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[online version](http://www.charltonslaw.com/stock-exchange-updates-listing-decision-on-prc-businesses-using-vie-structures/)

# Stock Exchange Updates Listing Decision On PRC Businesses Using VIE Structures

## Introduction

In August 2012, the Stock Exchange of Hong Kong (the Exchange) updated its 2005 listing decision (HKEx-LD43-3) (the **Listing Decision**) regarding the suitability for listing of PRC businesses using the so-called Variable Interest Entity (VIE) structure, which uses a series of contractual arrangements to give foreign investors control over companies operating in the PRC that they do not actually own. The VIE structure has been used for a number of years primarily to circumvent PRC restrictions on foreigners investing in certain industry sectors such as internet and telecommunication. Most of China’s well established internet companies – Sina (NASDAQ), Baidu.com (NASDAQ), Tudou (NASDAQ), Sohu.com (NASDAQ) among them – are listed in the US using this structure.

The Listing Decision was last updated in November 2011. The August 2012 update (the **Update**) elaborates further on the listing requirements and prospectus disclosure requirements for applicants who conduct businesses based on contractual arrangements.

The Listing Decision is available [here](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld35-2012.pdf) on the Exchange website.

## The Facts

The Update concerned Company A (a Main Board listing applicant) incorporated outside Hong Kong which operated a business in the PRC in an industry sector in which foreign investment is restricted under PRC foreign investment regulations. Company A and its subsidiaries (the **Group**) did not therefore possess the licences required to conduct the Group’s business in the PRC. The Group entered into contractual arrangements with the actual owners of the business (**Registered Owners**) designed to give it various interests and rights so that it acquired de facto control on the restricted business in the PRC indirectly.

The Contractual Arrangements conferred upon Company A, inter alia, the right to enjoy all the economic benefit of the business, the right to acquire, if and when permitted by PRC law, the equity interests in and/or the assets of the Registered Owners and a first priority security interest in the shares of the restricted business held by the Registered Owners.

The sponsor submitted that Company A had satisfied all conditions for listing under the Listing Rules. The sponsor intended to disclose full details of the contractual arrangements in the prospectus. Company A’s legal adviser issued an opinion that the contractual arrangements complied with PRC laws, rules and regulations, including those applicable to the restricted business of Company A.

## The Issue Raised For Consideration

The Update concerned whether Company A was unsuitable for listing due to legal questions associated with the Contractual Arrangements.

## Applicable Listing Rules

Rule 1.01 states that “subsidiary” includes “any entity which is accounted for and consolidated in the audited consolidated accounts of another entity as a subsidiary pursuant to applicable Hong Kong Financial Reporting Standards or International Financial Reporting Standards”.

Rule 8.04 provides that in the opinion of the Exchange both the issuer and its business must be suitable for listing.

## Standard Of Review For Businesses Involving Contractual Arrangements

Initially, the Exchange set out the following standards of review, inter alia, when making the decision:

1. the Contractual Arrangements should be narrowly tailored so as to achieve the applicant’s business purposes and minimise the potential for conflict with relevant PRC laws and regulations;
2. the listing applicant must demonstrate genuine efforts to comply with applicable laws and regulations;
3. the Exchange would undertake a broad review of the applicant’s legal and compliance history, its management systems, its records in protecting shareholder interests and its financial resources to ensure compliance with the applicable laws and regulations; and
4. subject to availability and practicability, appropriate regulatory assurance should be obtained from the relevant regulatory authorities. In the absence of such regulatory assurance, the applicant’s legal counsel would be required to make a statement to the effect that in its legal opinion all possible actions or steps taken to enable it to reach its legal conclusions had been taken.

As the sponsor had demonstrated, supported by professional opinions, that Company A satisfied all the above requirements, the Exchange determined that the Contractual Arrangements were legal and binding and that Company A was able to ensure proper operation of the Contractual Arrangements. Since full disclosure of the Contractual Arrangements would be made in the prospectus, the Exchange decided that Company A or its business would not be rendered unsuitable for listing by reason of the use of the Contractual Arrangements

## Further Standard Of Review For Businesses Involving Contractual Arrangements

In a review in 2011, the Exchange further elaborated on the standard of review for businesses involving Contractual Arrangements adopted in the case. The standards set out above continue to apply.

1. If non-restricted businesses are involved, the Listing Division will normally refer the case to the Listing Committee;
2. The listing applicant and its sponsor should provide the Exchange with reasons for the use of Contractual Arrangements in its business operation;
3. The listing applicant should unwind the Contractual Arrangements as soon as the law allows the business to be operated without them;
4. The listing applicant must ensure that the Contractual Arrangements contain:
   1. a power of attorney by which the shareholders of the restricted business grant to the applicant’s directors and their successors (including a liquidator replacing the directors) the power to exercise all rights of the shareholders of the applicant;
   2. dispute resolution clauses that provide for arbitration and that arbitrators may award remedies over the shares or land assets of the restricted business, injunctive relief or order the winding up of the restricted business;
   3. jurisdiction clauses which provide the courts of Hong Kong, the place of incorporation of each of the applicant and the restricted business and the place where the principal assets of the applicant or the restricted business are located with the power to grant interim remedies in support of the arbitration pending formation of the arbitral tribunal or in appropriate cases; and
   4. provisions that grant the right to dispose of the assets of the restricted business.

## Prospectus Disclosure Requirements

The Exchange also required that listing applicants using Contractual Arrangements for the entire or part of its business should disclose the following information in its prospectus:

1. Detailed discussion about the registered shareholders of the restricted business and a confirmation that appropriate arrangements have been made to protect the applicant’s interests;
2. The extent to which the applicant has arrangements to address the potential conflicts of interest between the applicant and the registered shareholders of the restricted business;
3. Reasons why the directors believe that each of the Contractual Arrangements is enforceable under the PRC and local law;
4. The economic risks the applicant bears as the primary beneficiary of the restricted business such as the share of financial losses, the need to provide financial support and circumstances that could expose the applicant to losses suffered by the restricted business;
5. A discussion on whether the applicant has encountered any interference from any PRC governing bodies in operating the restricted business under the Contractual Arrangements;
6. The limitations in exercising the option to acquire ownership in the restricted business with a separate risk factor explaining the limitations;
7. The contracts forming the Contractual Arrangements must be included as material contracts in the “Statutory and General Information" section and they must be available on the applicant’s website, or their non-disclosure must be justified and disclosed;
8. The corporate structure table in the “Summary” section must be included for the purpose of illustrating the Contractual Arrangements.
9. The prospectus should include at least the following Contractual Arrangements related risk factors:
   1. The PRC government may determine that the Contractual Arrangements do not comply with applicable regulations;
   2. The Contractual Arrangements may not provide control as effective as direct ownership;
   3. The domestic shareholders may have potential conflicts of interest with the applicant; and
   4. Contractual Arrangements may be subject to scrutiny of the PRC tax authorities and additional tax may be imposed.

## Conclusion

The Listing Decision and subsequent Update issued by the Exchange set out the requirements to be satisfied by listing applicants engaging in industry via Contractual Arrangements where foreign investment is restricted in the PRC. In addition, it is clear that the Listing Division would normally refer the listing application to the Listing Committee to determine suitability if Contractual Arrangements are being used in an industry with no foreign investment restrictions.

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