates of PRC properties are a pre-requisite for listing approval;
 - ▶ For mineral and exploration companies, the Listing Rules require them to obtain adequate rights to participate actively in the exploration and extraction of resources. Title certificates are normally required to prove their rights;
 - ▶ For other companies, the Exchange no longer requires title certificates of PRC properties. Instead, it expects listing applicants to disclose in the prospectus the risks to their operations of not having the relevant title certificates.
- ❖ Practice Note 12 of the Listing Rules provides that where the issue of a land use right certificate is pending, a properly approved land grant or land transfer contract in writing accompanied by a PRC legal opinion as to the validity of the approval may be acceptable as evidence of a transferee's pending title to the land to be granted or transferred.

Pre-IPO Investment

Pre-IPO Equity Investment

- ▶ In October 2012, the Exchange published a guidance letter (**HKEx-GL43-12**) to consolidate its past listing decisions on pre-IPO investments. Last updated in July 2013.
- ▶ Pre-IPO investments generally take the form of private placements to investors of preference shares or convertible bonds exchangeable into ordinary shares.
- ▶ The purpose → provide the company with cash to fund its operations in the period prior to listing on the Exchange.

Applicable Listing Rules

Main Board Listing Rule 2.03(2) (GEM Rule 2.06(2)):

- ▶ the issue and marketing of securities must be conducted in a fair and orderly manner and potential investors must be given sufficient information for making a properly informed assessment of an issuer.

Main Board Listing Rule 2.03(4) (GEM Rule 2.06(4)):

- ▶ all holders of listed securities must be treated fairly and equally.

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Pre-IPO Investment

- ▶ Exchange considers that where the investment is made very shortly before an IPO, the pre-IPO investor cannot be said to have taken any special risk different from that taken by the IPO investors, which would justify the pre-IPO investor having protections under the terms of the pre-IPO investment.
- ▶ The general principle is that atypical special rights or rights which do not extend to all other shareholders are not permitted to survive after listing.

PERMISSIBILITY OF SPECIAL RIGHTS/OBLIGATIONS

- ▶ **The 28/180 Day Requirement** - Pre-IPO investments are required to be *completed* **either** at least **28 clear days** before the date of the first submission of the first listing application form **or 180 clear days** before the first day of trading. Pre-IPO investments are only considered completed when the funds are irrevocably settled and received by the applicant.
- ▶ **Price Adjustments – Disallowed:** Any price adjustment provisions, such as a guaranteed discount to the IPO price or share price or an adjustment linked to the market capitalisation of the shares.
- ▶ **Put or Exit Options – Disallowed:** All put or exit options which grant pre-IPO investors the right to put back the investments to the applicant or its controlling shareholder. The only event in which a put or exit option is allowed is when the terms of the pre-IPO investment state that the put or exit option can only be exercised if listing does not take place.

Pre-IPO Investment

PERMISSIBILITY OF SPECIAL RIGHTS/OBLIGATIONS (Cont'd)

- ▶ **Director Nomination Rights – Disallowed:** Pre-IPO investors may exercise a right to nominate or appoint a director before listing, **BUT** that director would be subject to the retirement and re-appointment requirements in the articles after listing.
- ▶ **Veto rights – Disallowed:** contractual right given to pre-IPO investors to veto the applicant's major corporate actions such as passing a resolution to wind up the company, any change to the business carried on by the group, and the amalgamation by any group member with any other company, etc.
- ▶ **Anti-dilution Rights:** Listing Rules provide that securities cannot be offered to the issuer's existing shareholders on a preferential basis and they must not be given preferential treatment in the allocation of securities.

Anti-dilution rights **allowed pre-Listing**

Pre-IPO investors can exercise anti-dilution rights at time of IPO if:

- the allocation is necessary to give effect to the pre-existing contractual rights of the pre-IPO investors
- full disclosure in prospectus of the pre-IPO investors' pre-existing contractual entitlement and the number of shares to be subscribed by the pre-IPO investors
- the proposed subscription will be conducted at the offer price of the IPO

Anti-dilution rights **disallowed post-Listing**

- Anti-dilution rights should be extinguished on listing so as to comply with Main Board Rule 13.36 (GEM Rule 17.39) on pre-emptive rights.

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Pre-IPO Investment

PERMISSIBILITY OF SPECIAL RIGHTS/OBLIGATIONS (Cont'd)

▶ **Profit Guarantee**

Profit guarantee **allowed**

- If it is settled by a shareholder (rather than the listing applicant) and the compensation is not linked to the market price or capitalisation of the shares.

Profit guarantee **disallowed**

- If the profit guarantee is to be settled by the applicant or is linked to the market price or market capitalisation of the shares.
- **Negative Pledges – Disallowed:** Negative pledges will generally be disallowed **UNLESS** they are **widely accepted provisions** in loan agreements, are not egregious and do not contravene the fairness principle in the Listing Rules.

Widely accepted provisions include:

- pledges not to create or effect any mortgage, charge, pledge, lien or other security interest on an applicant's assets and revenues; and
- pledges not to dispose of any interest in the economic rights or entitlements of a share the controlling shareholder owns or controls to any person.

Pre-IPO Investment

PERMISSIBILITY OF SPECIAL RIGHTS/OBLIGATIONS (Cont'd)

- ▶ **Prior Consent for Corporate Actions/Changes in Articles – Disallowed unless not egregious and not contrary to Listing Rules**

Example of corporate actions/changes in articles

- a declaration of dividend;
 - the sale, lease or transfer of a substantial part of the applicant's business or assets;
 - any amendments to the applicant's constitutional documents; and
 - any change in executive directors.
-
- ▶ **Exclusivity Rights and No More Favourable Terms – Disallowed unless “Fiduciary Out” Provision:** Terms that the applicant is not allowed to issue any shares, options, warrants or rights to any direct competitor of the pre-IPO investor or to other investors on more favourable terms. These rights will be disallowed after listing **UNLESS** the investment agreement is modified to include an explicit **“fiduciary out” clause** allowing directors of the applicant to ignore the terms if complying with the terms would prevent them from carrying out their fiduciary duties.
 - ▶ **Information Rights – Allowed:** right to receive corporate information from the applicant. Allowed **ONLY IF** pre-IPO investor receives only published information or information which is made available to the general public at the same time.
 - ❖ For PSI, the issuer needs to comply with the statutory PSI disclosure regime in Part XIVA SFO.

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Pre-IPO Investment

PERMISSIBILITY OF SPECIAL RIGHTS/OBLIGATIONS (Cont'd)

- ▶ **Right of First Refusal and Tag-along Rights – Allowed:** A right granted to the pre-IPO investor to purchase the shares at the same price and on the same terms as a proposed sale of shares to a third party purchaser, or, if the pre-IPO investor does not purchase the shares, the right granted to it to include its shares for sale together (i.e. tag along) with the shares of the controlling shareholder
- ▶ **Qualified IPOs – Allowed:** Term providing for pre-IPO investor to receive compensation if applicant does not achieve IPO at or above a specified amount by a set date. This term will be allowed **IF** the amount to be compensated is set out in the investment agreement or can be derived from the compensation provisions under the agreement. Otherwise, it will be viewed as an amendment or variation to the original terms of the agreement and the 28 Day/180 Day Requirement applies.
- ▶ **Lock-up and Public Float:**

Pre-IPO investors are usually required by the applicant to lock-up their pre-IPO shares for a period of six months or more. These shares are counted as part of the public float so long as Main Board Listing Rule 8.24 (shares are not financed directly or indirectly by a core connected person of the applicant) is fulfilled.

 - Prospectus disclosure requirements for pre-IPO investments are set out in Guidance Letter HKEx-GL43-12.
 - Guidance Letter HKEx-GL44-12 sets out specific guidance on pre-IPO investments in convertible instruments (e.g. convertible bonds, notes, loans and convertible preference shares).

Pre-IPO Investment

Pre-IPO Investment in Convertible Instruments

- ▶ In October 2012, the Exchange published a guidance letter (HKEx-GL44-12) to set out the current practice in dealing with convertible instruments issued to pre-IPO investors. Guidance on general principles re. special rights attached to pre-IPO investments can be found in GL43-12.
- ▶ The purpose → to set out the current practice in dealing with convertible instruments (i.e. convertible or exchangeable bonds, notes or loans and convertible preference shares) issued to pre-IPO investors.

Applicable Listing Rules

Main Board Listing Rule 2.03(2) (GEM Rule 2.06(2)):

- ▶ the issue and marketing of securities must be conducted in a fair and orderly manner and potential investors must be given sufficient information for making a properly informed assessment of an issuer.

Main Board Listing Rule 2.03(4) (GEM Rule 2.06(4)):

- ▶ all holders of listed securities must be treated fairly and equally.

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Pre-IPO Investment

- ▶ The concern with pre-IPO convertible instruments is that while these do not constitute shares, they may be structured so as to provide investors with a risk-return profile which is similar to, or better than, that of a shareholder.
- ▶ In the past, the Exchange has requested removal of conversion price reset mechanisms of convertible instruments and the termination of all atypical special rights for holders. This is to ensure the fair and equal treatment of all shareholders under the Rules.

Current Practice in Dealing With Convertible Instruments

a) Conversion price linked to IPO price or market capitalisation

- The conversion price for convertible instruments should be a fixed dollar amount or at the IPO price;
- Where instruments will be converted into shares at a price based on a guaranteed discount to the applicant's IPO price, or the conversion is linked to market capitalisation, this will create two different prices for the same securities at listing, which is inconsistent with the Rules;
- Discount to the applicant's IPO price or any linkage to the market capitalisation of shares may also give rise to concerns that the pre-IPO investors do not bear the same investment risk as public investors.

Pre-IPO Investment

b) Conversion price reset

- Any conversion price reset mechanism should be removed as they are contrary to the principles of the Listing Rules.
- **Example:** where the conversion price reset mechanism is based on the lower of a fixed price and a floating price, the price reset mechanism allows conversion at a discount to the fixed price. As the share price declines, the formulae would lead to more shares being issued, leading to greater dilution and greater potential for share price reduction which can work in a spiral.

c) Mandatory or Partial Conversions

- Partial conversion is only allowed if all atypical special rights are terminated after listing – this prevents the situation where a pre-IPO investor enjoys special rights as a bondholder, from converting a significant portion of their convertible instruments into shares while remaining entitled to the special rights by retaining a portion of the convertible instruments.

Pre-IPO Investment

d) Redemptions and Early Redemptions

- Certain convertible instruments give holders the option to redeem early at a price enabling the holders to receive a fixed internal rate of return (**IRR**) on the principal amount of the instruments redeemed.
- Upon maturity, all outstanding instruments will be payable at a price including the same fixed IRR.
(note: IRR is the interest rate needed in the discounting of cash flows to their present value so the investment's net present value is equal to zero)
- Exchange regards the IRR on the principal amount of the convertible instruments to be redeemed as compensation for the investment and risk undertaken by the holders.
- Early redemption is allowed and should be distinguished from other cases where the holders do not undertake any risk and the investment money is not yet paid.

e) Disclosure Requirements

- Additional disclosure is required due to the complexity of convertible instruments and their terms.
- Additional information must be disclosed in “Financial Information” and “Risk Factors” sections of the prospectus, to explain the impact of the instruments on the applicant, including if the applicant was called upon to redeem before maturity date.

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Pre-IPO Investment

- The additional disclosure requirements include:
 - i. Qualitative analysis on the cash flow and cash position in the event of redemption;
 - ii. Terms and impact of early redemption;
 - iii. Maximum number of shares that would be converted;
 - iv. Change in shareholding in the “Risk Factor” section; and
 - v. Expected source of cash inflows upon listing.

- Additional information to be disclosed in interim and annual reports to inform investors of the dilution impact:
 - i. Number of shares that may be issued upon full conversion of the outstanding convertible instruments;
 - ii. Dilutive impact on the issued share capital and respective shareholdings of the substantial shareholders;
 - iii. Dilutive impact on earnings per share;
 - iv. Analysis on the applicant’s financial and liquidity position at the relevant point in time, and discussion of its ability to meet its redemption obligations;
 - v. Number of shares that may be issued and the dilutive impact on shareholdings and earnings per share assuming that the holders have elected to have all interests under the instruments to be paid in kind; and
 - vi. Analysis on the applicant’s share price at which the holders will be indifferent to whether the instruments are converted or redeemed.

Cornerstone Investors

- ▶ Cornerstone Investors are usually large institutional investors or well-known individuals who are given a guaranteed allocation of shares in an IPO;
- ▶ Cornerstone placings are common, especially in difficult market conditions. Aim = to demonstrate confidence in the IPO.

Exchange's Guidance Letter (HKEx-GL51-13)

- ▶ No direct or indirect benefits are allowed to be given by side letter or otherwise to Cornerstone Investors, except for a guaranteed allocation of shares at the IPO price;
- ▶ Such practice would be misleading to the public and would violate the principle that all holders of listed securities must be treated fairly and equally;
- ▶ The non-disclosure of the existence of benefits would violate the requirements of the Listing Rules that all material information should be included in the prospectus.

Cornerstone Investors (Cont'd)

Cornerstone investments are generally permitted, provided that:

- the placing must be at the IPO price;
- the IPO shares placed are subject to a lock-up period (usually 6 months after listing);
- the cornerstone investors will not have board representation and are independent of the listing applicant, its connected persons and their respective associates;
- details of the cornerstone investors and the placing arrangement are included in the listing document; and
- the shares placed will be part of the public float under rule 8.08 of the Rules provided the investors are members of the public under rule 8.24.

Cornerstone Investors must be reclassified as pre-IPO investors if the investors receive any direct or indirect benefits such as

- a waiver of brokerage commission;
- a put option from the controlling shareholder or any other person to buy back the shares after the listing;
- sharing of underwriting commissions;
- an assurance that the listing applicant will re-invest the proceeds from the IPO in funds that are managed by the Cornerstone Investor;
- an agreement to allow an allocation of shares in another IPO; or
- any other transaction or arrangement entered into on non-arm's length commercial terms in relation to the acquisition of the IPO shares.

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Qualifications for MB listing of H share Cos

(a) Incorporation

- PRC issuer must be incorporated as a joint stock limited company in PRC.

(b) Suitability for listing

- Must satisfy Exchange that applicant and its business are suitable for listing

(c) Operating History and Management

- A Main Board applicant must have a trading record period of, and management continuity for, at least **3 financial years** and **ownership continuity and control** for at least the **most recent audited financial year**.

Exception:

- Under the market capitalisation/ revenue test, the Exchange may accept a shorter trading record period under substantially the same management if the new applicant can demonstrate that:
 - its directors and management have sufficient and satisfactory experience of at least 3 years in the line of business and industry of the new applicant; and
 - management continuity for the most recent audited financial year.

Qualifications for MB listing of H share Cos (Cont'd)

(d) Financial Tests – Applicants must meet one of the three financial tests:

	<u>Profit</u>	<u>Market Cap</u>	<u>Revenue</u>	<u>Cash flow</u>
<u>1. Profit test</u>	At least HK\$50 million in the last 3 financial years (with profits of at least HK\$20 million recorded in the most recent year, and aggregate profits of at least HK\$30 million recorded in the 2 years before that)	At least HK\$200 million at the time of listing		
<u>2. Market cap/ Revenue test</u>		At least HK\$4 billion at the time of listing	At least HK\$500 million for the most recent audited financial year	
<u>3. Market cap/ Revenue/Cash flow test</u>		HK\$2 billion at the time of listing	At least HK\$500 million for the most recent audited financial year	Positive cash flow from operating activities of at least HK\$100 million in aggregate for the 3 preceding financial years

- ❖ For both Tests 2 & 3, only revenue from **principal activities** (not revenue from incidental activities) will be recognised. Revenue from “book transactions” is disregarded.

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Qualifications for MB listing of H share Cos (Cont'd)

(e) Shares in public hands

- The Rules require:
 - (1) a **25%** public float;
 - (2) that the expected market capitalisation of shares held by the public at the time of listing must be **at least HK\$50 million**.
- Where a listing applicant has more than 1 class of securities apart from the H shares, the total securities held by the public **on all regulated market(s) including the Exchange** must be **at least 25%** of the issuer's total issued share capital. The H shares must not be **less than 15%** of the issuer's total issued share capital, having an expected market capitalisation at the time of listing **of at least HK\$50 million**.

Qualifications for MB listing of H share Cos (Cont'd)

(e) Shares in public hands (Cont'd)

Exchange's Discretion to Accept Lower Public Float (Rule 8.08(1)(d))

- For large companies, with an expected market capitalisation in excess of HK\$10 billion, the percentage required to be in public hands, may, at the Exchange's discretion, be lower (but not lower than 15%) provided that:
 1. the Exchange is satisfied that the number of securities and their distribution will enable the market to operate properly with a lower percentage;
 2. the issuer makes appropriate disclosure of the lower prescribed percentage of public float in the listing document;
 3. the issuer confirms the sufficiency of public float in successive annual reports after listing; and
 4. a sufficient proportion (to be agreed in advance with the Exchange) of any securities to be marketed contemporaneously in and outside Hong Kong, must normally be offered in Hong Kong.

- The waiver cannot be applied for post-listing if the issuer subsequently satisfies the HK10 billion market capitalisation requirement

Qualifications for MB listing of H share Cos (Cont'd)

(f) Minimum number of shareholders

- The minimum number of shareholders at the time of listing is 300.
- Not more than 50% of the publicly held shares can be beneficially owned by the 3 largest public shareholders.

(g) Market capitalisation at time of listing

Minimum expected market capitalisation of new applicant is:

- HK\$200 million for Profit Test applicants;
- HK\$4 billion for Market Capitalisation/Revenue Test applicants; or
- HK\$2 billion for Market Capitalisation/Revenue/Cash Flow Test applicants.

Determination of Market Capitalisation

- ▶ Expected market capitalisation at the time of listing is calculated on the basis of all issued share capital of the applicant including:
 - a. the class of securities to be listed;
 - b. any other class(es) of securities whether unlisted or listed on another regulated market.
- ▶ The expected issue price of the securities to be listed is used to determine the market value of securities that are unlisted or listed on other markets.

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Qualifications for MB listing of H share Cos (Cont'd)

(h) Working capital sufficiency

- Listing document must contain confirmation of sufficient working capital for at least next 12 months.
- The sponsor must provide written confirmation to the Exchange that it has obtained written confirmation from the applicant as to the sufficiency of the working capital and it is satisfied that the issuer's confirmation is given after due and careful enquiry.
- Sponsor to confirm existence of financing facilities.

(i) Competing Businesses

The Main Board Listing Rules allow competing businesses of an applicant's directors and "controlling shareholder(s)" provided that full disclosure is made at the time of listing and on an on-going basis.

- A "controlling shareholder" is person(s) controlling 30% or more of the voting power at general meetings; or the composition of a majority of the board of directors (PRC Governmental Bodies are not "controlling shareholders").

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Qualifications for MB listing of H share Cos (Cont'd)

(j) Accountants' report and accounting standards

Requirements:

- must cover 3 financial years prior to issue of listing document
- may be prepared in accordance with Chinese accounting standards as an alternative to Hong Kong or International Financial Reporting Standards
- Exchange may accept a Chinese firm of accountants as the reporting accountant and auditor of an H share company (if approved by China's Ministry of Commerce and the China Securities Regulatory Commission). H share company's accounts can be prepared in accordance with financial reporting standards issued by China Accounting Standards Committee and the China Ministry of Finance

(k) Directors and supervisors

- Collectively responsible for management and operations of listed issuer.
- Fiduciary duties and duties of due skill and care (Rules 3.08).
- Character, experience and integrity requirement (Rules 3.09 and 19A.18(2)).

Qualifications for MB listing of H share Cos (Cont'd)

(I) Independent non-executive directors

Minimum Number of INEDs

- Rules require appointment of a minimum of 3 INEDs. **At least 1/3** of an issuer's board must be INEDs (MB Rule 3.10A). Listed issuer to inform the Exchange and publish an announcement immediately if the number of its INEDs falls below the minimum or it does not have one qualified INED. It will have 3 months to rectify the situation.

Qualification of INEDs

- Rules require appointment of at least one INED with appropriate professional qualifications or accounting or related financial management expertise.

Independence will be questioned when the INED:

- (1) holds more than 1% of the issued share capital;
- (2) has received the issuer's shares as a gift or with financial assistance from the issuer or a connected person;
- (3) is a partner or director of a professional adviser to the issuer within the previous year or an employee involved in giving advice;
- (4) is or was in the previous 2 years a director or executive of the issuer, its group companies or connected persons.

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Qualifications for MB listing of H share Cos (Cont'd)

(m) Committees

- Establishment of an **audit committee** and **remuneration committee** is compulsory under Main Board Rules.
- Audit Committee must be made up only of non-executive directors, the majority must be INEDs of the issuer. Minimum of 3 members: at least one must be an INED with appropriate professional qualifications or accounting or related financial management expertise.
- Remuneration Committee must be made up of a majority of INEDs with written terms of reference and chaired by an INED.

(n) Sponsor

- A new applicant seeking a listing of equity securities on the Main Board must appoint one or more sponsors under a written engagement agreement to assist with its listing application (Rule 3A.02). Only firms that are licensed under part V of the Securities and Futures Ordinance for Regulated Activity Type 6 (Advising on Corporate Finance) and are permitted by their licence to conduct sponsor work are allowed to act as sponsors to new listing applicants.
- At least one sponsor must be independent of the listing applicant. The sponsor(s) must be appointed at least 2 months before submission of the listing application.

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Qualifications for MB listing of H share Cos (Cont'd)

(o) Compliance adviser

- PRC issuer must appoint a compliance adviser for the period commencing on initial listing and end on the publication of financial results for the first full financial year after listing.
- A compliance adviser must be either a corporation licensed or an authorised institution registered to advise on corporate finance matters under the SFO.
- Issuers must consult their compliance adviser:
 - before publication of any regulatory announcement or report, circular or financial report;
 - where a notifiable or connected transaction is contemplated (including share purchases and share repurchases);
 - where the issuer proposes to use IPO proceeds other than as set out in the Listing Document or where its business activities, developments or results differ from information in the Listing Document; and
 - where the Exchange makes an inquiry as to unusual movements in the price or trading volume of the issuer's securities.
- A compliance adviser to a PRC issuer is additionally required to inform the issuer on a timely basis of **any amendment or supplement** to the Listing Rules and any change to Hong Kong's laws, regulations or codes which apply to the issuer and **on continuing compliance** with the Listing Rules and applicable laws and regulations.

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Qualifications for MB listing of H share Cos (Cont'd)

(p) Mandatory Provisions for Articles of Association

- Apart from provisions set out in Appendix 3 and Appendix 13 Part D Section 1) of the Listing Rules, additional requirements for PRC issuers include, among others, provisions to reflect the different nature of domestic shares and overseas listed foreign shares (including H shares) and the different rights of their respective holders (Rule 19A.01(3)).

(q) Arbitration (Rule 19A.01(3))

- Disputes involving holders of H shares and arising from a PRC issuer's articles of association, or from any rights or obligations conferred or imposed by the Company Law and any other relevant laws and regulations concerning the affairs of the PRC issuer, are to be settled by arbitration in either Hong Kong or the PRC at the election of the claimant.

(r) Service agent (Rule 19A.13(2))

- The PRC issuer must appoint and maintain the appointment of a person authorised to accept service of process and notices on its behalf in Hong Kong.

(s) Receiving agent (Rule 19A.51)

- The PRC issuer must appoint a receiving agent in Hong Kong to receive dividends declared and other monies owing in respect of H shares.

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Qualifications for MB listing of H share Cos (Cont'd)

(t) Share register (Rule 19A.13(3)(a))

- PRC issuers must maintain a register for H shares in Hong Kong

(u) Management Presence (Rule 8.12)

- * This will normally mean that at least two of the executive directors must be ordinarily resident in Hong Kong. PRC issuers will generally seek a waiver from the Exchange from this requirement.

(v) Authorised Representatives (Rule 3.05)

- Every issuer must appoint 2 authorised representatives to act at all times as the issuer's principal channel of communication with the Exchange (either 2 directors or a director and the company secretary)

Responsibilities of an authorised representative

- being the principal channel of communication between the Exchange and the listed issuer; and
- to ensure that whenever he is outside Hong Kong suitable alternates are appointed, available and known to the Exchange.

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Qualifications for MB listing of H share Cos (Cont'd)

(w) Company Secretary (Rule 3.28)

- The academic or professional qualifications which the Exchange considers acceptable are membership of The Hong Kong Institute of Chartered Secretaries and being a Hong Kong solicitor, barrister or certified public accountant.
- A company secretary is not required to be resident in Hong Kong.

(x) Communication

- * There must be adequate communication and cooperation agreements in place between the Exchange and the relevant securities regulatory authorities in the PRC. If the PRC issuer has securities listed on another stock exchange, there must also be adequate communication arrangements in place with that stock exchange.

Listing Application Procedure

- ▶ At the time of application to list, an applicant must submit a draft listing document (the **Application Proof**) the information in which must be “**substantially complete**” except in relation to information that by its nature can only be finalised and incorporated at a later date (MB Rule 9.03(3));
- ▶ The Exchange has the power to **return** a listing application on the ground that the information in the listing application or Application Proof is not “substantially complete” (MB Rule 2B.01A & 9.03(3));
- ▶ If the Exchange returns a listing application to a sponsor before issuing its first comment letter to the sponsor, the initial listing fee will be refunded but in other cases it will be forfeited;
- ▶ If an application is returned, a new application **cannot be submitted until 8 weeks after** the Return Decision;
- ▶ The names of the applicant and sponsor(s) together with the return date will also be published on the Exchange’s website;
- ▶ Before submitting the listing application, the sponsor is required to perform all reasonable due diligence on the listing applicant (except in relation to matters that can only be dealt with later);
- ▶ Sponsors also have a duty to report to the Exchange any material information concerning non-compliance with Listing Rules or other regulatory requirements relevant to the listing.

Listing Application Procedure (Cont'd)

Other documents which must be submitted with the listing application include:

- ❖ Written confirmation by each director/supervisor that the information in the Application Proof is accurate and complete in all material respects and not misleading or deceptive;
- ❖ Reporting accountants' confirmation that no significant adjustment is expected to be made to the draft reports included in the Application Proof (Guidance Letter HKEx-GL58-13));
- ❖ Experts' confirmation – that no material change is expected to be made to their reports included in the Application Proof (see Guidance Letter HKEx-GL60-13);
- ❖ Draft letter from the sponsor confirming that it is satisfied that the directors' sufficiency of working capital statement has been made by the directors after due and careful enquiry; and
- ❖ Certified copy of the applicant's certificate of incorporation or equivalent.

Listing Application Procedure (Cont'd)

Initial 3-day check (from 1 Oct 2013 to 30 Sept 2014)

- ▶ the Application Proof will be subject to an initial 3-day check by the Exchange based on a prescribed checklist in Table B of Guidance Letter HKEx-GL56-13 (***the Initial 3-day Checklist***);
- ▶ If an Application Proof fails to include matters listed in the Initial 3-day Checklist or it is considered not substantially complete for other reasons (e.g. failure to include material information), the Exchange may return the listing application;
- ▶ At the end of this 3-day check, the Exchange will either confirm acceptance of the listing application for detailed vetting or will return the listing application with a letter detailing the reasons for its return;
- ▶ Since the initial 3-day check involves only a limited qualitative assessment, the Exchange may return a listing application for not being substantially complete after it accepts an application for detailed vetting following the 3-day check period;
- ▶ Listing applications returned during the initial 3-day check are also ***subject to an 8-week moratorium*** on filing a new application and the publication of the names of the sponsor(s) and listing applicant together with the date of the return.

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Listing Application Procedure (Cont'd)

- ❖ The Exchange will comment on the Application Proof within 10 business days from receipt of the application.
- ❖ Second and further rounds of comments (if any) are given within 10 business days from receipt of reply to the previous comment letter.
- ❖ If there is only one set of comments from Exchange, assuming sponsor takes 5 business days to respond, the listing application can be heard by the Listing Committee within around 25 business days.
- ❖ If there are 2 rounds of Exchange comments, assuming sponsor takes 5 business days to respond, the listing application can be heard by the Listing Committee within around 40 business days.
- ❖ If the listing is approved at the Listing Committee hearing, the Exchange will issue a letter requiring the posting of a near-final draft of the listing document (**PHIP**) on the Exchange's website. This must be submitted for publication before distribution of the red herring prospectus to institutional or other professional investors and before book-building commences.

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GEM Listing – Qualifications

▶ **Chapter 11** of the GEM Listing Rules sets out the basic requirements that must be met before any initial listing of equity securities on the GEM. **Chapter 25** contains additional requirements, modifications and exceptions to those requirements which apply to PRC incorporated companies.

a) Incorporation

The PRC issuer must be duly incorporated in the PRC as a joint stock limited company.

b) Suitability for Listing

Both the issuer and its business must, in the opinion of the Exchange, be suitable for listing (Rule 11.06). The Exchange may, in its discretion, refuse a listing of a PRC issuer's securities if it believes that it is not in the interest of the Hong Kong public to list them (Rule 25.07(1)).

c) Cash Flow Requirement

A GEM listing applicant must have a positive cashflow from operating activities in the ordinary and usual course of business of at least HK\$20 million in total for the 2 financial years immediately preceding the issue of the listing document.

GEM Listing – Qualifications (Cont'd)

d) Statement of Business Objectives (Rule 14.19)

A new applicant must include in its listing document a statement of business objectives setting out the following information:

- i. The overall business objectives;
 - ii. The market potential for the business over the period of the remainder of the current financial year of the applicant and the two financial years thereafter; and
 - iii. A detailed description of the new applicant's objectives for each of the products, services or activities (and any other objectives) analysed over the period comprising the remainder of the current financial year of the applicant and the two financial years thereafter (Rule 14.19).
- ❖ GEM issuers are required to report on the achievement of the business objectives stated in their listing documents in the annual and half year reports published in the first 2 full financial years after listing.

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GEM Listing – Qualifications (Cont'd)

e) Operating history and management

New applicants must have a trading record of at least two financial years with:

- (i) Management continuity throughout the 2 preceding financial years; and
- (ii) Ownership continuity and control throughout the preceding full financial year.

The Exchange may accept a shorter trading record and/or waive or vary the ownership and management requirements for:

- newly-formed 'project' companies; (for example a company formed for the purpose of a major infrastructure project);
- Mineral companies where the directors and senior management have > 5 years' relevant experience; and
- in exceptional circumstances under which the Exchange considers it desirable to accept a shorter period, provided the cash flow requirement of HKD 20 million for that shorter trading period is met.

GEM Listing – Qualifications (Cont'd)

(f) Market Capitalisation

GEM applicants must have a market cap of > HK\$100 million at the time of listing.

(g) Public float

- Minimum **25%** of the issuer's total issued share capital (HK\$30 million minimum) must be held by the public at all times (*11.23(7)*). If the issuer has more than one class of securities, the total securities in public hands at the time of listing must be 25% of the issuer's total issued share capital and the securities for which listing is sought must be at least 15% of the total issued share capital with an expected market cap of HK\$30 million at listing.
- Issuers with an expected market cap of over HK\$10 billion may have a lower percentage of between **15% - 25%** (*11.23(10)*).

(h) Minimum Number of shareholders

- There must be at least 100 public shareholders at the time of listing (Rule 11.23(2)(b)).
- In addition, not more than 50% of the securities in public hands at the time of listing can be beneficially owned by the three largest public shareholders.

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GEM Listing – Qualifications (Cont'd)

(i) Accountants' Report and Accounting Standards

- Must cover at least 2 financial years and can be prepared in accordance with either Chinese accounting standards, HK Financial Reporting Standards or International Financial Reporting Standards..

(j) Directors and Supervisors

- The board of directors of an issuer is collectively responsible for the management and operations of the user.

(k) Independent Non-Executive Directors (Same as MB applicants)

- A Minimum of 3 INEDs and INEDs must make up one third of board.
- One INED must have professional qualifications or accounting or related financial management expertise.
- INEDs of PRC issuers are further required to demonstrate an acceptable standard of competence and adequate commercial or professional experience to ensure that the interests of the general body of shareholders will be adequately represented (Rule 25.13).

GEM Listing – Qualifications (Cont'd)

(l) Audit Committee and Remuneration Committee

- Same as for Main Board applicants (see GEM Rules 5.28 – 5.36).

(m) Sponsor

- * A new applicant seeking a listing of equity securities on GEM must appoint one or more sponsors to assist with its listing application (Rule 6A.02). The listing application cannot be submitted less than 2 months after the appointment of the last sponsor to be appointed.

(n) Compliance Adviser

- A compliance Adviser must be appointed for remainder of financial year during which listing occurs and following **2 financial years**.
- Issuer must consult its Compliance Adviser in the same situations as Main Board Issuers.

(o) Compliance Officer

- * A GEM issuer must appoint one of its executive directors as a compliance officer to ensure that the issuer complies with the Listing Rules and the issuer responds promptly and efficiently to all enquiries by the Exchange.

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GEM Listing – Qualifications (Cont'd)

(p) Mandatory Provisions for Articles of Association (Appendix 3 of GEM Listing Rules)

- Appendix 11 Part C Section 1 → additional requirements for PRC issuers.
- The AA of a PRC Issuer must contain provisions reflecting different nature of domestic shares and overseas foreign shares (including H shares) and the different rights of their respective holders (Rule 25.01(3)).
- It must also provide for the appointment of a receiving agent in Hong Kong to receive from the issuer, and hold, pending payment, in trust for H shareholders, dividends declared and other moneys owing in respect of the H shares (Rule 25.38).

(q) Competing Business

- The GEM Listing Rules allow competing businesses of an applicant's directors and "controlling shareholder(s)" provided that full disclosure is made at the time of listing and on an on-going basis (in prospectus and periodic reports) (Rule 11.03).
- A "controlling shareholder" is person(s) controlling 30% or more of the voting power at general meetings; or the composition of a majority of the board of directors (PRC Governmental Bodies are not "controlling shareholders").

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GEM Listing – Qualifications (Cont'd)

(r) Arbitration (Rule 25.01(3))

- Disputes involving holders of H shares and arising from a PRC issuer's articles of association, or from any rights or obligations conferred or imposed by the Company Law and any other relevant laws and regulations concerning the affairs of the PRC issuer, are to be settled by arbitration in either Hong Kong or the PRC at the election of the claimant.

(s) Service agent (Rule 25.07)

- The PRC issuer must appoint and maintain the appointment of a person authorised to accept service of process and notices on its behalf in Hong Kong.

(t) Receiving agent (Rule 19A.51)

- The PRC issuer must appoint a receiving agent in Hong Kong to receive dividends declared and other monies owing in respect of H shares.

(u) Register of Shareholders (Rule 25.07)

- PRC issuers must maintain a register for H shares in Hong Kong.

GEM Listing – Qualifications (Cont'd)

(v) **Authorised Representatives (Rule 5.24)**

- Every issuer must have 2 authorised representatives at all times.

Responsibilities of an authorised representative (Rule 5.25)

- (i) Supplying the Exchange with contact details; and
- (ii) For so long as the issuer continues to have a Sponsor or Compliance Adviser, assisting the Sponsor or Compliance Adviser in their roles under the Listing Rules and, in particular the Sponsor's role as the principal channel of communication with the Exchange concerning the affairs of the issuer.

(w) **Company Secretary (Rule 5.14)**

- The secretary of the issuer must be a person who has the requisite knowledge and experience to discharge the functions of the secretary of the issuer and who possesses the qualifications prescribed under the GEM Listing Rules.

GEM Listing Division

GEM Listing Division

- ▶ The power to approve new listings has been delegated from the Listing Committee to the Listing Division. GEM applicants have a right of appeal to the Listing Committee against the Listing Division's initial decision on an IPO.
- ▶ Application for listing on the GEM is to be made to the Listing Division. All documents have to be submitted to the Listing Division which reviews all applications.

Restrictions following Listing

Restriction on Disposals of Shares by Controlling Shareholders

- ❖ Any person who is a controlling shareholder at the time of listing must not:
 - i. dispose of, nor enter into any agreement to dispose of, or create any options, rights, interests or encumbrances in respect of his shares in the listed issuer in the 6 months after the commencement of dealing in the issuer's securities on the Exchange;
 - ii. in the 6 months following the expiry of the period in (i) above, dispose of, nor enter into any agreement to dispose of, or create any options, rights, interests or encumbrances in respect of his shares in the listed issuer that would result in such person ceasing to be a controlling shareholder of the company.

Restrictions following Listing (Cont'd)

Restriction on New Issues of Shares

- ❖ A listed issuer cannot issue (or agree to issue) any shares or securities convertible into shares of the issuer in the 6 months following listing except for:
 - ▶ the issue of shares under a share option scheme under Chapter 17 of the Main Board Rules or Chapter 23 of the GEM Rules;
 - ▶ the exercise of conversion rights attaching to warrants issued as part of the IPO;
 - ▶ any capitalisation issue, capital reduction or consolidation or sub-division of shares;
 - ▶ the issue of shares or securities pursuant to an agreement entered into before the listing and disclosed in the issuer's listing document;
 - ▶ the issue of shares or securities to be traded on the Main Board by a listed issuer that has successfully transferred its listing from GEM to the Main Board;
 - ▶ for GEM issuers, the issue:
 - for the purpose of an acquisition of assets which would complement the listed issuer's business and the acquisition does not constitute a major (or above) transaction; and
 - does not result in a controlling shareholder ceasing to be a controlling shareholder after the issue.

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Continuing Obligations of Listed Companies

- ❖ Companies listed on the HK Exchange have a number of obligations under the Listing Rules and the Securities and Futures Ordinance. The Listing Rule obligations for Main Board and GEM issuers are virtually the same, the principal difference being in relation to the publication of quarterly financial reports and the deadlines for publication of financial statements.

Disclosure of Inside Information (i.e. Price Sensitive Information)

- ▶ Listed companies have a statutory obligation to disclose price sensitive information (called **inside information**) under Part XIVA SFO.
- ▶ Breach of statutory obligation is a civil offence subject to a maximum fine of HK\$8 million for listed companies and their directors.

What is Inside Information?

Inside information is defined as specific information that is about:

- ▶ the corporation;
- ▶ a shareholder or officer of the corporation; or
- ▶ the listed securities of the corporation or their derivatives; **and**
- ▶ is not generally known to the persons who are accustomed or would be likely to deal in the listed securities of the corporation but would if generally known to them be likely to materially affect the price of the listed securities.

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Definition of “Inside Information” (Cont’d)

Key elements of the definition

The three key elements of the definition are that:

- the information must be **specific**;
- the information **must not be generally known** to that segment of the market which deals or which would likely deal in the corporation’s securities; and
- the information would, if generally known be **likely to have a material effect on the price of the corporation’s securities**;
- SFC guidelines provide guidance on interpretation.

Definition of “Inside Information” (Cont’d)

Likely to have a material effect on the price of listed securities

- Test: whether the inside information would influence persons who are accustomed to or would be likely to deal in the company’s shares, in deciding whether to buy or sell the shares.

Examples of possible Inside Information (Non-Exhaustive)

- Changes in performance, or the expectation of performance, of the business or its financial condition;
- Changes in financial conditions: cashflow crisis, credit crunch;
- Changes in directors and their service contracts;
- Changes in auditors or any information related to their activity;
- Changes in the share capital, e.g. new share placing, bonus issue, rights issue, share split etc.;
- Issue of debt securities, options or warrants to subscribe for shares;
- Takeovers and mergers;
- Purchase or disposal of equity interests or other major assets etc.;
- Legal disputes and proceedings;
- Changes in expected earnings or losses;
- Insolvency of relevant debtors;
- Reduction of real properties' values;
- Orders received from customers, their cancellation or important changes;

Timing of disclosure

- ▶ Companies must announce inside information as soon as reasonably practicable after it has come to the corporation's knowledge (i.e. when the inside information has, or ought reasonably to have, come to the knowledge of an officer (a director, manager or secretary)).
- ▶ Companies must therefore have effective systems and procedures in place to ensure that any material information which comes to the knowledge of any of their officers is promptly identified and escalated to the board to determine whether it needs to be disclosed.
- ▶ The company must ensure that the information is kept strictly confidential until it is publicly disclosed. If the company believes that confidentiality cannot be maintained or has been breached, it must immediately announce the information.
- ▶ Company may issue a "holding announcement" to give it time to clarify the details and likely impact of an event before full announcement.
- ▶ Inside information must be disclosed to the public by means of an announcement published on the websites of the Exchange and the listed company.

The Safe Harbours

4 situations where companies are not required to disclose inside information:

1. if disclosure would **breach an order by a HK court or any provisions of other HK statutes**;
2. if the information relates to an **incomplete proposal or negotiation** (e.g. a contract is being negotiated but has not been finalised);
3. if the information is a **trade secret**; or
4. if the information concerns the provision of **liquidity support** from the Government's Exchange Fund or a Central Bank (or institution performing such functions, inside or outside HK).

Companies can only rely on the safe harbours in paragraphs 2, 3 and 4 if they have taken reasonable precautions to preserve the confidentiality of the inside information and the inside information has not been leaked.

If confidentiality is lost or information is leaked, company must announce the information as soon as practicable.

Liability of officers

A listed company's officers are required to take all reasonable measures to ensure that proper safeguards exist to prevent the company's breach of the disclosure requirement. If a listed company breaches the disclosure obligation, an officer of the company will also have breached the obligation if either:

- ▶ the breach resulted from the officer's intentional, reckless or negligent conduct; or
- ▶ the officer has not taken all reasonable measures to ensure that proper safeguards exist to prevent the breach.

The SFC Guidelines focus on the responsibility of officers, including non-executive directors, to ensure that appropriate systems and procedures are put in place and reviewed periodically to enable the company to comply with the disclosure requirement. Officers with an executive role also have a duty to oversee the proper implementation and functioning of the procedures and to ensure the detection and remedy of material deficiencies in a timely manner.

Possible penalties include:

- a fine of up to HK\$8 million on the company, a director or chief executive (but not officer);
- disqualification of a director or officer for up to 5 years.

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Obligation to respond to HKEx

- Under Main Board Rule 13.10 (GEM Rule 17.11), the Exchange may make enquiries of listed issuers regarding unusual movements in the price or trading volume of securities, the possible development of a false market and other matters.
- An issuer that receives an enquiry must respond by:
 - providing (and announcing, if so required by the Exchange) any information it has that is relevant to the subject matter of the enquiry, so as to inform the market or to clarify the situation; **or**
 - if appropriate and if requested by the Exchange, issuing a standard announcement confirming that the directors, **having made such enquiry with respect to the issuer as may be reasonable in the circumstances**, are not aware of any information that is or may be relevant to the subject matter of the enquiry or of any inside information that needs to be disclosed under the SFO.
- The latter response should be made in a standard form that is set out in Note 1 to Main Board 13.10.

Announcements

▶ Announcements

The Listing Rules require listed companies to publish announcements in a wide range of situations. Announcements are published on the websites of the Exchange and the listed company. Matters which must be announced include (among others):

- **Inside Information** must be announced and kept strictly confidential until a formal announcement is made.
- **Notifiable transactions** – any notifiable transaction within Chapter 14 of the Main Board Rules (GEM Chapter 19).
- **Connected transactions** – any connected transaction (unless an exemption is available) within Chapter 14A of the Main Board Rules (Chapter 20 of the GEM Rules).
- **Board meeting for approval of financial results** – an issuer must publish an announcement at least 7 clear business days before the date of a board meeting at which profits or losses are to be approved for publication (Main Board Rule 13.43/GEM Rule 17.48).
- **Annual, half-year and quarterly results** – must be published by way of announcement.
- **Change in auditor or financial year end**

Announcements (Cont'd)

- **Memorandum and Articles of Association** – any proposed alteration of the memorandum or articles of association of the listed issuer.
- **Change in directors or supervisors** – any change of directors, supervisors or the chief executive.
- **Notice of general meetings** – notice of an issuer's annual general meeting and other general meetings must be announced.
- **Issues of securities** – an issue of securities (including convertible securities or warrants, options or similar rights) will almost always require an announcement.
- **Public float** – the company must inform the Exchange immediately if it becomes aware that the number of listed securities required to be held by the public has fallen below the prescribed minimum percentage (i.e. 25% unless a lower percentage of between 15% and 25% was approved by the Exchange on listing).
- **Share Repurchases** – any purchase, sale, drawing or redemption by the company or its group members of its listed securities.

Disclosure of Financial Information

Annual Report and Accounts

Qualifications of auditors

Practising accountants of good standing; independent of the PRC issuer under the Companies Ordinance and in accordance with the statements on independence issued by the International Federation of Accountants.

If the PRC issuer's primary listing is to be on the Exchange

1. Qualified under the Professional Accountants Ordinance; OR
2. An accountants' firm with international name, reputation and being a member of a recognised body of accountants; OR
3. A joint venture accountants' firm approved by the CSRC to act as an auditor of PRC listed companies and at least one of the joint venture partners is qualified under 1 or 2; OR
4. An accountants' firm approved by MOF and CSRC as being suitable to act as an auditor or a reporting accountant for PRC listed companies.

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Disclosure of Financial Information (Cont'd)

Annual Report and Accounts

Audit standards

- A standard comparable to that required in HK or under International Standards on Auditing or China Auditing Standards.
- The auditors' report must be annexed to all copies of the annual accounts and indicate whether the accounts give **a true and fair view**.
- If the PRC issuer is not required to prepare accounts to give a true and fair view, it can prepare them to an equivalent standard only if allowed by the Exchange.

Disclosure of Financial Information (Cont'd)

Annual Report and Accounts

Timing of Distribution of Annual Report

- ▶ Listed companies must send a copy of their annual report to every shareholder of the company and every holder of the company's listed securities:
 - not less than **21 days** before the date of the company's AGM; and
 - not later than:
 - **4 months** after the financial year end for **Main Board** listed companies; or
 - **3 months** after the financial year end for **GEM** listed companies.

- ▶ In the case of overseas shareholders, the company may mail the English version only **provided that** a statement is included that a Chinese language version is available from the company on request.

Disclosure of Financial Information (Cont'd)

Half-year reports and accounts

- ▶ Main Board listed companies must send half-year reports to the company's shareholders and holders of the company's listed securities **within 3 months of the end of the first 6 months** of each financial year.
- ▶ GEM listed companies must publish half-year reports within **45 days of the end of the first 6 months** of each financial year and must send reports to shareholders and securities holders as soon as practicable after publication.
- ▶ Financial statements in the half-year report are generally unaudited. This fact must be stated. If audited, the auditors' report and any qualifications must be included.
- ▶ Half-year reports must be **reviewed by the Audit Committee**

Quarterly Reporting

- ▶ For Main Board listed companies – quarterly reporting is not mandatory. It is a Recommended Best Practice under the Corporate Governance Code.
- ▶ Once a Main Board company decides to publish quarterly results, an announcement is required disclosing the reasons for any decision not to publish results for any particular quarter.
- ▶ GEM listed companies must publish quarterly reports.
- ▶ Publication must be within 45 days of the end of relevant quarter.

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Disclosure of Financial Information (Cont'd)

Preliminary Announcements of Results

- A preliminary announcement of a **Main Board company's** annual and half-year results must be published on the business day after their approval by the board and:
 - for Annual Results → within 3 months of the financial year end.
 - for Half-year Results → within 2 months of the half-year end.
- A preliminary announcement of a **GEM company's** annual and half-year results must be published on the business day after their approval by the board and:
 - for Annual Results → within 3 months of the financial year end.
 - for Half-year Results → within 45 days of the half-year end.
 - for Quarterly Results → within 45 days of the quarter end.
- The Exchange may suspend dealings in a listed company's shares or cancel the listing if a listed company fails to publish its financial information on time.

Notifiable Transactions

- Chapter 14 of the Main Board Listing Rules (GEM Chapter 19) sets out detailed requirements in respect of certain transactions, principally acquisitions and disposals by a listed issuer.
- “Listed Issuer” → both the listed issuer itself and its subsidiaries
- The requirements include obligations to notify the Exchange, disclose the transaction to the public by publication of an announcement and to obtain prior shareholders’ approval depending on the size of the transaction.

Definition of transaction includes (among others)

- a) an **acquisition or disposal** of assets;
- b) a grant, acceptance, transfer, exercise or termination of **an option to acquire or dispose of assets or to subscribe for securities**;
- c) entering into or terminating **finance leases** where the financial effects of such leases have an impact on the balance sheet and/or profit and loss account of the listed issuer;

Notifiable Transactions (Cont'd)

Definition of transaction (Cont'd)

- d) entering into or terminating operating leases which, by virtue of their size, nature or number, have a significant impact on the operations of the listed issuer;
 - e) granting **an indemnity** or a **guarantee** or providing **financial assistance**, except to the listed issuer's own subsidiaries; and
 - f) entering into a **joint venture entity** in any form.
- ▶ the definition of “transaction” excludes any transaction of a revenue nature in the ordinary and usual course of business of the listed issuer.

Notifiable Transactions (Cont'd)

Transaction Type	Assets Ratio	Consideration Ratio	Profits Ratio	Revenue Ratio	Equity Capital Ratio
Shared Transaction	<5%	<5%	<5%	<5%	<5%
Discloseable Transaction	5%< >25%	5%< >25%	5%< >25%	5%< >25%	5%< >25%
Major-Transaction Disposable	25%< >75%	25%< >75%	25%< >75%	25%< >75%	Not Applicable
Major-Transaction acquisition	25%< >100% or >75%				
Very substantial disposable	75% or more	75% or more	75% or more	75% or more	Not Applicable
Very substantial acquisition	100% or more				

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Notifiable Transactions (Cont'd)

- **Share transaction:** an acquisition of assets (excluding cash) by a listed issuer where the consideration includes securities for which listing will be sought and where all percentage ratios are less than 5%;
- **Discloseable transaction:** a transaction or a series of transactions by a listed issuer where any percentage ratio is 5% or more, but less than 25%;
- **Major transaction:** a transaction or a series of transactions by a listed issuer where any percentage ratio is 25% or more, but less than 100% for an acquisition or 75% for a disposal;
- **Very substantial disposal:** A disposal or a series of disposals of assets (including deemed disposals) by a listed issuer where any percentage ratio is 75% or more;
- **Very substantial acquisition:** An acquisition or a series of acquisitions of assets by a listed issuer where any percentage ratio is 100% or more; and
- **Reverse takeover:** 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

Notifiable Transactions (Cont'd)

- ***“Reverse Takeover”***
 - a) an acquisition/series of acquisitions of assets **constituting a very substantial acquisition** where there is or which will result in a **change in control** (i.e. 30% or more of the voting rights) of the listed issuer; or
 - b) an acquisition/series of acquisitions of assets **from the incoming controlling shareholder(s) or his/their associates within 24 months after the change in control of the listed issuer** that had not been regarded as a reverse takeover, which individually or together **reach the threshold for a very substantial acquisition**.

Notifiable Transactions (Cont'd)

- ***“Percentage Ratios” – the “Five Tests”***
 - Assets ratio: the total assets which are the subject of the transaction divided by the total assets of the listed issuer;
 - Profits ratio: the profits attributable to the assets which are the subject of the transaction divided by the profits of the listed issuer;
 - Revenue ratio: the revenue attributable to the assets which are the subject of the transaction divided by the revenue of the listed issuer;
 - Consideration ratio: the consideration divided by the total market capitalisation of the listed issuer. The total market capitalisation is the average closing price of the listed issuer’s securities as stated in the Exchange’s daily quotations sheets for the five business days immediately preceding the date of the transaction; and
 - Equity capital ratio: the nominal value of the listed issuer’s equity capital issued as consideration divided by the nominal value of the listed issuer’s issued equity capital immediately before the transaction. The value of the listed issuer’s debt capital (if any), including any preference shares, is not included in the calculation of the equity capital ratio.
 - The Exchange may require aggregation of a series of transactions and treat them as one transaction if they were completed within 12 months or are related.

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Notifiable Transactions (Cont'd)

	<u>Notification to exchange</u>	<u>Short suspension of dealings</u>	<u>Publication of announcement</u>	<u>Circulation to shareholders</u>	<u>Shareholder approval</u>	<u>Accountants reports</u>
<u>Share transaction</u>	Yes	Yes	Yes	No	No ¹	No
<u>Disclosable transaction</u>	Yes	No unless there is inside information	Yes	No	No	No
<u>Major transaction</u>	Yes	Yes	Yes	Yes	Yes ²	Yes ³
<u>Very substantial disposal</u>	Yes	Yes	Yes	Yes	Yes ²	No ⁵
<u>Very substantial acquisition</u>	Yes	Yes	Yes	Yes	Yes ^{2, 6}	Yes ⁴
<u>Reverse takeover</u>	Yes	Yes	Yes	Yes	Yes ^{2, 6}	Yes ⁴

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Notifiable Transactions (Cont'd)

Consequences of entering into a notifiable transaction (Cont'd)

Notes to the table

1. No shareholder approval is necessary if the consideration shares are issued under a general mandate. However, if the shares are not issued under a general mandate, the listed issuer is required to obtain shareholders' approval in general meeting prior to the issue of the consideration shares.
2. Any shareholder and his associates must abstain from voting if such shareholder has a material interest in the transaction.
3. An accountants' report on the business, company or companies being acquired is required.
4. An accountants' report on any business, company or companies being acquired is required.
5. A listed issuer may at its option include an accountants' report.
6. Approval of the Exchange is necessary.

Notifiable Transactions (Cont'd)

Notification and Announcement Requirements

As soon as possible after the terms of a notifiable transaction have been finalised, the listed issuer must:

1. inform the Exchange; and
2. publish an announcement on the websites of the Exchange and the listed issuer.

Circular to Shareholders

- Circulars for major transactions to be approved in general meeting, very substantial acquisitions and very substantial disposals, must be sent to shareholders **on or before the deadline** for giving notice of the GM under the PRC Company Law. The deadline for giving notice under PRC Company Law is **20 days in the case of a GM** and **15 days for a SGM**.

Notifiable Transactions (Cont'd)

Shareholders' Approval Requirements

- Major Transactions, Very Substantial Disposals, Very Substantial Acquisitions and Reverse Takeovers must be made conditional on approval by shareholders in general meeting.
- Any shareholder that has a material interest in the transaction must abstain from voting.

Notifiable Transactions – Reverse Takeovers

Requirements for Reverse Takeovers (RTOs)

- Exchange will treat an issuer proposing an RTO as a new listing applicant.
- Enlarged group or assets to be acquired must be able to meet the financial tests for listing and all other basic listing requirements.
- Listed issuer must appoint a sponsor, issue a prospectus and pay an initial listing fee.

Connected Transactions

Detailed rules in MB Chapter 14A (GEM Chapter 20) on transactions between listed issuer's group and its connected parties

Objectives:

- ▶ To ensure that a listed issuer takes into account the interests of shareholders as a whole when it enters into connected transactions;
- ▶ To provide safeguards against the directors, chief executive and substantial shareholders (or their associates) taking advantage of their positions. This is achieved by the general requirement of **independent shareholders' approval** for connected transactions.
- ▶ “Connected Transactions” → generally any transaction between a listed issuer or any of its subsidiaries and a connected person.
- ▶ For classification purposes, the Exchange may aggregate a series of transactions that are completed over a 12-month period or are otherwise related.

Connected Transactions (Cont'd)

Definition of "Transaction"

- the acquisition or disposal of assets;
 - any transaction involving an option to acquire or dispose of assets or to subscribe for securities;
 - entering into or terminating finance or operating leases;
 - granting an indemnity or a guarantee or providing financial assistance;
 - entering into a joint venture;
 - issuing new securities;
 - provision or receipt of services;
 - sharing of services;
 - providing or acquiring raw materials, intermediate products and finished goods; and
 - a qualified property acquisition.
- ❖ The definition includes transactions of a revenue nature entered into in the ordinary and usual course of the listed issuer's business.

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Connected Transactions (Cont'd)

Definition of “Connected Person”

- a) a **director, supervisor, chief executive or substantial shareholder** (holding 10% or more of the voting rights) of the listed issuer or any of its subsidiaries, or an **associate** of any such persons;
- b) a **person who was a director** of the listed issuer or any of its subsidiaries in the past 12 months, or an **associate** of such a person; or
- c) a **non-wholly owned subsidiary** of the listed issuer where any connected person(s) at the issuer level are entitled to exercise, or control the exercise of, **10% or more of the voting power** at general meetings of the non-wholly owned subsidiary or a **subsidiary of such a non-wholly owned subsidiary**

Note: a wholly-owned subsidiary of a listed issuer is **not** a connected person.

Connected Transactions (Cont'd)

Definition of “Associates of an individual”

- ▶ his spouse, his (or his spouse’s) child or step-child (natural or adopted) under the age of 18 years (each an “**immediate family member**”);
- ▶ the trustees, acting in their capacity as trustee of any trust of which the **individual** or his **immediate family member** is a beneficiary or, in the case of a discretionary trust, is (to his knowledge) a discretionary object (the “**trustees**”).
- ▶ a company in which the **individual**, his **immediate family members** and/or the **trustees** (individually or together) control the exercise of **30%** or more of the voting power or control the composition of a majority of the board of directors, and **any subsidiary** of such company;
- ▶ a person cohabiting with him as a spouse, or his child, step-child, parent, step-parent, sibling or step-sibling (each a “**family member**”);

Connected Transactions (Cont'd)

Definition of “Associates of an individual” (Cont'd)

- ❖ a company in which the **family members** (individually or together), or the **family members** together with the **individual**, his **immediate family members** and/or the **trustees** control the exercise of **50%** or more of the voting power or control the composition of a majority of the board of directors, and any of its **subsidiaries**;
- ❖ a parent-in-law, brother-in-law, sister-in-law, son-in-law, daughter-in-law, grandparent, grandchild, uncle, aunt, nephew, niece or cousin of the connected person (each a “**relative**”) whose association with the **connected person** is such that, in the opinion of the Exchange, the proposed transaction should be subject to the connected transaction requirements; and
- ❖ a company in which the **relatives** (individually or together) or the relatives together with the connected person, the trustees, his immediate family members and/or family members control the exercise of **50%** or more of the voting power or control the composition of a majority of the board of directors, and any of its **subsidiaries**, whose association with the **connected person** is such that, in the opinion of the Exchange, the proposed transaction should be subject to the connected transaction requirements.

Connected Transactions (Cont'd)

Definition of “Associates of a Company”

- a) its **subsidiary** or **holding company**, or **fellow subsidiary** of such a holding company (together, the “**group companies**”));
 - b) the trustees of any trust of which the company is a beneficiary or, to the company’s knowledge, discretionary object (the “**trustees**”);
 - c) a company in which the company, the group companies and/or the trustees (individually or together), can:
 - exercise or control the exercise of **30%** or more of the voting power at general meetings; or
 - control the composition of a majority of the board of directors; and
 - d) a subsidiary of a company in (c).
- ❖ ***The Exchange will not normally treat a PRC Governmental Body as a connected person of a PRC issuer***

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Connected Transactions (Cont'd)

Deemed Connected Persons

The Exchange has the power to deem a person or entity as an issuer's connected person where:

- ❖ the person or entity has entered, or proposes to enter, into:
 - a transaction with the group; and
 - an agreement, arrangement, understanding or undertaking (whether formal or informal and whether express or implied) with respect to the transaction with a director, chief executive, supervisor or substantial shareholder of the issuer or any of its subsidiaries or a person who was such a director within the previous 12 months; and
- ❖ the person or entity should, in the Exchange's opinion, be considered as a connected person.

Connected Transactions where there is no transaction with a connected person

A transaction between an issuer and a non-connected person will constitute a connected transaction if:

- ❖ it involves an acquisition of an interest in a company; and
- ❖ a substantial shareholder of that company is (or will become) a controller (i.e. a director, chief executive or controlling shareholder of the listed issuer) or an associate of a controller of the listed issuer.

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Connected Transactions (Cont'd)

“Financial assistance”

- Financial assistance includes granting credit, lending money, providing security for, or guaranteeing a loan.
- Financial assistance provided by/to a listed issuer or its subsidiaries will constitute a connected transaction where it is provided to/by:
 - a connected person; or
 - a Commonly Held Entity.
- “Commonly Held Entity” refers to a company whose shareholders include: (a) a member of the listed issuer’s group; and (b) a connected person(s) at the issuer level, who (individually or together) can exercise or control the exercise of 10% or more of the voting power at the company’s general meeting.

Connected Transactions (Cont'd)

Options involving Connected Persons

- ❖ The grant, acceptance, transfer, exercise or non-exercise of an option by a listed issuer to or from its connected person is a connected transaction and is classified by reference to the percentage ratios (except the profits ratio).
- ❖ Termination of an option by a listed issuer is a “transaction” unless termination is in accordance with the terms of the original agreement and there is no payment of any penalty, damages or other compensation.

Joint ventures involving Connected Persons

- ❖ The entering into of any arrangement or agreement involving the formation of a joint venture entity in any form by a listed issuer and a connected person is a connected transaction.

Connected Transactions (Cont'd)

Continuing Connected Transactions

- Continuing connected transactions are connected transactions that:
 - a) involve the provision of goods, services or financial assistance;
 - b) are carried out on a continuing or recurring basis; and
 - c) are expected to extend over a period of time.

They are usually transactions in a group's ordinary and usual course of business.

Classification of Connected and Continuing Connected Transactions

- Connected and continuing connected transactions fall into three categories:
 - a) Non-exempt transactions which must be: (i) reported in the listed issuer's annual report; (ii) announced on the websites of the Exchange and the listed issuer; and (iii) made conditional on being approved by the issuer's independent shareholders;
 - b) Transactions exempt from the reporting, announcement and independent shareholders' approval requirements ("**wholly exempt**" transactions); and
 - c) Transactions exempt from the independent shareholders' approval requirement only (but subject to the reporting and announcement requirements) ("**partially exempt**" transactions).

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Connected Transactions (Cont'd)

Connected Transaction Requirements

- ❖ The listed issuer must enter into a written agreement with all relevant parties in respect of the connected transaction.
- ❖ **Independent board committee and financial adviser** – An independent board committee must be established to advise shareholders as to:
 - whether the terms of the connected transaction are fair and reasonable;
 - whether the transaction is in the interests of the listed issuer and the shareholders as a whole; and
 - how to vote, taking into consideration the views of the independent financial adviser.
- ❖ An **independent financial adviser** acceptable to the Exchange must be appointed to make recommendations to the independent board committee as to the matters set out above.
- ❖ Additional requirements apply to continuing connected transactions including requirements that:
 - the agreement does not exceed 3 years;
 - a maximum annual cap must be set; and
 - the transactions must be reviewed annually by the issuer's INEDs and auditors.

Connected Transactions (Cont'd)

Exemptions from Connected Transaction Requirements – Wholly exempt

There are a number of exemptions from the connected transactions requirements including (among others):

- **Intra-group transactions** – Transactions between a listed issuer and a non wholly-owned subsidiary or between its non wholly-owned subsidiaries are wholly exempt where:
 - a) none of the subsidiaries concerned are connected persons; and
 - b) no connected persons at the issuer level exercise or control the exercise of 10% or more of the voting power at any general meeting of any of the subsidiaries concerned.

- **De minimis transactions** – Transactions on normal commercial terms are wholly exempt where each or all of the percentage ratios except the profits ratio is/are:
 - (a) Less than 0.1%;
 - (b) less than 1% and the transaction is a connected transaction only because it involves a connected person at the subsidiary level; or
 - (c) less than 5% and the total consideration is less than HK\$3 million.

Connected Transactions (Cont'd)

Exemptions from Connected Transaction Requirements – Partially exempt

- Connected transactions are exempt from the independent shareholders' approval requirement only (and are subject to the reporting and announcement requirements) where each or all of the percentage ratios (except the profits ratio) is/are:
 - a) less than 5%; or
 - b) less than 25% and the total consideration is less than HK\$10 million.

Corporate Governance Code

- The Corporate Governance Code (the “Code”) has two levels of recommended practices.
- The first level contains “Code Provisions”.
- Companies must state in their half-year and annual reports whether they have complied with the Code Provisions and give reasons for any non-compliance.
- The second level consists of recommended best practices which listed companies are encouraged to adopt.
- The Code covers 5 principal areas: Directors; Remuneration of Directors and Senior Management; Accountability and Audit; Delegation by the Board and Communication with Shareholders.

The Model Code For Security Transactions by Directors & Supervisors Of Listed Companies (“Model code”)

Listed companies are required to adopt rules governing dealings by directors and supervisors in their listed securities on terms no less stringent than the terms set out in the Listing Rules.

Absolute Prohibition

A director or supervisor of a listed issuer is prohibited from dealing in the securities of the company:

- at any time when he is in possession of unpublished inside information in relation to those securities;
- on the publication date of the company’s financial results;
- during the 60 days preceding the publication of the annual results or, if shorter, the period from the end of the relevant financial year up to the publication date of the results; and
- during the 30 days preceding the publication date of the quarterly or half-year results or, if shorter, the period from the end of the relevant quarter or half-year up to the publication date of the results.

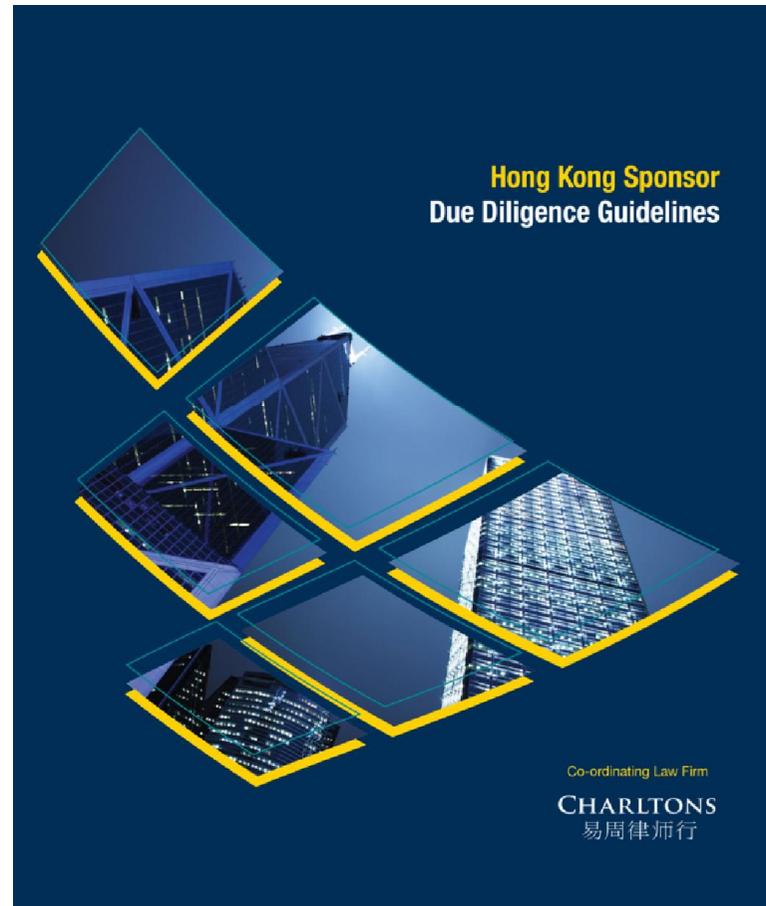
The Model Code For Security Transactions by Directors & Supervisors Of Listed Companies (“Model code”)

- ▶ A director or supervisor of a listed issuer is also prohibited from dealing in the securities of a listed issuer if he is in possession of inside information in relation to those securities by virtue of his position as a director of another listed issuer.
- ▶ The restrictions on dealings in the Model Code apply equally to dealings by directors’/supervisors’ spouses and children under the age of 18 and to any dealings in which they are deemed to be interested.

Duty of Notification

Listed companies must establish a procedure requiring directors and supervisors to give written notification to the chairman or a director designated by the board and receive a dated written acknowledgement before dealing in any securities of the listed company.

Hong Kong Sponsor Due Diligence Guidelines



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Hong Kong Sponsor Due Diligence Guidelines

- ❖ In 2013, Charltons led a group of 20 leading Hong Kong corporate law firms and 40 investment banks in the production of the Hong Kong Sponsor Due Diligence Guidelines;
- ❖ Provide practical guidance on the due diligence that needs to be conducted on companies listing on the Hong Kong Stock Exchange in order to comply with new requirements that came into effect on 1 October 2013;
- ❖ Contain 3 main sections:
 - Standards – sponsors’ due diligence obligations under Hong Kong laws & regulations;
 - Guidance – the market’s interpretation of the standards; and
 - Recommended Steps - practical steps to meet the Standards;
- ❖ Comprehensive handbook for practitioners –incorporates relevant regulatory standards and guidance from the Hong Kong regulators and industry guidance;
- ❖ English version of the Due Diligence Guidelines was published in September 2013 and is available free online at <http://duediligenceguidelines.com>;
- ❖ The Chinese version of the Guidelines is also available free online at <http://duediligenceguidelines.cn/>;
- ❖ The Chinese translation of some chapters is being finalised but these will be available online in the very near future.

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