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# HKEx Listing Committee Announces Interim Guidance On Pre-IPO Investments

## Introduction

The publication on 13 October 2010 of interim guidance on pre-IPO investments aims to clarify the position in relation to pre-IPO investments pending a consultation on possible Listing Rule amendments. This comes in response to concerns raised by market participants that recent listing decisions have created uncertainty as to the principles applied and Exchange practice in this area.

In two cases recently considered by the Listing Committee, the pre-IPO investment agreements were signed on the date of submission of the listing application forms with settlement to take place at a later date, a date set close to the Listing Committee hearing date. The agreed prices were set at a deep discount to the IPO price and the pre-IPO investors would have been entitled to substantially more favourable terms than investors at the IPO stage.

The Listing Committee concluded in both cases that the pre-IPO investment agreements contravened the Listing Rule principles regarding fair and equal treatment of all securities holders and the conduct of issues and marketing of securities in a fair and orderly manner (Main Board Rules 2.03(2) and (4)/GEM Rules 2.06(2) and (4)). The Listing Committee stated that either the investments must be retracted or the listing timetable extended to ensure the pre-IPO investors faced risks which were significantly different to those to which investors at the IPO stage would be exposed.

These recent developments take place against the backdrop of a review of the Listing Rules and their practical operation, undertaken by a consultant engaged by the Listing Committee. One of the review's key findings was that market participants had difficulty in identifying consistent requirements for pre-IPO investments. The consultant also advised conducting a review of the placing guidelines in the light of current market practice. This review of the placing guidelines and relevant Listing Rules will be conducted by the Exchange in the near future.

## Interim Guidance

The interim guidance (Guidance) relates primarily to the time at which pre-IPO investments must be completed. The Guidance requires completion either:

1. at least 28 clear days before the date of submission of the first listing application form; or
2. 180 clear days before the first day of trading of the applicant's securities.

However, these deadlines may be varied in "very exceptional circumstances".

Under the terms of the Guidance, pre-IPO investments are regarded as being completed when the funds are irrevocably settled and received by the applicant. In addition, clear days exclude the day of the pre-IPO investment completion, the day of the submission of the listing application form and the first day of trading of securities.

The Listing Committee also noted that each case will be assessed on its own merits and that there may be situations in which more favourable terms for pre-IPO investors are justified, for example if the applicant is in grave financial difficulty. Companies considering a listing on the Exchange are encouraged to consult the Listing Division prior to submission of their listing applications if they have any questions.

## Background

The Listing Committee's general position in relation to pre-IPO investments on terms more favourable than those available to IPO shareholders has been set out in the Exchange's Annual Reports for 2006 and 2007.

In the 2006 Annual Report, the Listing Committee noted that while it did not necessarily consider pre-IPO placings shortly before listing to be objectionable, it considered that preferential investment terms available to the pre-IPO placees ran the risk of being contrary to the principle, enshrined in Listing Rule 2.03,[[1]](#footnote-26) that all holders of listed securities are to be treated fairly and equally. The Committee gave as an example of such a situation the case where the equity risk taken by private equity investors is substantially the same as that taken by the public investors or where the private equity investors are protected from equity risk after listing, in a manner substantially different to that experienced by the public investors. In such cases, the Committee maintained that the correct course of action was to require that the preferential terms be removed or altered prior to listing in order to satisfy the principles of Rule 2.03.

In a similar vein, the 2007 Annual Report focused on pre-IPO investment arrangements which meant that pre-IPO investors took no equity investment risk prior to the IPO. Particularly objectionable were arrangements which effectively created two different purchase prices on the day of listing for the same securities but without any difference in the extent of investment risk assumed to justify the price differential. The Listing Committee gave as a further example of unfairly preferential terms for pre-IPO investors, a pre-IPO convertible bond investment which was structured to enable the pre-IPO investors to partially convert the bonds post listing so that as shareholders of the listed company they retained certain rights under the bonds which were not generally available to the other shareholders of the company. Ensuring fairness to, and the equality of treatment of, public investors are the prime motivating factors underlying the Listing Committee's position on preferential terms for pre-IPO investors.

## Listing Decision Findings

The following is a summary of the Series 36, 55 and 59 Listing Decision findings in relation to pre-IPO placings and convertible bond issues.

### Decision Series 36 - The applicability of the lock-up provisions of the Listing Rules to Pre-IPO investments

In decisions 36-1 and 36-2 of October 2003, HKEx upheld as a general principle the ability to conduct pre-IPO placings of shares, even at a discount to the IPO price, subject to full prospectus disclosure. However, this mechanism may not be used to circumvent the lock-up provisions of the Listing Rules and the placee may be subject to a lock-up of his/her shares, this being determined on a case-by-case basis. HKEx noted that factors increasing the likelihood of a lock-up being imposed included the amount of the discount to the IPO share price and the proximity in time of the placing to the submission of the listing application. In addition, any shares subjected to the lock-up will not be counted towards the public float on listing.

### Decision Series 55 - Listing Rules 2.03 and 9.09[[2]](#footnote-29)

Listing decisions 55-1, 55-2 and 55-3 of June 2006 state that notwithstanding compliance with the disclosure, public float and lock-up requirements outlined in decision 36-1, HKEx may require certain terms of a Pre-IPO placing to be removed if they contravene Listing Rule 2.03 and/or 9.09. The terms which HKEx objected to in the context of the pre-IPO placings discussed in these decisions related to the following:

1. Placing price at a discount to the IPO price:
* The Exchange considered that a placing price at a discount to the IPO price, especially when the arrangements were being concluded shortly before listing, would create two different prices for the same securities at listing which could have a disruptive effect on the market at the time of listing. This was considered to be contrary to the fair and orderly principle in List Rule 2.03(2).
1. Guaranteed exit
* Two of the three cases in the Series 55 listing decisions allowed the pre-IPO investor to sell the shares back to the company or the controlling shareholder at an agreed price after listing. HKEx found that the put options gave the pre-IPO investors rights that were not generally available to the public shareholders and were therefore contrary to the terms of Listing Rule 2.03.
1. Exit option if listing did not proceed
* Two of the cases gave the pre-IPO investor the right to sell the shares back to the company or the controlling shareholder if the listing did not proceed. One of those cases also allowed the pre-IPO investor to defer payment of its investment until after in-principle listing approval had been granted. HKEx considered that the combined effect of the deferred payment feature and the availability of the put option if the listing did not proceed effectively meant that the pre-IPO investor took no equity investment risk. This was stated to be different from a conventional pre-IPO investment where the pre-IPO investor would be exposed to equity investment risk before the IPO.
1. Timing
* In listing decision 55-2, terms of the pre-IPO placing which were conditional on milestones of the listing approval process were found to be contrary to Listing Rule 2.03. In listing decision 55-3, proposals to substantially amend the terms of the pre-IPO placing after the grant of in-principle listing approval were also found to violate the no-dealing requirement under Listing Rule 9.09.

### Decision Series 59: Pre IPO Convertible Bonds

Most of the series 59 decisions relate to convertible bonds issued by the applicant prior to the IPO. However listing decision 59-1 concerned certain rights granted to a pre-IPO equity investor (including a right of director nomination, an exclusivity right preventing the applicant from issuing securities to the investor's competitors and a term preventing the applicant company from issuing shares to others on more favourable terms than those negotiated by the investor). HKEx determined that the director nomination right had to be terminated upon listing and the other rights should be modified in order to comply with Listing Rule 2.03.

In listing decision 59-3, the Exchange noted that the setting of different IPO prices at a listing through the use of a pre IPO investment was highly unusual, save in the case of government owned companies, and that the pre-IPO investment in question should only be allowed provided that the price for the pre-IPO investment negotiated proved not to be less than the final IPO price of the public offer of the applicant company's shares.

In decisions 59-2, 59-4, 59-5, 59-6 and 59-7 the convertible bond terms to which HKEx objected included:

1. A Conversion Price at a Discount to the IPO price and Negative Pledge
* In Listing Decision 59-2, where the convertible bonds were issued a few months before the listing application, it was found that the guaranteed discount to the IPO price and the apparent preferential investment terms by way of negative pledge together constituted a violation of Listing Rule 2.03 and "may give rise to concerns that the pre-IPO investors would not have assumed investment risks significantly different from those assumed by public investors".
1. Veto Rights over Matters Affecting the Company
* In Listing Decision 59-4, convertible instruments were issued which gave the investors veto rights over a number of important company matters upon the company listing on the Exchange, including any amendment to the memorandum or articles of association. These were held to be rights additional to those enjoyed by the other shareholders of the company and as such were in conflict with Listing Rule 2.03. Similarly in Listing Decision 59-6, where convertible bonds were issued before submission of the listing application, it was found that "it was more than likely that the convertible bonds would be converted given the deep discount (over 50% of the mid point of the offer range) of the conversion price vis-a-vis the offer price, and as such the pre-IPO investment did not carry greater risks than those investors participating at IPO would assume." Accordingly the pre-IPO investor's special rights under the bonds were required to be removed so as to satisfy the requirements of Listing Rule 2.03.
1. Conversion Price Reset Mechanism
* In Listing Decision 59-5, the company issued convertible bonds to the pre-IPO investor roughly five months before the submission of the listing application. Although the Exchange demanded the removal of a feature of the bonds which allowed for a conversion price reset mechanism (which could have resulted in minority shareholders retaining only 0.02% of the company), it allowed the conversion price at a discount to the IPO offer price to remain as there was no guarantee that the listing would occur. Additionally the bondholders were entitled to receive a fixed rate of return on redemption of the bonds as "compensation and income for the investment risk undertaken".
1. In Listing Decision 59-7, Company A issued redeemable convertible bonds to Company B, bonds which would be converted into shares in Company A upon the share issue becoming unconditional. As this conversion would place Company B in the position of a substantial shareholder and connected person under the GEM Listing Rules and that of a significant shareholder holding more than 10% of Company A's shares, Company B would not be regarded as a member of the public and its holdings would be subject to the appropriate lock-up period.

Please note that a more detailed discussion of the listing decisions summarised above is set out in our [November 2007 newsletter](/newsletters/hklaw/en/2007/54/nl-hklaw-20071106-54.html).

*This newsletter is intended as a summary only of the position in relation to pre-IPO investments as set out in listing decisions of the Listing Committee of the Hong Kong Stock Exchange. Specific advice should be sought in relation to any particular situation.*

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1. Listing Rule 2.03 requires that the issue and marketing of securities is conducted in a fair and orderly manner and that all holders of listed securities are treated equally. [↑](#footnote-ref-26)
2. Since November 2009, Rule 9.09 has been amended to :"There must be no dealing in the securities for which listing is sought by any connected person of the issuer (except as permitted by rule 7.11):(a) in the case of listing application by listed issuers, from the time of submission of the formal application for listing until listing is granted; and (b) in the case of a new applicant, from 4 clear business days before the expected hearing date until listing is granted. The directors of the issuer for whose securities listing is being sought shall forthwith notify the Exchange of any such dealing or suspected dealing of which they become aware. If any of the directors or their associates are found to have engaged in such dealing, the application may be rejected." [↑](#footnote-ref-29)