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# Changes To Connected Transaction Rules Effective 3 June, 2010

The Stock Exchange of Hong Kong Limited ("**HKEx**") has published its consultation conclusions ("**Consultation Conclusions**") on its proposals to amend the connected transaction rules contained in its consultation paper of 2 October 2009. The amended rules came into effect on **3 June 2010**.

The Consultation Conclusions are available [on HKEx's website](http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp200910ctcc.pdf). Our newsletter summarising the proposals in the consultation paper is available on our website [here](http://www.charltonslaw.com/en/index.htm) (Resources - Newsletters - Hong Kong law, Issue 84 – December 2009).

The amended [Main Board](http://www.hkex.com.hk/eng/rulesreg/listrules/mbrulesup/mb_rupdate18_cover.htm) and [GEM](http://www.hkex.com.hk/eng/rulesreg/listrules/gemrulesup/gem_rupdate18_cover.htm) Listing Rules ("**Rules**") are available on HKEx's website.

## 1. New Exemption For Persons Connected With An Issuer At The Subsidiary Level Where The Size Of The Subsidiary Is "Insignificant" To The Issuer

HKEx has decided not to adopt at this stage the proposal to exclude from the connected transaction requirements all persons connected at the level of an issuer’s subsidiaries. It has instead adopted the alternative proposal of exempting only transactions with persons connected at the level of a subsidiary the size of which is "insignificant" to the issuer.

### 1.1 The "insignificant subsidiary" exemption

The amended Listing Rules (Main Board Rule 14A.31(9) and GEM Rule 20.31(9)) exempt from the connected transaction requirements transactions with a person who is connected with an "insignificant" subsidiary. Under the amended Rules:

1. a subsidiary is "insignificant" if:
   1. the values of its total assets, profits and revenue represent less than 10% of the issuer's total assets, profits and revenue based on the accounts for each of the latest 3 financial years (or if less, the period since the establishment of the subsidiary); or
   2. the values of its total assets, profits and revenue represent less than 5% of the issuer's total assets, profits and revenue based on the accounts for the latest financial year.
2. If the person is connected to more than one subsidiary, the total assets, profits and revenue of all the relevant subsidiaries must be aggregated.
3. If any percentage ratio calculation produces an anomalous result, HKEx may disregard the calculation and consider an alternative test. Concerns were expressed by respondents that a percentage ratio calculation (e.g. the revenue or profits ratio) may not reflect a subsidiary's materiality and give rise to anomalous results. HKEx considers that such cases can be dealt with on a case-by-case basis.
4. The exemption is also applicable to subsidiaries that have been part of the issuer's group for less than 3 years if they are insignificant to the issuer. For a subsidiary established for less than 3 years, the assessment will be determined by reference to its accounts for the period since establishment. For an acquired subsidiary, the assessment would be based on its accounts for the last 3 years. Where no accounts have been prepared, a suitable size test may be proposed by the issuer.
5. The exemption is not available if the insignificant subsidiary is itself a party to the transaction or its securities / assets are the subject of the transaction, the transaction is capital in nature and the transaction's size is 10% or more based on the consideration ratio.

* The consideration test is intended as an additional safeguard against potential abuse in significant transactions where there is concern regarding the connected person's direct influence over the subsidiary. The consideration test will only be applicable to capital transactions, for example, subscription of new shares in the subsidiary by its connected person, or the subsidiary acquiring or disposing of a business from or to its connected person.

1. If a connected person no longer qualifies for the exemption, the issuer must, subject to paragraph (7) below, comply with all applicable connected transaction requirements (i.e. reporting, annual review, announcement and independent shareholders' approval requirements) for its subsequent continuing connected transactions with this person.

* In the case of continuing connected transactions, an issuer should therefore assess whether the connected person and the transaction qualify for the insignificant subsidiary exemption at the time of entering into each transaction, unless paragraph (7) below applies. Once the exemption ceases to apply, the issuer will have to apply with all applicable requirements for continuing connected transactions in respect of subsequent transactions.

1. The only exception to this is where:
   1. the issuer has entered into an agreement for the continuing connected transactions for a fixed period with fixed terms; and
   2. the exemption applies at the time of entering into the agreement.

* In this case, an issuer is only required to comply with the applicable reporting, annual review and announcement requirements if the connected person is no longer qualified for the exemption during the term of the agreement.

HKEx states in the Consultation Conclusions that it will adopt a phased approach in relation to transactions with persons connected at the subsidiary level. It proposes to consult the market again following a review of the scope of the connected transaction rules to govern persons who are in positions of control or significant influence, and transactions that pose higher risks to the market.

### 1.2 Definition of "major subsidiary" for the disclosure requirement in Chapter 13

HKEx has decided not to proceed with the proposal to align the definition of "material subsidiary" in Main Board Rule 13.25 (GEM Rule 17.27) with the new definition of "insignificant subsidiary". The disclosure requirement in relation to winding-up or liquidation of a "major subsidiary" will therefore continue to apply to a subsidiary where the value of its assets, profits or revenue represent 5% or more under any of the percentage ratios, although HKEx will remove "major" from the term "major subsidiary".

## 2. Relaxation Of De Minimis Thresholds

Under the amended Rules (Main Board Rule 14A.33 and GEM Rule 20.33(3)):

1. The current 0.1% threshold will be retained for fully exempted transactions with connected persons who have more direct and significant influence over the issuer and may be in positions to make decisions. These include all directors and substantial shareholders (and their associates) of the issuer.
2. The threshold will be revised from 0.1% to 1% for fully exempted transactions with persons who are connected at the level of the issuer's subsidiaries.
3. The threshold for the exemption from the shareholder approval requirement will be increased to 5% from the current 2.5%.

However, the proposal to impose an additional fixed monetary cap (applicable irrespective of the percentage thresholds) will not be adopted.

## 3. New Exemption For Revenue Transactions With Associates Of A Substantial Shareholder Who Is A Passive Investor

Due to the high proportion of majority controlled listed companies and state-controlled PRC issuers, HKEx still considers it inappropriate to generally exempt revenue transactions with connected persons. It acknowledges however that there are areas where revenue transactions may be exempted and it proposes to continue its review of this area in the next phase of its review of the Rules.

The amended Rules (Main Board Rule 14A.31/GEM Rule 20.31(10)) implement the exemption proposed in the consultation paper for transactions of a revenue nature entered into in the ordinary course of the issuer's business on normal commercial terms which are connected transactions only because they involve an associate of a substantial shareholder who is a "passive investor".

Despite the majority of respondents favouring a broader exemption, the criteria for the application of the exemption are restrictive. The exemption will only apply if it involves an associate (Relevant Associate) of a substantial shareholder who is a passive investor in the issuer and meets the following criteria:

1. it is a sovereign fund, or a unit trust or mutual fund authorised by the SFC or an appropriate overseas authority;
2. it has a wide spread of investments other than the securities of the listed issuer and the Relevant Associate;
3. it and the Relevant Associate are connected persons only because it is a substantial shareholder of the listed issuer;
4. it is not a controlling shareholder of the listed issuer;
5. it does not have any representative on the board of directors of the listed issuer, and is not involved in the management of the listed issuer (including any influence over the listed issuer's management through negative control e.g. veto rights on material matters of the listed issuer); and
6. it is independent of the directors, chief executive, controlling shareholder(s) and any other substantial shareholder(s) of the listed issuer.

## 4. Extension Of Exemption For Acquisitions Of Consumer Goods Services

HKEx has extended the exemption under Main Board Rule 14A.31(7)(b)/GEM 20.31(7) to allow an issuer to acquire consumer goods or services from connected persons for the purpose of or in connection with the issuer’s business if there is an open market and transparency in pricing the relevant goods or services.

## 5. Amendments To The Definition Of "Associate"

### 5.1 Removal of certain companies related to an "investee company"

The definition of associate in Main Board Rule 1.01 (for non-PRC issuers) and Rule 19A.04 (for PRC issuers) has been amended to remove:

1. an investee company’s holding company and its fellow subsidiaries; and
2. a company controlled by an investee company (not being a subsidiary of the investee company) and its subsidiaries, holding company and fellow subsidiaries.

An investee company includes a company over which a connected person, for example, a director or substantial shareholder of the issuer and/or any party closely related to this connected person, such as his spouse or, if the connected person is a company, its subsidiary or holding company, individually or together, has "control" as defined under HKFRS or IFRS. An example is a company where the connected person is a 30% shareholder or is able to control the composition of a majority of the company’s board of directors.

### 5.2 Extended definition of associate

HKEx has expanded the definition of associate in Main Board Rules 14A.11(4)(b) and (c)/GEM Rules 20.11(4)(b) and (c) to include a company in which any relative referred to in the Rules has majority control. Control for these purposes means control of more than 50% of the voting power at the company’s general meetings or control of the composition of a majority of the company’s board of directors. In addition, HKEx will consider the interests of the connected person and his relatives in a company to determine whether they together have majority control over the company. Upon HKEx’s request, the issuer must provide information to HKEx to determine whether the company is majority controlled by these persons or not.

## 6. Amendments To The Definition Of "Connected Person"

### 6.1 In relation to non-wholly owned subsidiaries

The following changes have been made in relation to non-wholly owned subsidiaries:

1. A non-wholly owned subsidiary may be eligible for an exemption for transactions between a "connected subsidiary" (as defined in Main Rule 14A.11(5)/GEM Rule 20.11(5)) and its own subsidiaries, or between subsidiaries of this connected subsidiary. This exemption is provided for at Main Board Rule 14A.31(1A) and GEM Rule 20.31(1A).

* A "connected subsidiary" (as defined in Main Rule 14A.11(5)/GEM Rule 20.11(5)) means a non-wholly owned subsidiary of an issuer where any connected person(s) of the issuer (at the level of the issuer) is/are (individually or together) entitled to exercise, or control the exercise of, 10% or more of the voting power at any general meeting of such non-wholly owned subsidiary.

1. New Main Board Rule 14A.12A and GEM Rule 20.12A specify that a non wholly-owned subsidiary will not be regarded as a connected person because it is:
   1. a substantial shareholder of another subsidiary of the issuer; or
   2. an associate of a director, chief executive or substantial shareholder of any subsidiary of the issuer.

### 6.2 Other changes to the definition of Connected Person

The following persons have been removed from the definition of "connected person":

1. "promoters" of PRC, or Mainland China, issuers;
2. "PRC Governmental Bodies" for non-PRC issuers; and
3. "management shareholders" of GEM issuers.

## 7. Allowing The De Minimis Exemptions To Apply To A Deemed Disposal Of An Issuer’S Interest In Its Subsidiary

Main Board Rules 14A.31(2) and 14A.32 and the GEM equivalents have been amended to remove the restriction on applying the de minimis exemptions to an issue of securities by an issuer’s subsidiary (i.e. deemed disposals). The rationale is that the exclusion of issues of securities from the exemption was meant to protect against the dilution of shareholders’ interest in the listed securities. This is not a concern at the subsidiary level.

## 8. Exemption For Financial Assistance Provided On A Pro-Rata Basis

Main Board Rule 14A.65(3)(b)(i) (GEM Rule 20.65(3)(b)(i)) has been amended so that financial assistance provided by an issuer to a company (which is a connected person) in proportion to the issuer's interest in that company would be exempt from the connected transaction requirements.

The current exemption only applies to a "commonly held entity" which is not a connected person. A "commonly held entity" is a company in which both the issuer (or its subsidiary) and a connected person are shareholders, and where any connected person(s) (at the listed company level) can control 10% or more of the voting power at any general meeting of the company.

The amended exemption will apply to financial assistance given by an issuer for the benefit of (i) a "commonly held entity", or (ii) a connected person in which the issuer is a shareholder, as long as the financial assistance being provided is on normal commercial terms and on a several and pro-rata basis.

## 9. Transactions With Third Parties Involving Joint Investments With Connected Persons

An exemption is available for a disposal in a connected transaction where a substantial shareholder of the disposal target is a controller only because of its position and/or shareholding in the disposal target immediately prior to the disposal. For the exemption to be applicable, there must be no change in the substantial shareholder's interest in the disposal target as a result of the issuer’s disposal or other transaction or arrangement related to the disposal.

## 10. Annual Review Of Continuing Connected Transactions

Amended Main Board Rules 14A.37 and 14A.38 and GEM Rules 20.37 and 20.38 clarify that the annual review requirements do not extend to fully exempted continuing connected transactions (i.e those under Main Board Rule 14A.33/GEM 20.33). The annual review requirements however apply to continuing connected transactions which are subject to the reporting and announcement requirements of Chapters 14A and 20 of the Main Board and GEM Rules, respectively.

## 11. Further Review Of The Connected Transaction Rules

HKEx acknowledges that Hong Kong has one of the strictest regimes on connected transactions in developed markets. A further review of the connected transaction rules will be conducted by HKEx and it is expected that it will cover the following areas:

1. reviewing the definition of connected person to see if it is sufficiently broad to cover the kinds of persons that can exert significant influence over an issuer’s actions and affect the interests of minority shareholders. For example, directors of the parent company of a listed company are connected persons in some jurisdictions but not in Hong Kong;
2. improving HKEx's regulation of revenue transactions with connected persons;
3. introducing specific requirements and/or exemptions for different categories of issuers; and
4. bringing the HKEx connected transaction Rules and practices into closer alignment with those in Mainland China and other overseas jurisdictions.

*The purpose of this newsletter is to provide a summary only of HKEx's "Consultation Conclusions on Proposed Changes to Connected Transaction Rules" (20 May 2010). Its contents do not constitute legal advice and specific advice should be sought in relation to any particular situation.*

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