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[online version](http://www.charltonslaw.com/hong-kong-stock-exchange-publishes-guidance-letter-gl51-13-disallowing-additional-benefits-for-cornerstone-investors/)

# Hong Kong Stock Exchange Publishes Guidance Letter GL51-13 Disallowing Additional Benefits For Cornerstone Investors

The Exchange has published guidance letter, [GL51-13](http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/iporq/Documents/gl51-13.pdf) ([see archive](gl51-13.pdf)) (**Guidance Letter**), to remind listing applicants that no direct or indirect benefits are allowed to be given by side letter or otherwise to **Cornerstone Investors** (i.e. investors who receive a preferential placement of IPO shares under the placing tranche), except for a guaranteed allocation of shares at the IPO price.

## Cornerstone Investors

Cornerstone Investors are usually large institutional investors or well-known individuals to whom shares of an IPO are allocated under the placing tranche at the IPO price to signal to the market that the IPO is a trusted investment and is worthwhile for other investors. Such placings are generally permitted based on the following principles:

* the placing must be at the IPO price;
* the IPO shares are subject to a lock-up period (usually ending at least six months from the listing date);
* the cornerstone investors would not have board representation and are independent from the listing applicant, its connected persons and their respective associates);
* details of the cornerstone investors and the placing arrangement are included in the listing document; and
* notwithstanding the lock-up period, and provided that the cornerstone investor is a member of the public (as defined in the Listing Rules), the shares placed will be part of the public float under rule 8.08 of the Main Board Listing Rules (**Rules**) (GEM Rule 11.23).

Cornerstone placings are common in difficult market conditions. In 2012, cornerstone placings in 50 newly listed Main Board companies ranged between 5% and 66% of the total offering size of IPO shares while in 2011, the range was between 9% and 76%.

## Relevant Listing Rules

Under Rules 2.03(2) and (4) (GEM Rules 2.06(2) and (4)), all holders of listed securities must be treated fairly and equally. Rule 2.13 (GEM Rule 17.56) requires all information in the prospectus to be accurate and complete in all material respects and not be misleading or deceptive.

## Exchange Guidance

In the Guidance Letter, the Exchange states that preferential placings to Cornerstone Investors can be justified by their purpose of encouraging retail investors to invest in the IPO. Provided that the above principles are followed, the Exchange considers that placings to Cornerstone Investors will not breach the requirement for fair and equal treatment of all shareholders. The Exchange notes that some listing applicants, their controlling shareholders, sponsors or other syndicate members may wish to offer Cornerstone Investors additional benefits by side letter or otherwise, other than a guaranteed allocation at the IPO price. This is particularly so when market sentiment is weak.

The Exchange states in the Guidance Letter that it considers it to be misleading to the public if Cornerstone Investors receive some other benefit (directly or indirectly) (i.e. in addition to a guaranteed allocation) for taking up shares in an IPO. In addition, the non-disclosure of direct or indirect benefits given to Cornerstone Investors by side letter or otherwise violates the requirements under Rule 2.13 (GEM Rule 17.56) that all material information should be included in the prospectus.

Cornerstone Investors must therefore be reclassified as pre-IPO investors if, in connection with their acquisition of shares in an IPO, they receive any direct or indirect benefit (apart from a guaranteed allocation of shares), such as:

* a waiver of brokerage commission;
* a put option from the controlling shareholder or any other person to buy back the shares after the listing;
* sharing of underwriting commissions;
* an assurance that the listing applicant will re-invest the proceeds from the IPO in funds that are managed by the Cornerstone Investor;
* an agreement to allow an allocation of shares in another IPO; or
* any other transaction or arrangement entered into on non-arm’s length commercial terms in relation to the acquisition of the IPO shares.

All guidance on pre-IPO investments that has been published by the Exchange also applies to Cornerstone Investors that have been reclassified as pre-IPO investors.

The Guidance Letter notes that it is not intended to preclude the entering into of arm’s length commercial arrangements between listing applicants and investors (such as when the investors are major customers and suppliers, or the establishment of joint ventures for business development). The Exchange considers these to be strategic dealings and/or arrangements with strategic investors and acceptable provided that details of such arrangements are fully disclosed in the prospectus.

## Guidance for Pre-IPO Investors

Guidance letter [GL43-12](http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/iporq/Documents/gl43-12.pdf) ([see archive](gl43-12.pdf)), published in by the Exchange in October of 2012, provides guidance as to whether a pre-IPO investor may be allowed certain special rights and obligations which continue after the IPO. Price adjustment provisions, put or exit options, director nomination rights and rights to veto major corporate actions are disallowed in all cases. Other rights, such as anti-dilution rights, profit guarantees and negative pledges, may or may not be allowed depending on various circumstances. For a full summary of guidance letter GL43-12, please see [our previous newsletter dedicated to this topic](/newsletters/hklaw/en/2012/170/nl-hklaw-20121105-170.html).

Additionally, the Exchange’s interim guidance set out in guidance letter [GL29-12](http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/iporq/Documents/gl29-12.pdf) ([see archive](gl29-12.pdf)) generally requires pre-IPO investments to be completed 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.

Guidance letter [GL44-12](http://www.hkex.com.hk/eng/rulesreg/listrules/listguid/iporq/Documents/gl44-12.pdf) ([see archive](gl44-12.pdf)) sets out guidance in relation to convertible instruments issued to pre-IPO investors. In summary, where convertible or exchangeable bonds, notes or loans (**CBs**) are issued to pre-IPO investors:

* the conversion price should be a fixed amount or the IPO price, not a price based on a guaranteed discount;
* conversion price reset mechanisms should be removed to avoid death spiral financing;
* partial conversion is allowed only if all atypical special rights are terminated after listing;
* early redemption is allowed and should be distinguished from situations where the bondholder undertakes no risk and has not paid for the investment;
* information should be disclosed in the “Financial Information” and “Risk Factors” sections of the prospectus to explain the impact of the CBs on the listing applicant; and
* information should be disclosed in the listing applicant’s interim and annual reports to explain the dilution impact on the company’s shares should all the outstanding CBs be converted at the end of the period or year.

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