

Hong Kong Stock Exchange Clarifies Pre-IPO Investment Policies

October 30, 2012

Introduction

On Thursday 25 October 2012, the Hong Kong Stock Exchange (the “Exchange”) issued two new Guidance Letters on pre-IPO investments. Consolidating and restating the Exchange’s latest policies in this area, these letters will hopefully clarify many of the uncertainties associated with the vibrant market in pre-IPO investments, very often a key component in Hong Kong listings as well as private equity investment practice.

The Guidance Letters are [GL43-12](#) (Guidance on Pre-IPO Investments) and [GL44-12](#) (Guidance on Pre-IPO Investments in Convertible Instruments).

The references to “Rule” in this briefing are of the Listing Rules of the Main Board, although the same treatment will be given by the Exchange to pre-IPO investments to be listed on the Main Board as well as the GEM Board.

28-day / 180-day rule

Ever since 13 October 2010, with the introduction of the [Interim Guidance on Pre-IPO Investments](#) (“Interim Guidance”), pre-IPO investments must be completed – i.e. funds must be irrevocably settled and received by the company – either (a) at least 28 clear days before the submission of the A1 listing application or (b) at least 180 clear days before the day dealing in the listed securities commences.

This rule remains unchanged and will be applicable to all but very exceptional cases (e.g. the applicant being in severe financial distress).

Can the investor reduce / eliminate his investment risk?

The Exchange has set out its policies on the following typical provisions frequently proposed for pre-IPO investments. These have some important ramifications in practice which we set out in the “Remarks” column below:

Contractual provisions	Disallowed	Allowed	Remarks
Price adjustments	Any price adjustment provisions (e.g. guaranteed discount to IPO price or share price, or adjustments linked to market capitalization of the shares) which effectively create two different prices for the same securities for pre-IPO investors and other shareholders at the time of listing.	Adjustment mechanisms that do not potentially create two different prices for the same securities and for that reason, do not offend the “fair and orderly marketing” principle under Rule 2.03(2) and the “equal treatment” principle under Rule 2.03(4).	

Contractual provisions	Disallowed	Allowed	Remarks
Put or exit options	All put or exit options granted to a pre-IPO investor to put back the investments to the company or its controlling shareholder, or any option that potentially removes the investment risk from the investor.	Any exit option that potentially makes a pre-IPO investment risk-free for the investor is allowed only if the listing does not take place.	<p>The “blanket” disallowance of put or exit options (including putting back the shares to controlling shareholders) appears not to be in line with the general policy allowing compensation to be settled between the investor and shareholders (as opposed to the company). See the discussion on profit guarantee below.</p> <p>In practice, this means that if a prescribed profit level is not met, the Exchange will accept an undertaking by the controlling shareholder to pay monetary compensation to the investor, but not an undertaking by the same shareholder to buy out the investor. This may be counter-intuitive to many practitioners.</p>
Qualified IPOs	An investment agreement may include a term that if the company does not achieve a qualified IPO within a specified period, the pre-IPO investor is entitled to compensation. This is allowed provided that the amount of compensation is set out in (or can be derived from) the investment agreement.	If the compensation amount is not set out in and cannot be derived from the investment agreement, it will be considered an amendment of / variation to the original investment terms, and the 28-day / 180-day rule for settlement of investment will apply.	

Can a shareholder’s / bondholders’ contractual right survive the listing?

As for various shareholders’ rights typically considered for pre-IPO investors, the Exchange’s position and our observations are summarized below:

Nature of right	Is it allowed before listing?	Will it survive listing?	Remarks
Right to nominate directors	Yes. A pre-IPO investor may nominate or appoint a director before listing.	No, as such right is not generally available to other shareholders. In addition, any director appointed before listing by the pre-IPO investor will be subject to the retirement and re-appointment provisions of the company's articles of association.	On the letter of the guidance, a nomination right tied to a shareholding percentage and written into constitutional document would appear to be acceptable as it is technically available to all shareholders apart from the pre-IPO investor.
Veto rights	Yes. A pre-IPO investor may be given contractual rights to veto certain corporate actions (e.g. making of any petition or passing of resolution for winding-up the company, change in the company's business, amalgamation or merger).	No. All such rights must be terminated upon listing.	
Anti-dilution	Yes, provided: (a) the allocation is necessary in order to give effect to pre-existing contractual rights given to the investor; (b) full disclosure of the pre-existing entitlement and the number of shares to be subscribed by the investor is made in the prospectus and the allotment results announcement; and (c) the subscription of additional shares by the investor will be conducted at the IPO price.	No. All anti-dilution rights must be terminated upon listing, in compliance with Rule 13.36.	

Nature of right	Is it allowed before listing?	Will it survive listing?	Remarks
Profit guarantee	Yes	<p>Yes, if the profit guarantee is settled by a shareholder and the compensation is not linked to the market price or capitalization of the shares.</p> <p>No, if the profit guarantee is settled by the company or if the compensation is linked to the market price or capitalization of the shares.</p>	<p>On this policy, it is possible for pre-IPO investor's protection to subsist after listing, if the protection is given to them by the controlling shareholder, not by the company.</p> <p>As a related point, investors need to be aware of the implications under the Takeovers Code, as the investor and the controlling shareholder may by virtue of such protection mechanisms be treated as concert parties going forward, particularly if voting undertakings or similar arrangements are involved.</p> <p>Although the Exchange appears to accept that "private arrangements" between the investor and the controlling shareholder are generally not subject to regulation, this would be at odds with its stated position that exchangeable bonds fall within its remit.</p>
Negative pledge	Yes	<p>No. Negative pledges must generally be removed before listing unless it:</p> <p>(a) is a widely accepted provision in loan agreements (e.g. pledge against creating any charges or other security interest on the company's assets and revenues, or pledge against disposal of interest by controlling shareholder);</p> <p>(b) is not egregious; and</p> <p>(c) does not contravene the fairness principle in the Rules.</p>	

Nature of right	Is it allowed before listing?	Will it survive listing?	Remarks
		<p>The Exchange will review all negative pledges and may require confirmation from the sponsor that those pledges that remain after listing are in line with normal terms of debt issues.</p>	
<p><i>Prior consent for corporate actions – e.g. declaration of dividends, disposal of assets, change of directors, alteration of articles</i></p>	<p>Yes</p>	<p>No, these terms must be removed before listing unless the company can demonstrate that the relevant terms:</p> <p>(a) are not egregious; and</p> <p>(b) do not contravene fundamental principles to the disadvantage of other shareholders.</p>	
<p><i>Exclusivity / “no more favourable terms” provisions for issue of shares, options, warrants and other rights</i></p>	<p>Yes</p>	<p>No, unless the agreement is modified to include a “fiduciary out” clause, so that directors may disregard the terms to discharge their fiduciary duties.</p>	
<p><i>Information rights</i></p>	<p>Yes</p>	<p>Yes, only if the information is made available to the general public at the same time. Any delivery of price-sensitive information to an investor will be subject to legal and regulatory disclosure requirements unless a safe harbour applies.</p>	<p>The fact that information rights are restricted to publicly available information highlights the importance for investors, in appropriate cases, to have board representation.</p>
<p><i>Representation / attendance rights</i></p>	<p>Yes</p>	<p>Yes, where the right to nominate persons to senior management is granted to the investor but appointment is subject to the decision of the board in discharge of directors’ fiduciary duties.</p>	

Nature of right	Is it allowed before listing?	Will it survive listing?	Remarks
Rights of first refusal / tag-along rights	Yes	Yes, if the investor obtains the right of first refusal from the company's controlling shareholder in respect of the latter's offer to sell his shares to any third party, or to include the investor's shares in the sale to the third party.	Drag-along rights are not mentioned in the guidance, but along the same policy lines, drag-along rights by the controlling shareholder is presumably also permissible.

What are the additional restrictions for convertible instruments?

Generally, the guidance confirms that there is no requirement for all convertible instruments (including convertible or exchangeable bonds, notes or loans and convertible preference shares) ("Convertibles") to be converted at the time of listing, but special rights must be removed before listing and full disclosure must be made. Companies and their counsel should note this when negotiating the investment.

Pre-IPO investments by way of Convertibles are subject to important constraints in addition to those discussed above. These are summarized as follows:

Contractual provisions	The Exchange's policy	Remarks
Conversion price reset	Disallowed. Any conversion price reset mechanism of Convertibles should be removed as contrary to the spirit of the Rules.	Conversion price reset is not allowed for a listing applicant, but we note that it is allowed for an already-listed company.
Mandatory / partial conversions	Allowed only if all atypical special rights given to the investor are terminated after listing, to prevent the investor from enjoying special rights by continuing to hold a small number of Convertibles.	
Redemptions (including early redemptions)	Early redemption provisions enabling the investor to receive a fixed internal rate of return ("IRR") are allowed, as the IRR on the principal amount of the redeemed securities is considered compensation for the investment risk undertaken by the investor. However, redemption provisions are not permissible where the investor does not undertake any risk and the investment money is not yet paid.	
Disclosure requirements for Convertibles	The following mandatory disclosures must be made: <ul style="list-style-type: none"> In the "Financial Information" and "Risk Factors" sections of the prospectus – the impact of the Convertibles on the company, including if the company were called upon to redeem the Convertibles before maturity: 	For the disclosure of expected source of cash inflows upon listing, the Exchange should clarify whether cash inflows is only for 12 months following listing (as per the working capital forecast) otherwise it would be difficult in practice for companies

Contractual provisions	The Exchange's policy	Remarks
	<ul style="list-style-type: none"> ▪ a qualitative analysis on the company's cash flow and cash position in the event of redemption; ▪ the terms and impact of early redemption – e.g. monetary amount payable to the investor on redemption at maturity vs. early redemption, to enable the investor to receive the required IRR; ▪ as a risk factor, the maximum number of shares to be converted and the corresponding change in the company's shareholding structure; and ▪ the expected source of cash inflows upon listing, including the company's existing cash position, any expected positive operative cash flows, and estimated net proceeds of the IPO. ▪ In the company's interim and annual reports – the dilutive impact of conversion of all outstanding Convertibles at the relevant year-end or period-end: <ul style="list-style-type: none"> ▪ the number of shares that may be issued upon full conversion; ▪ the dilutive impact on the then issued share capital and respective shareholders of the substantial shareholders; ▪ the dilutive impact on the earnings per share; ▪ an analysis on the company's financial and liquidity position at the relevant time, including its ability to meet the redemption obligations; ▪ the number of shares that may be issued and the dilutive impact on shareholdings and earnings per share, assuming that the holders of the Convertibles have elected for payment in kind; and ▪ an analysis on the company's share price at which the holders of the Convertibles will be indifferent to whether the Convertibles are converted or redeemed. 	<p>to prepare such forecast.</p> <p>The required disclosures appear to be suitable for convertible securities (issued by the company) but not exchangeable securities (issued by the controlling shareholder). The Exchange's clarification would be welcome as to what, if any, disclosures would be appropriate for exchangeable securities.</p>

Do the pre-IPO investors’ shares count towards public float?

Despite the lock-up undertaking typically given by pre-IPO investors, the shares subject to the lock-up are considered part of the public float so long as Rule 8.24 is satisfied – namely, the acquisition of the shares are not financed directly or indirectly by a connected person of the company.

Past decisions superseded

The Exchange clarified that the Listing Decisions issued on the subject of pre-IPO investments before the date of the Interim Guidance (13 October 2010) have been superseded. A list of the superseded decisions is set out in the Appendix to this briefing.

Listing Decisions continuing to be effective

A number of Listing Decisions in this area will continue to be effective. These include:

Link to Listing Decision	Date	Subject matter of decision
LD15-2011	July 2011	The Interim Guidance (28-day rule) would apply to a loan and warrant issue which entitled the lender to exercise the warrants to purchase a number of shares at a pre-determined price upon listing.
LD12-2011	June 2011	The Interim Guidance (28-day rule) would not apply to a company with a primary listing overseas and secondary listing in Hong Kong, in respect of plans to issue shares and convertible bonds to independent investors, which plans will be subject to shareholders’ approval in the place of the company’s primary listing.
LD99-3	July 2010	The terms of a convertible bond issue to a pre-IPO investor, enabling the investor to require the company to redeem the bonds early upon certain events (including the removal of certain directors and failing to obtain shareholders’ approval for certain continuing connected transactions) would contravene the fairness principle of Rule 2.03(4).

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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Listing Decisions superseded by GL43-12

Link to Listing Decision	Subject matter of decision
LD59-7	Whether Company B would be regarded as a member of the public at the time of listing and whether shares held by it should be subject to lock-up in a case where Company B was entitled to hold approximately over 10% shareholding interest in Company A upon the conversion of the convertible bonds subscribed by it prior to listing
LD59-6	Whether the special rights available to the Pre-IPO Investor complied with the principles under Listing Rules 2.03(2) and (4)
LD59-5	Whether certain special rights available only to the Bondholders under the terms of the convertible bonds would be in compliance with the general principle that all holders of listed securities are to be treated fairly and equally under Listing Rule 2.03
LD59-4	Whether the grant of veto rights over certain major corporate matters to the Investors of the Convertible Instruments prior to listing would violate the requirement to treat all holders of listed securities fairly and equally under Listing Rule 2.03(4)
LD59-3	Whether the pre-IPO investment in Company A by Investor A would fulfill the requirement under Listing Rule 2.03(4) that all holders of listed securities are to be treated fairly and equally
LD59-2	Whether the guaranteed discount to the IPO price of the mandatory Convertible Bonds and the negative pledge under the non-mandatory Convertible Bonds available only to the Convertible Bondholders would violate the fair and orderly principle and the requirement to treat all holders of listed securities fairly and equally under Listing Rule 2.03
LD59-1	Whether certain rights granted to Investor X would be permitted to continue after listing, given that the rights were not generally available to other shareholders of Company A and the nominated directors' compliance with such rights might, in certain circumstances, conflict with the duty of directors to act in the best of the interests of shareholders as a whole at all times
LD55-3	Whether a placing of Company A's shares to the Pre-IPO Investor prior to listing that met the technical requirements regarding disclosure, lock-up and public-float as memorialised in Listing Decision HKEx-LD36-1 complied with Listing Rules 2.03 and 9.09 (case 3)
LD55-2	Whether a placing of Company A's shares to the Pre-IPO Investor prior to listing that met the technical requirements regarding disclosure, lock-up and public-float as memorialised in Listing Decision HKEx-LD36-1 complied with Listing Rule 2.03 (case 2)
LD55-1	Whether a placing of Company A's shares to the Pre-IPO Investor prior to listing that met the technical requirements regarding disclosure, lock-up and public-float as memorialised in Listing Decision HKEx-LD36-1 complied with Listing Rule 2.03 (case 1)

Link to Listing Decision	Subject matter of decision
LD36-2	Pre-IPO placing-whether shares subject to lock-up and counted as part of public float (GEM Board)
LD36-1	Pre-IPO placing-whether shares subject to lock-up and counted as part of public float (Main Board)