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[online version](http://www.charltonslaw.com/hong-kong-stock-exchange-publishes-guidance-on-pre-ipo-investments/)

# Hong Kong Stock Exchange Publishes Guidance On Pre-IPO Investments

## Introduction

In October 2012, the Stock Exchange of Hong Kong (the **Exchange**) published a guidance letter (HKEx-GL43-12) (the **Guidance Letter**) to consolidate its past listing decisions on pre-IPO investments. Guidance letter (HKEx-GL43-12) (the **Interim Guidance**) and listing decisions (HKEx-LD12-2011 and HKEx-LD15-2011) (the **Listing Decisions**) will remain in force. Other previous listing decisions on pre-IPO investments are superseded[[1]](#footnote-24). This newsletter summarises the current requirements on pre-IPO investments as set out in the Guidance Letter which is available on [the Exchange’s website](http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/iporq/Documents/gl43-12.pdf) ([see archive](gl43-12.pdf)).

## Background

Pre-IPO investments generally take the form of private placements to investors of preference shares or convertible bonds exchangeable into ordinary shares. The purpose of the investment is normally to provide the company with cash to fund its operations in the period prior to listing on the Exchange.

The Exchange’s Listing Committee has in the past issued a number of listing decisions on whether the terms of such pre-IPO investments should be allowed to survive the listing of the relevant company or whether they should be terminated as a condition of listing approval being granted on the basis that they are contrary to certain principles enshrined in the Listing Rules.

## Applicable Listing Rules

Main Board Listing Rule 2.03(2) (GEM Rule 2.06(2)) states that the issue and marketing of securities must be conducted in a fair and orderly manner and that 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)) further requires that all holders of listed securities must be treated fairly and equally.

## Interim Guidance Requirement As To Timing Of Pre-IPO Investments

A number of pre-IPO investment terms were disallowed in the past on the basis that the pre-IPO investments were entered into only very shortly before the IPOs. The Exchange considered that where the investment was made for example only after the grant of in-principle approval of listing by the Listing Committee, the pre-IPO investor could not 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 which were not available to the wider body of shareholders.

In October 2010, the Exchange published the Interim Guidance which clarified when the Exchange requires a pre-IPO investment to be entered into in relation to the IPO itself.

### The 28/180 Day Requirement

The Interim Guidance requires pre-IPO investments 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 of the applicant’s securities, except in very exceptional circumstances. Pre-IPO investments are only considered completed when the funds are irrevocably settled and received by the applicant. The Listing Decisions are the precedent for this requirement[[2]](#footnote-31).

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.

## Guidance Letter Provisions On Permissibility Of Special Rights/Obligations

Pre-IPO investors may be offered special rights, some of which are typical and some atypical. 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 so as to comply with the requirement of even treatment of shareholders under the Rules. The Guidance Letter sets out examples of common special rights given to pre-IPO investors and the Exchange’s guidance on whether they are allowed to continue after listing.

### (i) 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 will be disallowed. These provisions effectively create two different prices for the same securities for pre-IPO investors and other shareholders at the time of listing which the Exchange considers could have a potentially disruptive effect at the time of listing. These provisions are considered to be contrary to the principle of fair treatment of all listed security holders and are not therefore allowed to survive the listing of the investee company.

### (ii) 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 is disallowed on the basis that they are contrary to the general principle of equal treatment of shareholders. The rationale is that if pre-IPO investors are allowed to exit the investment, they do not bear any investment risk. Put or exit options are allowed only if the applicant’s listing does not occur.

### (iii) Director Nomination Rights - Disallowed

The right of a pre-IPO investor to nominate a director will not be allowed to survive after listing as this right is not generally available to other shareholders and is thus contrary to the general principle of equal treatment. 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 under the applicant’s articles of association after listing.

### (iv) Veto rights - Disallowed

Pre-IPO investors may be given a contractual right 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. These rights are not allowed to survive the company’s listing.

### (v) Anti-dilution Rights

Main Board Rule 10.04 and Paragraph 5 of Appendix 6 to the Main Board Rules (GEM Rules 10.11 to 10.16 and 13.02), 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.

Some pre-IPO investors may however be granted preferential rights to purchase additional securities to be issued by listing applicants so as to maintain their percentage shareholding in the applicant.

#### Rights Allowed pre-Listing

Pre-IPO investors can exercise anti-dilution rights in the IPO at the time of listing if:

* the allocation is necessary to give effect to the pre-existing contractual rights of the pre-IPO investors under the investor rights agreement;
* full disclosure of the pre-IPO investors’ pre-existing contractual entitlement and the number of shares to be subscribed by the pre-IPO investors will be made in the prospectus and the allotment results announcement; and
* the proposed subscription will be conducted at the offer price of the IPO.

#### Disallowed Rights

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.

### (vi) Profit Guarantee

Pre-IPO investors may be entitled to compensation if an applicant’s profit does not meet a certain level.

#### Allowed

A profit guarantee will only be allowed if it is settled by a shareholder (rather than the listing applicant) as it is then regarded as a private arrangement between a shareholder and a pre-IPO investor and the compensation is not linked to the market price or capitalisation of the shares.

#### 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, it will be disallowed.

### (vii) Negative Pledges – Disallowed Unless Widely Accepted Provisions of Loan Agreements

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. Negative pledges which are regarded as 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.

The Exchange will review all other negative pledges and may require confirmation from the sponsor that the relevant pledges which remain after listing are in line with the normal terms of debt issues.

### (viii) Prior Consent for Corporate Actions/Changes in Articles – Disallowed unless not Egregious and not Contrary to Listing Rules

A pre-IPO investment agreement may provide that the consent of the pre-IPO investor is required before certain corporate actions can proceed. These actions may include:

* 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.

These terms will generally be required to be removed before listing unless the applicant can demonstrate that the relevant terms are not egregious and do not contravene the fundamental principles of the Listing Rules to the disadvantage of other shareholders.

### (ix) Exclusivity Rights and No More Favourable Terms – Disallowed Unless “Fiduciary Out” Provision

A pre-IPO investment agreement may include 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 terms more favourable than the terms on which the shares are issued to the pre-IPO investor. These rights may limit the options of the applicant’s board to consider alternative bona fide proposals that would be in the best interest of the applicant and its shareholders as a whole.

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. The directors would not then be prevented from exercising their judgment as to whether to undertake certain corporate actions in the applicant’s best interest.

### (x) Information Rights – Allowed if Information Simultaneously Made Publicly Available

A pre-IPO investment agreement may include terms that grant a pre-IPO investor a right to receive corporate information from the applicant. This right will only be allowed to continue after listing if the pre-IPO investor receives only published information or information which is made available to the general public at the same time, with a view to avoiding unequal dissemination of information. If the issuer provides price sensitive information to a pre-IPO investor, it will need to comply with requirement to disclose such price-sensitive information under Main Board Rule 13.09 (GEM Rule 17.10)(or, with effect from 1 January 2013, under the obligation to disclose inside information under new Part XIVA of the Securities and Futures Ordinance).

### (xi) Right of First Refusal and Tag-along Rights - Allowed

A pre-IPO investor may be granted a right of first refusal by the listing applicant’s controlling shareholder so that the controlling shareholder will first offer to sell shares to the pre-IPO investor at the same price and on the same terms and conditions as a proposed sale of shares to a third party purchaser. If the pre-IPO investor does not exercise its right of first refusal, it will be permitted to include its shares for sale together (i.e. tag along) with the shares of the controlling shareholder as part of the sale to the third party purchaser.

This right will be regarded as a purely contractual right between two shareholders and will thus be allowed to survive after listing,

### (xii) Qualified IPOs

Investment agreements with pre-IPO investors may include a term which states that if an applicant does not achieve an IPO valued at or above a specified amount within a specified period of time, the pre-IPO investors are entitled to a certain amount of compensation. 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. However, if the amount to be compensated is not set out in the investment agreement or cannot be derived from the compensation provisions, it will be viewed as an amendment or variation to the original terms of the agreement and the 28 Day/180 Day Requirement under the Interim Guidance applies.

### (xiii) 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 connected person of the applicant) is fulfilled.

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1. They are HKEx-LD36-1 and 36-2, HKEx-LD55-1, 55-2 and 55-3 and HKEx-LD59-1, 59-2, 59-3, 59-4, 59-5, 59-6 and 59-7. [↑](#footnote-ref-24)
2. [HKEx-LD15-2011](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld15-2011.pdf)([see archive](ld15-2011.pdf)), [HKEx-LD12-2011](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld12-2011.pdf)([see archive](ld12-2011.pdf)) [↑](#footnote-ref-31)