HKEx GUIDANCE LETTER
HKEx-GL44-12 (October 2012)

Subject	**Guidance on Pre-IPO investments in convertible instruments**
Listing Rules	**Main Board Rules 2.03(2) and (4)** **GEM Rules 2.06(2) and (4)**
Related Publications	**HKEx News Release (updated: 13/10/2010) and Guidance Letter HKEx-GL29-12** **HKEx-GL43-12 (October 2012)**
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Important note: *This letter does not override the Listing Rules and is not a substitute for advice from qualified professional advisers. If there is any conflict or inconsistency between this letter and the Listing Rules, the Listing Rules prevail. You may consult the Listing Division on a confidential basis for an interpretation of the Listing Rules, or this letter.*

1. Purpose

1.1 This guidance sets out our current practice in dealing with convertible instruments issued to pre-IPO investors. For guidance on general principles relating to special rights attached to pre-IPO investments, refer to Guidance Letter HKEx-GL43-12.

2. Applicable rules, regulations and principles

2.1 Main Board Listing Rules 2.03(2) and (4) (GEM Rules 2.06(2) and (4)) (the "**Rules**") require the issue and marketing of securities to be conducted in a fair and orderly manner and that all holders of listed securities be treated fairly and equally.

3. Convertible or exchangeable bonds, notes or loans and convertible preference shares (collectively "CBs")

3.1 CBs issued to pre-IPO investors may be structured in such a way that they are not shares in form, but the investors would enjoy a risk-return profile similar to or even better than that of a shareholder. We have in the past requested the removal of conversion price reset mechanism of CBs and the termination of all atypical special rights for bondholders. The rationale is to ensure that all shareholders are treated fairly and equally under the Rules.

3.2 We set out in paragraphs 3.3 to 3.5 our current practices in dealing with convertible instruments with conversion price reset mechanism issued to pre-IPO investors.

(a) Conversion price linked to IPO price or market capitalisation

3.3 The conversion price for the CBs should be at a fixed dollar amount or at the IPO price. Where the CBs will be converted into shares at a price based on a guaranteed discount to the applicant's IPO price or the conversion is linked to market capitalisation, this essentially creates two different prices for the same securities at listing, which is inconsistent with the principles of the Rules. The discount to the applicant's IPO price or any linkage to the market capitalization of shares may also give rise to concerns that the pre-IPO investor does not bear the same investment risk as public investors.

(b) Conversion price reset

3.4 We consider that any conversion price reset mechanism of the CBs should be removed as they are considered to be contrary to the principle of the Rules.

3.5 An example is where the conversion price reset mechanism is based on the lower of a fixed price and a floating market price. Such a price reset mechanism allows conversion at a discount to the fixed price. As the share price declines, the market price based conversion formulae would lead to more shares to be issued, hence greater dilution and greater potential for share price reduction which can work in a spiral.

(c) Mandatory or partial conversions

3.6 Partial conversion of CBs is only allowed if all atypical special rights are terminated after listing. This prevents the situation where a pre-IPO investor enjoys the special rights it held as bondholder by converting a significant portion of their CBs into shares and yet still be entitled to special rights by holding a small portion of the CBs.

(d) Redemptions and early redemptions

3.7 Certain CBs provide bondholders the option to redeem early the outstanding CBs at a price which would enable the bondholders to receive a fixed internal rate of return (**IRR**)[1] on the principal amount of the CBs being redeemed. Upon maturity, all outstanding CBs shall become immediately payable at a price which would enable the bondholders to receive the same fixed IRR.

3.8 We consider that the IRR on the principal amount of the CBs to be redeemed is compensation for the investment and risk undertaken by the bondholders. Such early redemption is allowed and should be distinguished from other cases where the bondholders do not undertake any risk and the investment money is not paid yet.

(e) Disclosure requirements

3.9 Given the complexity of CBs and their terms, additional information should be disclosed in the "Financial Information" and "Risk Factors" sections of the prospectus to explain the impact of the CBs on the applicant, including if the applicant was called upon to redeem the CBs before the maturity date:

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[1] IRR is the interest rate needed in the discounting of cash flows to their present value so the investment's net present value is equal to zero. For example, if the cost of investment of a financial instrument is HK$100 and it is expected to pay its holder $110 in one year's time, the investment's internal rate of return is 10%.

(i) a qualitative analysis on the cash flow and cash position in the event of CBs redemption;

(ii) the various terms and impact of early redemption, including the monetary amount that the applicant is required to pay to the bondholders on the assumption of redemption upon maturity or early redemption, so as to enable the bondholders to receive the required percentage of IRR;

(iii) the maximum number of shares that would be converted and the corresponding change in shareholding in the Risk Factors section; and

(iv) the expected source of cash inflows upon listing, in particular the applicant's existing cash position of the Group, the additional positive operating cashflow the applicant expects to generate and estimated net proceeds from the IPO.

3.10 Additional information should be disclosed in the applicant's interim and annual reports to enable investors to be aware of the dilution impact on the applicant's shares in the event that all outstanding CBs were converted as at the relevant year end or period end:

(i) the number of shares that may be issued upon full conversion of the outstanding CBs;

(ii) the dilutive impact on the then issued share capital of the applicant and respective shareholdings of the substantial shareholders of the applicant;

(iii) the dilutive impact on earnings per share;

(iv) an analysis on the financial and liquidity position of the applicant, at the relevant point in time, discussing its ability to meet its redemption obligations under the CBs;

(v) the number of shares that may be issued and the dilutive impact on shareholdings and earnings per share assuming that the bondholders have elected to have all the interests under the CBs to be paid in kind; and

(vi) an analysis on the applicant's share price at which the bondholders will be indifferent to whether the CBs are converted or redeemed.

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