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# HKEx Publishes FAQs On Models For RMB IPOs

## Introduction

Hong Kong Exchanges and Clearing Ltd (**HKEx**) has published Frequently Asked Questions on Models for RMB IPOs (the **FAQs**) on 22 June 2011. The FAQs confirm the readiness of the HKEx and the Hong Kong market for RMB denominated IPOs, describe key features of two RMB IPO models to be offered by the HKEx and the RMB equity trading support facility designed to counter difficulties investors may face in sourcing RMB funds.

## Background

Mainland China’s long term project of internationalising the RMB has progressed over the last two years, with Hong Kong playing a role in the process. Key stages in this process include: the establishment of the RMB trade settlement pilot scheme in June 2009, which enabled settlement in offshore RMB for the first time; the inaugural sovereign RMB bond issue outside Mainland China in September 2009; Hopewell’s sale of RMB denominated bonds to international investors through an issuance on the HKEx in July 2010; the issue of a RMB denominated bond by McDonalds in August 2010; and the signing by the People’s Bank of China and the Hong Kong Monetary Authority of the Supplementary Memorandum of Cooperation on the Expansion of the RMB Trade Settlement Scheme, enabling the free circulation of the RMB outside the Mainland. Hong Kong’s role in assisting in the internationalisation of the RMB is facilitated by its close historical relationship with the Mainland as regards economic and regulatory coordination, its role in the unique one country, two systems arrangement and its ability to provide the Mainland’s trading partners with the political, economic and legal infrastructure, and credibility, needed to experiment with the use of the RMB offshore.

This newsletter examines a further key step along the road to RMB internationalisation and the preparation by the Hong Kong market for further RMB IPOs following the inaugural such offering in April of this year. The [FAQs](http://www.hkex.com.hk/eng/newsconsul/hkexnews/2011/Documents/1106223news.pdf) ([see archive](1106223news.pdf)) and a [presentation](http://www.hkex.com.hk/eng/newsconsul/hkexnews/2011/Documents/1106222news.pdf) ([see archive](1106222news.pdf)) by the HKEx heads of Issuer Marketing and RMB Products Taskforce on RMB IPO models (the **Presentation**) are available on the HKEx website.

## What Makes An RMB Denominated IPO An Attractive Option?

The HKEx presents the key advantages of the introduction of RMB denominated IPOs as being:

* the positive effect such a move will have on a company’s profile, nationally and internationally;
* the unexploited demand for RMB products – the HKEx highlights the fact that Hong Kong RMB deposits amounted to RMB 510 billion by the end of April 2011;
* the reduction in foreign exchange risk, as an offering represents a method for companies with substantial RMB operating expense requirements to hedge against an appreciating RMB and to deploy capital for Mainland expansion; and
* the potential for exposure to Mainland issuers - as the capital account on the Mainland opens in future years, a company which has conducted a RMB denominated IPO will be positioned to take advantage of this opportunity and also to conduct follow on fund raisings.

The HKEx has stated that, in general, the launch of a RMB IPO should not cause any delay to an issuer in terms of the listing process. However this is qualified by the HKEx making reference to the fact that the RMB equities market in Hong Kong is in its infancy, so that additional disclosure obligations and other requirements could arise in the case of a RMB IPO.

## Hong Kong’s RMB Product Market And The First RMB IPO

Three RMB denominated debt securities of Asian Development Bank, Galaxy Entertainment Group and HKCG (Finance) Ltd (subsidiary of HK & China Gas) are currently trading on the HKEx. The staging of the first RMB denominated IPO on the HKEx in April 2011 was a recent step in the evolution of the RMB as an international currency. That offering by the Hui Xian real estate investment trust (**REIT**) raised 10.5 billion yuan (US$1.6 billion). As of 31 May 2011, 196 Exchange Participants (**EPs**) have traded the Hui Xian REIT at least once, with these 196 EPs contributing approximately 80% of the total market turnover for May 2011.

This development was the latest in a series of steps in the RMB product market in Hong Kong. Other steps include the first public listing of a RMB denominated bond by Asian Development Bank in October 2010, the HKEx’s successful RMB Readiness Testing in March 2011 with EPs, participating banks and others to verify operational readiness for dealing RMB securities and the forthcoming launch of the HKEx’s Trading Support Facility in October 2011. The latter is aimed at addressing the issue of liquidity in the RMB market and will be discussed in detail in this newsletter. A HKEx Taskforce has also been formed to study the effectiveness and sustainability of various RMB IPO models. The HKEx has confirmed recently that Hong Kong Deposit Receipts (**HDRs**) may be listed in RMB.

The HKEx has addressed concerns regarding the sufficiency of liquidity in the RMB denominated product market, seeking to assure investors that the total current RMB deposits of RMB510 billion provide enough RMB liquidity to accommodate initial fund raisings. Furthermore, the HKEx points to past issues of RMB products to support their view that there is demand in the market for such products. The HKEx also emphasised the importance of the forthcoming RMB Trading Support Facility, which will be operational by September/October 2011, due to its ability to facilitate secondary market trading. Lastly, the HKEx pointed out the flexibility of the RMB IPO models, particularly the manner in which HKD holders are permitted to subscribe for RMB shares. These last two points are discussed in detail below.

## RMB IPO Models

### Features of Single Tranche, Single Counter Model

The HKEx notes that the single tranche, single counter model has a number of desirable features for investors and issuers. If an offer is oversubscribed, this model can assist in easing the pressure on the CNH (i.e. RMB products in Hong Kong) market. Furthermore, the HKEx has stated that it is open to investors using HKD in addition to RMB to subscribe for RMB IPOs, while also noting the role that HKD can play in margin financing. However, the HKEx emphasised that any model that includes the option of HKD subscription must reflect the reality that RMB is the principal fundraising currency in a RMB IPO and that a minimum level of subscription in RMB is mandatory. Any issuer that grants a HKD subscription option to investors must ensure that the prospectus describes explicitly the detailed subscription mechanism, with a special focus on the HKD/RMB conversion mechanism, the associated costs and risks to the investors as well as the application of the claw-back and re-allocation mechanism between subscriptions in RMB and subscriptions in HKD. The HKEx has confirmed its intention to work with key stakeholders to ensure that a balance is struck between the key drivers and operational complexity of such a model.

### Features of the Dual Tranche, Dual Counter Model

The dual tranche, dual counter model permits the simultaneous offering and initial listing of a tranche of RMB-traded shares and a tranche of HKD-traded shares by the same issuer, with all shares from the two tranches being of the same class and all shareholders being treated equally. Once the listing process has been completed, the shares of the two tranches will be traded, in their respective currencies, under two separate counters on the HKEx. All trades occurring on these two counters will be cleared and settled separately under the HKEx’s Central Clearing and Settlement System for securities (**CCASS**). The HKEx also notes in relation to the dual tranche model that the ownership disclosure and control requirements will be based on the combined tranches, as opposed to applying to each tranche separately.

In a concept akin to that whereby the shares of dual listed companies may be traded in different currencies in different markets, the dual tranche, dual counter model may include a procedure allowing a shareholder to convert his/her shares from one tranche to the other through the share registrar. The key difference with the mechanism employed by dual listed companies is that the dual tranche, dual counter model being examined by the HKEx will operate in the same market.

The HKEx has also confirmed that the existing “Greenshoe” mechanism (i.e. the over-allotment option) will apply to each of the two tranches on the basis of their respective pre-determined offer size and that, in general, it does not foresee the need for any additional intermediaries (such as the additional requirement for a depositary for a HDR) for a RMB IPO, other than what is required under the Listing Rules for the issue of shares. However both of these points may be revisited in individual cases, depending on what the circumstances demand.

#### Allocation Mechanism and Pricing

The expectation of the HKEx is that the two tranches will function in much the same way as two parallel IPOs, save that the upfront allocation of shares between the two tranches and the minimum RMB tranche size must be clearly disclosed in the prospectus. Additional disclosure of the clawback and re-allocation mechanisms and the manner in which they operate independently within the tranche is also required in the prospectus. Furthermore, the offer price of the two tranches, subject only to HKD/RMB conversion, should be the same after foreign exchange conversion. The HKEx stressed that the foreign exchange rate, or the mechanism for the determination of the foreign exchange rate, to be used for the purpose of calculating the final offer price should be clearly disclosed in the prospectus. Once the issuer’s obligations as regards the intra-tranche claw-back/re-allocation are met, shares can be reallocated between the two tranches in light of market demand, subject to the minimum RMB tranche size.

#### Convertibility under the dual tranche model

In principle the HKEx will take a positive view of permitting convertibility between the HKD-traded and RMB-traded shares post listing. The key reason for this stance is that allowing such convertibility will enhance the efficiency of arbitrage and ensure that the prices of the two tranches are largely maintained, with a reasonable differential, in the secondary market. On the positive side, as regards convertibility the HKEx placed emphasis on the following:

* the facilitation of efficient arbitrage;
* the creation of a comprehensive safeguard against any regulation of offshore RMB which may have negative consequences for issuers and investors; and
* the enabling of market forces to dictate the movement of shares between the two counters.

On the cautionary side, the HKEx underlined the fact that a lack of liquidity on the RMB counter side could cause great difficulties. Thus an advantage of non-convertibility is that it would lock shares up in the RMB counter and create liquidity in that counter. Nevertheless the HKEx considers that, in principle, these factors are outweighed by the advantages of permitting convertibility and the disadvantages of the opposite approach, such as the creation of a large price gap between the RMB and HKD traded shares, and the storing up of problems to be confronted when convertibility is introduced at some point in the future.

However a note of caution in this regard is struck by the HKEx in connection with the initial RMB IPOs, which may require a period of non-convertibility, owing to the fact that the RMB equities market in Hong Kong at present remains in the evolutionary stage. The HKEx has stated its intention to remain flexible on this matter and to work with issuers to find the best solution in all the circumstances with regard to convertibility.

## RMB IPOs And Corporate Actions

### Dividends

A number of market participants had enquired whether dividends would be paid in HKD or RMB. In response, the HKEx underlined the fact that any policy regarding corporate actions must take into account that the shares of the two tranches are of the same class. With that in mind, it is open to issuers to permit shareholders to take a dividend in the currency in which the dividend is declared or in an alternative currency or currencies, and set a different default currency for the respective tranches should the shareholder fail to make a specific selection in this regard. The HKEx also highlights the fact that if an issuer offers to pay a dividend in RMB, consideration must be given to its access to that currency for dividend payment and its responsibilities in that respect in relation to the availability of RMB. Finally the prospectus must contain adequate disclosure of any dividend payment or currency options.

### RMB IPOs and Additional Compliance Rules

The HKEx has stated that it has no plans at present to impose additional regulation on issuers of RMB IPOs, other than the requirements currently contained in the Listing Rules, although it will monitor the situation as the RMB equity market in Hong Kong expands.

### Remitting funds raised in a RMB IPO to the Mainland

The HKEx has confirmed that irrespective of the currency used, an issuer that intends on remitting IPO proceeds to the Mainland must obtain all necessary approvals from the relevant Mainland authorities. The procedure should be similar to the existing arrangement for remitting funds raised in Hong Kong back to the Mainland. The HKEx has also stated that there is no Listing Rule requirement for an issuer to have obtained prior approval to remit the RMB proceeds to the Mainland at the time of the A1 filing, the Listing Committee Hearing or the listing.

## The RMB Equity Trading Support Facility (TSF)

The TSF was designed to act as a back up to the developing RMB equity market in Hong Kong, allowing investors encountering difficulty in sourcing RMB to buy RMB denominated shares using HKD. The HKEx has stated that the purpose of the TSF is to “develop a sustainable trading model for RMB equity not completely dependent upon availability of RMB liquidity”.

The HKEx has stated that the TSF will obtain RMB from Hong Kong banks and make it available, via brokers, to investors who wish to purchase RMB denominated shares in the secondary market. The TSF will only use offshore RMB, at least in its initial stages. It will also adhere to the existing RMB policy framework, meaning that there will be no requirement to seek approval from Mainland authorities and a policy exemption from the HKMA. Trades in RMB-denominated shares will be settled through the HKEx’s securities clearing house, the Hong Kong Securities Clearing Company (**HKSCC**), using RMB from the TSF. The foreign exchange rate used by the TSF will be determined on a commercial basis by the banks involved in the scheme.

The TSF will operate as follows:

* those using the TSF pay HKD for RMB;
* upon selling the RMB denominated shares purchased using RMB from the TSF, market participants then return the RMB to the TSF for the equivalent amount of HKD. This procedure, described as the “HKD In, HKD Out” mechanism by the HKEx and occurring entirely inside CCASS, is intended to guarantee the sustainability of the TSF, despite its lack of access to an unlimited supply of RMB.

The structure of the TSF is aimed at ensuring that the price discovery process for RMB-denominated shares in the secondary market and their liquidity will not be restricted by the actual level of RMB available in the market at any moment in time. It has the additional advantage of not necessitating any adjustment to the trade settlement process presently in use in CCASS. The use of the TSF is optional for both investors and brokers, with the interest of the former group likely to be determined by their level of access to other supplies of RMB and the interest of the latter group depending on their business model and the demands of their customers. The TSF will not be available during subscription for an IPO and operates only in the secondary market, including the stabilisation period.

The HKEx is aware that the prospects for growth and stability of the RMB equities market in Hong Kong are dependent on reliable RMB liquidity. The TSF represents an effort to alleviate liquidity concerns. Furthermore, the HKEx has also stated that the TSF will assist in the support of “the normal trading of RMB-denominated shares in exceptional situations if RMB supply becomes constrained.”

At present, the HKEx plans to commence operation of the TSF in September or October 2011 and two rounds of market briefings on its workings have taken place with this date in mind.

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