



EXCHANGE PUBLISHES GUIDANCE ON LISTED ISSUERS' USE OF STRUCTURED CONTRACTS

The Stock Exchange of Hong Kong (the **Exchange**) has issued Guidance Letter HKEx-GL77-14 (the **Letter**), providing guidance on disclosure requirements and other requirements in relation to the use of contractual arrangements (**Structured Contracts**) to own or control a business or part of a business. While the Letter refers specifically to companies listed on the Exchange that invest in businesses in the People's Republic of China (the **PRC**), it is also applicable to investments in other jurisdictions as well.

Foreign Investment Restrictions

Certain businesses may be subject to foreign investment restrictions if they belong to certain industry sectors (**Restricted Businesses**). For example, the PRC's Catalogue for the Guidance of Foreign Investment Industries (Decree No. 57 issued by the State Development and Reform Commission of the Ministry of Commerce) prohibits foreign investment in industry sectors such as compulsory education and news agencies. Another example of foreign investment restriction is to require foreign investors to operate Restricted Businesses through a joint venture owned by the foreign investor and a local partner. In this situation, the foreign investor would own less than 50% of the shareholding, allowing the local partner to maintain control of a majority of the voting rights.

A common method for a foreign investor to gain control of a PRC operating company that engages in a Restricted Business (**OPCO**) is to use a PRC subsidiary (wholly-owned by the foreign investor) (**PRC Subsidiary**) to enter into Structured Contracts with the OPCO that give the foreign investor indirect

control over the OPCO. Since the OPCO is wholly owned by PRC nationals (**Registered Owners**), the foreign investor is able to obtain control of the OPCO without violating PRC law. On the other hand, the foreign investor's control is not based on ownership of the OPCO's equity or possession of a majority of its holding rights; it is entirely dependent on the Structured Contracts between its wholly-owned PRC Subsidiary and the OPCO. The Letter sets out guidance for listed issuers to ensure the legality and validity of their Structured Contracts, and to provide sufficient disclosure of the Structured Contracts in their announcements, circulars and annual reports.

Guidance on Structured Contracts

Generally, the Exchange only accepts the use of Structured Contracts to address foreign ownership restrictions on Restricted Businesses. Where a listed issuer proposes to acquire or establish a business using Structured Contracts that constitute a notifiable and/or connected transaction, the listed issuer should obtain a PRC legal opinion that the Structured Contracts comply with PRC laws, rules and regulations, including those applicable to the PRC Subsidiary and the OPCO. The legal opinion must confirm that the Structured Contracts would not be deemed as "concealing illegal intentions with a lawful form" and thus void under PRC contract law. In situations where laws and regulations specifically disallow foreign investors from gaining control of or operating an OPCO by using Structured Contracts, the PRC legal opinion must confirm that the Structured Contracts do not breach those laws and regulations. Subject to availability and practicability, the listed issuer is also required to obtain appropriate assurance

from the relevant regulatory authorities, or a legal opinion from its PRC legal adviser that all possible actions have been taken to enable it to reach its legal conclusions.

The Structured Contracts should include a power of attorney by which the issuer's directors and their successors (including a liquidator) are granted the power to exercise all rights of the OPCO's shareholders and dispute resolution clauses that provide for arbitration between the listed issuer and the OPCO. Such provisions must not only deal with the right to manage the OPCO's business and the right to revenue, but also include how the OPCO's assets will be handled.

The listed issuer should confirm with its auditors or reporting accountants whether the prevailing accounting principles allow it to account for and consolidate the OPCO's financial results in the listed issuer's consolidated accounts (as with subsidiaries of the listed issuer's group) if it wishes to do so. There should be effective internal controls over the PRC Subsidiary and OPCO to safeguard the assets held by the listed issuer through the Structured Contracts.

Structured Contracts should be unwound when the law no longer regards the OPCO's business as a Restricted Business. The listed issuer should ensure that the OPCO's shareholders undertake that they will return any consideration they receive from the listed issuer when it acquires the OPCO's shares in order to unwind the Structured Contracts.

Any deviation from the above guidance should be disclosed by the listed issuer. The Exchange may then require the listed issuer to take further actions if necessary, on a case-by-case basis. Permission must be received from the Exchange before any major acquisition or very substantial acquisition (as defined by the Listing Rules) may proceed.

Disclosure in Announcements and Circulars

The listed issuer should publish the Structured Contracts on its website. Disclosure of Structured Contracts in announcements and any circulars must include:

- an explanation of why they were executed;
- details of the steps taken by the listed issuer to ensure the validity and legality of the Structured Contracts (as summarised in the preceding section of this newsletter);

- details of the OPCO's registered shareholders and confirmation that appropriate arrangements have been made to protect the listed issuer's investment in case of their death, bankruptcy or divorce;
- reasons why the listed issuer's directors believe that each Structured Contract is enforceable;
- the arrangements in place to address potential conflicts of interest between the listed issuer and the registered shareholders of the OPCO (especially if these shareholders include officers and directors of the listed issuer);
- a corporate structure table that illustrates the Structured Contracts;
- a separate disclosure of revenue from the businesses under the Structured Contracts, where the target of the acquisition generates revenue from subsidiaries other than the OPCO;
- the economic risks borne by the listed issuer as primary beneficiary of the OPCO;
- a discussion of any interference or encumbrance from governing bodies that the OPCO has experienced in operating its business;
- any limitations in the listed issuer's exercise of its option to acquire the OPCO and clarification that such a transfer of ownership may still be subject to costs; and
- details of any insurance purchased to cover the risks associated with the Structured Contracts or a statement that no such insurance has been purchased.

It should also be made clear in the disclosure that (i) the government may decide that the Structured Contracts do not comply with applicable regulations; (ii) that the Structured Contracts do not provide as effective control as direct ownership; (iii) that the OPCO's registered shareholders may have potential conflicts of interest with the listed issuer, and (iv) that the Structured Contracts may be subject to additional tax resulting from the scrutiny of the tax authorities.



If an OPCO or any of the OPCO's registered shareholders is a connected person of the listed issuer, any continuing transactions between the listed issuer and such connected persons under the Structured Contracts are subject to the requirements for connected transactions under Chapter 14A of the Listing Rules.

Disclosure in Annual Reports

Where business operations acquired or begun through Structured Contracts are maintained during (or at the end of) the financial year, and such operations are material when taken in aggregate, the listed issuer must disclose in its annual report:

- the particulars of the OPCOs and their Registered Owners;
- a summary of the major terms of the Structured Contracts;
- a description of the OPCOs' businesses and their significance to the listed issuer's group;
- the revenue and assets subject to the Structured Contracts;
- the extent to which the Structured Contracts relate to requirements other than foreign ownership restrictions;
- the reasons for using the Structured Contracts;
- the risks of using the Structured Contracts and the steps taken by the listed issuer to mitigate them;
- any material changes to the Structured Contracts;
- the circumstances in which the Structured Contracts were executed; and
- any instance of unwinding or failure to unwind any Structured Contract when the legal and regulatory requirements that necessitated them are removed.

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