

HKE_x LISTING DECISION
HKE_x-LD88-1 (May 2010)

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

Summary	
Parties	Company A – a Main Board listing applicant Parentco – the parent company of Company A, a connected person of Company A
Subject	Whether to allow a continuing connected transaction to exceed three years with an annual cap expressed as a percentage of Company A’s gross revenues
Listing Rules	Rule 14A.35(1)& (2)
Decision	The Exchange granted Company A a waiver of Rule 14A.35(1) & (2) on the condition that Company A would modify the terms of the continuing connection transaction and directors and sponsors would give confirmations that the transaction was fair and reasonable to Company A and the shareholders as a whole

SUMMARY OF FACTS

1. Company A was granted a 20-year licence by the local government for its operation. The unexpired term of the licence was over 10 years when Company A applied for listing.
2. Company A proposed to continue a licence agreement with Parentco for the use of certain trade names and intellectual property for an indefinite term for a monthly royalty fee based on Company A’s gross revenues.
3. Company A submitted that the trade names and other intellectual property were crucial to its business and an agreement that guaranteed the use of those rights indefinitely would provide stability. It applied for a waiver of Rule 14A.35.
4. Company A indicated that it would re-structure the terms of the licence agreement to meet the Exchange’s criteria for granting a Rule 14A.35 waiver.

THE ISSUE RAISED FOR CONSIDERATION

5. Whether to allow a continuing connected transaction to exceed three years with an annual cap expressed as a percentage of Company A’s gross revenues?

APPLICABLE LISTING RULES OR PRINCIPLE

6. Rule 14A.42 provides that the Exchange will consider granting waivers for the following transactions:

...
(3) upon an application by a new applicant, specific continuing connected transactions. Such waivers will be from the announcement and independent shareholders' approval requirements of this Chapter. General waivers will not be granted. The applicant's sponsor is required to state in the listing document whether the continuing connected transactions for which the waivers are sought are in the ordinary and usual course of business of the listed issuer, on normal commercial terms, are fair and reasonable and in the interests of the shareholders as a whole. In addition, the issuer is required to comply with rules 14A.35(1), 14A.35(2), 14A.36, 14A.37, 14A.38, 14A.39 and 14A.40.

7. Rule 14A.35 provides that when an issuer enters into a non-exempt continuing connected transactions, it must:

(1) in respect of each connected transaction, enter into written agreement(s) with the connected person. The agreement must set out the basis of the calculation of the payments to be made. The period for the agreement must be fixed and reflect normal commercial terms and, except in special circumstances, must not exceed 3 years. Special circumstances are limited to cases where the nature of the transaction requires the contract to be of a duration longer than 3 years. In such cases, the independent financial adviser will need to explain why a longer period for the agreement is required and to confirm that it is normal business practice for contracts of this type to be of such duration;

(2) in respect of each connected transaction, set a maximum aggregate annual value ("cap"), the basis of which must be disclosed. This annual cap must be expressed in terms of monetary value rather than a percentage of the issuer's annual revenue as derived from its latest published audited accounts or, where consolidated accounts have been prepared, its latest published audited consolidated accounts. The cap must be determined by reference to previous transactions and figures which are readily ascertainable from published information of the issuer. If

there are no previous transactions, the cap must be made based on reasonable assumptions, details of which must be disclosed.

Note: Reference to annual revenue and other bases may help to determine the monetary value of the cap.

THE ANALYSIS

Continuing Connected Transactions over 3 years

8. Rule 14A.35(1) contemplates that continuing connected transactions may have a term beyond 3 years. The burden is on the issuer and its sponsor to explain why a longer term is justified in the circumstances.
9. Before the Listing Rules amendment in 2004 to require continuing connected transactions to normally be of a fixed term of no more than 3 years under a monetary cap, the Exchange had allowed annual caps to be expressed as percentages of the listing applicants' revenue or costs of sales. See example in Case 1.

Case 1

10. In 2002 a waiver was granted to a new issuer, an airport operator, for the use of a runway owed by its parent for a term of 20 years and the cap was set as a fixed percentage of the issuer's revenue.
11. After the 2004 Listing Rules amendment, issuers were still entering into continuing connected transactions for grants of intellectual property rights by their parents for a term significantly longer than three years or even for an indefinite term. Two examples are illustrated below.

Case 2

12. The issuer was engaged in the financial service industry. The licensing agreement for the use of brand names owned by its parent had the following terms:-
 - a. royalty free;
 - b. indefinite term;
 - c. only terminable by the parent if it ceased to be the issuer's holding company, or by either party upon breach of the agreement or winding-up.

Case 3

13. The issuer was a provider of information technology software and services. The licensing agreement for the continuous use of the parent's brand name had the following terms:-
 - a. an initial term of 10 years renewable for a further 10 years at the issuer's discretion;
 - b. royalty free; and
 - c. if there were a change in control, the parent would continue the agreement for three more years for an annual payment fixed as the higher of a percentage of the issuer's revenue and a fixed amount. At the end of the three years, the licence would continue at fair market value determined by an internationally recognised brand consultant.
14. Since the licensing agreements in Case 2 and Case 3 were royalty free, the de-minimis exemption applied and no continuing connected transaction waiver was required.

Monetary Cap Requirement

15. In 2007 the Exchange was asked to waive the monetary cap requirement (effective since 2004) for issuers in the oil and gas business. The reason was that volatility in the commodity prices of oil and gas had given rise to concerns about insufficient provision of caps for normal business use. The Exchange agreed to waive the monetary cap requirement to these issuers provided that the annual cap was disclosed as a fixed quantum (expected transaction volume) with a sensitivity analysis on the correlation of the annual cap with the respective commodity prices, and how changes to the commodity prices (which is public information) would affect the value of the connected transaction.
16. Taking into account the precedent cases, the Exchange was of the view that it might not be in Company A's best interest to tie royalty fee to its gross revenues for too long.

THE DECISION

17. The Exchange granted Company A a waiver from announcement and independent shareholder's approval under Rule 14A.35 (1) and (2) on the basis that:
 - a. while the licence agreement would remain an indefinite arrangement with Parentco, the waiver granted would be for a fixed term co-terminus with the remaining term of the licence that Company A had obtained from the

local government. Upon expiry of the waiver, the licence agreement would only continue if approved by Company A. Company A would then need to comply with the Listing Rules requirements for continuing connected transactions or obtain fresh waiver;

- b. Parentco would need Company A's prior consent if it wanted to terminate the head agreement that granted Parentco the intellectual property rights. Company A's directors who would be Parentco's directors must not vote on any resolution to give consent to the termination of the head agreement;
- c. the prospectus would clearly disclose the basis of the royalty fee calculation during the track record period and going forward; Company A would separately disclose in its future interim and annual financial statements the royalty fee calculation and related amounts;
- d. any change to the basis of calculating the gross revenues would be subject to the approval of shareholders;
- e. the setting of the annual cap expressed as a percentage of Company A's gross revenues was reviewed by an independent appraisal agent using market comparables;
- f. directors including independent non-executive directors confirmed that the long duration of the licence agreement and the non-monetary annual cap were fair and reasonable to Company A and shareholders as a whole;
- g. the sponsor confirmed in the prospectus that:
 - (i) the non-monetary annual cap of the licence agreement was fair and reasonable in the interests of the shareholders as a whole;
 - (ii) it was normal business practice for agreements in the nature of the licence agreement to have a long duration and the incorporation of an initial fixed term was normal business practice to provide stability to Company A's business;
 - (iii) the terms of the licence agreement were in the ordinary and usual course of Company A's business, on normal commercial terms, and the terms were fair and reasonable and in the interest of shareholders as a whole reasonable and it was normal business practice.