

HKEx LISTING DECISION
Cite as HKEx-LD52-5 (March 2006)

[Streamlined and incorporated into the Guide for New Listing Applicants in January 2024]

Summary	
Name of Parties	<p>Company A – a Main Board listing applicant and its subsidiaries (the ‘Group’)</p> <p>Sponsor– the sponsor of Company A</p> <p>Associate – a subsidiary of the parent company of Sponsor</p>
Subject	<p>Whether, in a case where Associate subscribed for not more than 2% of the enlarged share capital of Company A through conversion of convertible notes shortly prior to listing at a conversion price discounted to the IPO price which is subject to adjustment based on a guaranteed profit clause,</p> <ul style="list-style-type: none"> • Sponsor could continue to act as a sponsor in the listing application of Company A; and • the shares held by Associate could be counted as part of the public float as required under Listing Rule 8.08(1)(a)?
Listing Rules	<p>Listing Rules 3A.07; 8.08(1)(a); 8.24; and Listing Decision HKEx-LD36-1 (October 2003)</p>
Decision	<p>The Exchange determined that:</p> <ul style="list-style-type: none"> • based on the revised terms of the subscription agreement removing the right of Associate to further downward adjustment to the conversion price, the Exchange accepted that the Sponsor was independent from Company A notwithstanding Associate’s interest in the equity capital in Company A upon listing. Full disclosure of Associate’s investment in Company A would be required to be made in the prospectus; and • the shares (containing no provision for guaranteed profit) issued to Associate, following the exercise of the conversion right of the convertible notes, should not be regarded as shares held by members of the public. Therefore, Company A must satisfy the public float requirement of 25% under Listing Rule 8.08(1)(a) by other means.

SUMMARY OF FACTS

1. Associate entered into a subscription agreement to subscribe for a number of convertible notes of Company A (the 'Investment') shortly before the date for the hearing of the listing application of Company A by the Listing Committee pursuant to a memorandum of understanding entered into between the parties shortly after the submission of Form A1 by Sponsor.
2. The directors of Company A confirmed that the subscription agreement was negotiated at arms' length and contained the following material terms:
 - a. Associate had the option to convert the convertible notes into shares ('Conversion Shares') at the conversion price ranging from 20% to 35% discount to the IPO price of the shares (depending on the final IPO price of the shares). If converted, the Conversion Share would represent approximately 2% of the enlarged issued share capital of Company A upon listing;
 - b. if Company A could not achieve the profit forecast as set out in the prospectus, Company A would pay to Associate an amount equal to the percentage decrease of the shortfall as adjustment for the amount of consideration paid earlier for the Conversion Shares (i.e. 'Guaranteed Profit').
3. Associate intended to convert the convertible notes into Conversion Shares before listing.

THE ISSUE RAISED FOR CONSIDERATION

4. Whether, in a case where Associate subscribed for not more than 2% of the enlarged share capital of Company A through conversion of convertible notes shortly prior to listing at a conversion price discounted to the IPO price which is subject to adjustment based on a guaranteed profit clause,
 - a. Sponsor could continue to act as the sponsor in the listing application of Company A; and
 - b. the Conversion Shares held by Associate could be counted as part of the public float required under Listing Rule 8.08(1)(a)?

APPLICABLE LISTING RULES OR PRINCIPLE

5. Listing Rule 3.01 (applicable at the time the present case was considered but repealed since 1st January 2005) set out that:

...A potential sponsor will not be considered acceptable by the Exchange if the Exchange does not consider that it will be able to give the new applicant impartial advice...

6. Listing Rules 3A.07(1) to (10) (not yet effective at the time the present case was decided) set out a number of circumstances where a sponsor is not considered independent from the new applicant. These circumstances include:

(1) the sponsor group and any director or Associated of a director of the sponsor collectively holds or will hold, directly or indirectly, more than 5% of the issued share capital of the new applicant, save and except that holding arises as a result of an underwriting obligation;

(9) any of the following has a current business relationship with the new applicant or director, subsidiary, holding company or substantial shareholder of the new applicant, which would be reasonably considered to affect the sponsor's independence in performing its duties as set out in this Chapter, might reasonably give rise to a perception that the sponsor's independence would be so affected, save and except where that relationship arises pursuant to the sponsor's engagement by the new applicant for the purposed of providing sponsor services:

(a) any member of the sponsor group; ...

7. Listing Rule 8.08(1)(a) provides that:

at least 25% of the issuer's total issued share capital must at all times be held by the public.

8. Listing Rule 8.24 sets out that the Exchange will not regard any connected person of the issuer as a member of 'the public' or shares held by a connected person as being 'in public hands'. The rule further provides that the Exchange will not recognise as member of the 'public where:

(1) any person whose acquisition of securities has been financed directly or indirectly by a connected person; or

- (2) any person who is accustomed to take instructions from a connected person in relation to the acquisition, disposal, voting or other disposition of securities of the issuer registered in his name or other held by him.
9. In Listing Decision Series 36 published in October 2003 ('HKEx-LD36-1') regarding pre-IPO placing it is stated that:

The Exchange was of the view that, as a general principle on the Main Board, placings of shares shortly before a listing application should be permitted subject to full disclosure in the prospectus. However, the placee may be subject to a lock-up of his shares. The question of whether the placee should be subject to a lock-up is determined on a case-by-case basis having regard to all the circumstances of the case.

It was noted that:

Furthermore, the Exchange would not regard any placee who is subject to a lock-up as a member of the public at the time of listing and for so long as the transferor and the placee together constitute a "group of persons who are together entitled to exercise or control the exercise of [30 per cent] or more of the voting power at general meetings of the issuer or who is or are in a position to control the composition of a majority of the board of directors of the issuer".

It was also noted that:

- "shortly before a listing application" tends to be measured in terms of months rather than weeks and with the date of the listing application as reference point;
- the greater the amount of any discount to the IPO price and/or the greater the proximity in time of the placing to the date of the listing application, the greater would be the doubt as to the genuine nature of the transaction such that a lock-up of the shares would be warranted;

THE ANALYSIS

Independence of Sponsor

10. The Exchange is of the view that a sponsor must ensure that it is able to give impartial advice to a listing applicant. A sponsor's independence is a question of

fact. When determining a sponsor's independence, it is necessary to take into account all the circumstances in each case.

11. In the present case the Exchange considered the following submissions by Sponsor:
 - a. Associate would not be entitled to appoint any representative to the board of Company A and no other arrangement was entered into or proposed to be entered into between Company A and Associate concerning the management of the Group;
 - b. the operation of Associate was independent from Sponsor. They shared only one common non-executive director. As such, none of the members of the management team of Associate was involved in the daily operation of Sponsor and vice versa;
 - c. save as acting as sponsor and global coordinator, no other relationship existed between the Group and Sponsor and between the Group and Sponsor's fellow subsidiaries; and
 - d. the proposed shareholding of Associate in Company A would be limited to approximately 2% of its enlarged share capital.
12. Having considered the above submissions, the Exchange accepted that the operation of Associate was independent from Sponsor. The Exchange also noted that the proposed shareholding of Associate in Company A would be below the threshold of 5% as stipulated in the proposed Listing Rules (meaning Listing Rule 3A.07(1)) for determining where a sponsor is sufficiently dependent or not. These two findings supported Sponsor's case to act as a sponsor of Company A.
13. However, the Exchange considered that the Guaranteed Profit clause in the subscription agreement was a financial commitment provided by Company A to Associate. Such commitment could be construed as a material interest of Sponsor in the listing of Company A that could adversely affect the independence of Sponsor.
14. In view of the Exchange's concern on the independence of Sponsor, Sponsor submitted that the Guaranteed Profit clause in the subscription agreement would be removed from the subscription agreement.

Public float requirement under Listing Rule 8.08(1)(a)

15. On the question of pre-IPO placing, the Exchange adopted the approach set out in HKEx-LD36-1 mentioned in paragraph 9 above. Pursuant to the principles set out in the listing decision, placing of shares shortly before a listing application should be permitted subject to full disclosure in the prospectus. However, the placee

may be subject to a lock-up of his/its shares and not be counted as a member of the public. In determining whether there should be a lock-up and whether the shares should be counted as part of the public float, the Exchange is mindful that placing of shares to individuals shortly before the proposed listing of a company tends to call into question the genuineness of the transaction and may lead one to query whether the placee will be holding the shares for his own benefit or for the benefit of a controlling shareholder, with a view to circumventing the lock-up provisions of the Listing Rules.

16. In determining whether or not there was a circumvention of the Listing Rules in the present case, the Exchange considered it relevant to take into account factors like the purpose of the subscription; whether a single investor or a number of investors were included; the timing of the subscription and the discount that was offered. Timing was relevant in terms of considering whether 'capital had been put at risk' before listing.
17. The Exchange noted that there were factors in support of the view that the Conversion Shares were public shares:-
 - a. Associate was not a connected person of Company A pursuant to the Listing Rules and it would not be involved in the management of the Group;
 - b. the investment would not be financed by a connected person and Associate would not take instructions from a connected person in relation to the acquisition, disposal, voting or other disposition of any of the Conversion Shares to be acquired;
 - c. Associate voluntarily agreed to be subject to a lock-up of its Conversion Shares in Company A for a period of six months from the listing date of Company A.
18. However, the Exchange considered that there were overriding factors in this case to the extent that the Conversion Shares should not be treated as shares held by the public:
 - a. it was stipulated in HKEx-LD36-1 that the greater the amount of any discount to the IPO price and/or the greater the proximity in time of the placing to the date of the listing application, the greater would be the doubt as to the genuine nature of the transaction such that a lock-up of the shares would be warranted. The Exchange was of the view that the discount percentage was significant given the proximity in time of the issue of the conversion shares to the listing of Company A; and
 - b. the completion of the investment was subject to the condition that the Conversion Shares to be held by Associate would be regarded as shares

held by the public for the purpose of the Listing Rules. The Exchange was of the view that Associate made the Investment in anticipation of making a substantial gain after the listing of the Conversion Shares on the Exchange.

THE DECISION

Regarding independence of Associate

19. Based on the revised terms of the subscription agreement removing the right of Associate to further downward adjustment to the conversion price of the Conversion Shares, the Exchange accepted that Sponsor was independent from Company A notwithstanding Associate's interest in the share capital of Company A upon listing. Full disclosure of Associate's investment in Company A would be required to be made in the prospectus.

Regarding whether shares held by Associate were part of the public float

20. The Exchange was of the view that the Conversion Shares subscribed by Associate (containing no provision for Guaranteed Profit) should not be regarded as shares held by members of the public. Therefore, Company A must satisfy the public float requirement of 25% under Listing Rule 8.08(1)(a) by other means.