

## ► Pre-IPO investments in Hong Kong

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**October 2014**

**CHARLTONS**  
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# Pre-IPO equity investment

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## 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 → to 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 equity investment (cont'd)

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- ▶ 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, is disallowed.

## Pre-IPO equity investment (cont'd)

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### PERMISSIBILITY OF SPECIAL RIGHTS/OBLIGATIONS (cont'd)

- ▶ **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.
- ▶ **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.

# Pre-IPO equity investment (cont'd)

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## PERMISSIBILITY OF SPECIAL RIGHTS/OBLIGATIONS (cont'd)

### 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.

## Pre-IPO equity investment (cont'd)

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### 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.

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## Pre-IPO equity investment (cont'd)

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### 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.

## Pre-IPO equity investment (cont'd)

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### PERMISSIBILITY OF SPECIAL RIGHTS/OBLIGATIONS (cont'd)

- ▶ **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 Price Sensitive Information (PSI), the issuer needs to comply with the statutory PSI disclosure regime in Part XIVA SFO.

## Pre-IPO equity investment (cont'd)

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### 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.

## Pre-IPO equity investment (cont'd)

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### PERMISSIBILITY OF SPECIAL RIGHTS/OBLIGATIONS (cont'd)

#### ▶ **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 in convertible instruments

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## 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 in convertible instruments (cont'd)

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- ▶ 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.

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## Pre-IPO investment in convertible instruments (cont'd)

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### Current Practice in Dealing With Convertible Instruments (cont'd)

#### 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 formula 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 in convertible instruments (cont'd)

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### Current Practice in Dealing With Convertible Instruments (cont'd)

#### 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.

# Pre-IPO investment in convertible instruments (cont'd)

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## Current Practice in Dealing With Convertible Instruments (cont'd)

### 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.

## Pre-IPO investment in convertible instruments (cont'd)

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- ▶ The additional disclosure requirements include:
  - 1) Qualitative analysis on the cash flow and cash position in the event of redemption;
  - 2) Terms and impact of early redemption;
  - 3) Maximum number of shares that would be converted;
  - 4) Change in shareholding in the “Risk Factor” section; and
  - 5) Expected source of cash inflows upon listing.

## Pre-IPO investment in convertible instruments (cont'd)

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- ▶ Additional information to be disclosed in interim and annual reports to inform investors of the dilution impact:
  - 1) Number of shares that may be issued upon full conversion of the outstanding convertible instruments;
  - 2) Dilutive impact on the issued share capital and respective shareholdings of the substantial shareholders;
  - 3) Dilutive impact on earnings per share;
  - 4) 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;
  - 5) 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
  - 6) Analysis on the applicant's share price at which the holders will be indifferent to whether the instruments are converted or redeemed.

## Cornerstone investors

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- ▶ 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)

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**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 (cont'd)

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**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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- ▶ Charltons have representative offices in Shanghai, Beijing and Yangon
- ▶ Charltons was named the **"Corporate Finance Law Firm of the Year in Hong Kong"** in the Corporate Intl Magazine Global Award 2014
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