

Amendments to Connected Transaction Rules ¹

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¹ This presentation material was first published in July 2010. Examples 18 and 19 were updated in October 2010 to reflect transitional arrangements set out in Items 10A and 14A of FAQ Series 10 published in September 2010.

Background

- 2 October 2009 - Consultation paper on Proposed Changes to Connected Transaction Rules published
- 2 December 2009 - Consultation period ended
- 20 May 2010 – Consultation conclusions and Rule amendments published
- 3 June 2010 – Rule amendments became effective

Purpose of Rule amendments

- Ensure our Rules meet their purpose and intent in a balanced and cost-effective manner
- Address market comments that some connected transaction Rules are burdensome or restrictive
- Amend Rules which have unintended effects

Agenda

- (1) Insignificant subsidiary exemption
- (2) De minimis exemptions
- (3) Scope of connected persons
 - Definition of connected person
 - Definition of associate
- (4) Other amendments
- (5) Transitional arrangements
- (6) Next step

(1) Insignificant subsidiary exemption

Insignificant subsidiary exemption

- (a) Scope of the exemption
- (b) How to determine an “insignificant subsidiary”
- (c) Size test calculation for assessing a subsidiary’s materiality
- (d) Additional requirement for transactions involving the “insignificant subsidiary”
- (e) Continuing connected transactions

Scope of the exemption

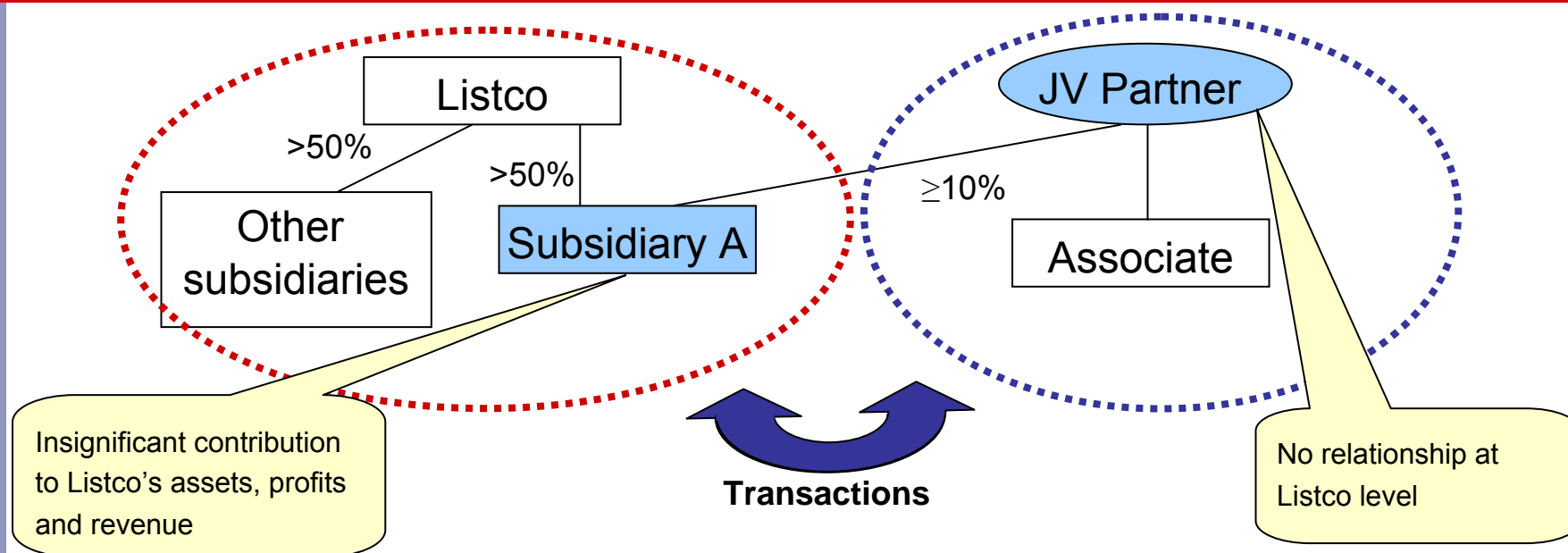
- Connected persons include:
 - Directors and substantial shareholders
 - at the listed company level
 - at the subsidiary level

Scope of the exemption

New Rule

- Exempt transactions with connected person related to “insignificant subsidiary” only

Scope of the exemption



- JV Partner and its Associate are connected persons only because of JV Partner's relationship with Subsidiary A
- Subsidiary A is an "insignificant subsidiary"
- Exempt transactions between Listco group and JV Partner (or its Associate) on normal commercial terms

How to determine an “insignificant subsidiary”

A subsidiary is “insignificant” if:

- Assets, profits and revenue ratios $< 5\%$ for the latest financial year
- OR
- Assets, profits and revenue ratios $< 10\%$ for each of the latest 3 financial years (*or if less, the period since the incorporation or establishment of the subsidiary*)



Can the issuer change from the one-year test to the three-year test (or vice versa) from time to time?

Yes

How to determine an “insignificant subsidiary”

Example 1

March 2010: Listco published its accounts for year ended 31/12/2009

Sept 2010 : First transaction between Listco and JV Partner (a substantial shareholder of Subsidiary A)

	Percentage ratios for Subsidiary A
2007	All > 10%
2008	6% to 8%
2009	All < 5%

Subsidiary A is “insignificant” at the time of the first transaction based on the one-year test (i.e. 5% for latest financial year)

→ First transaction with JV Partner exempt

How to determine an “insignificant subsidiary”

Example 1 (cont'd)

March 2011: Listco published its accounts for year ended 31/12/2010

May 2011 : Second transaction between Listco and JV partner

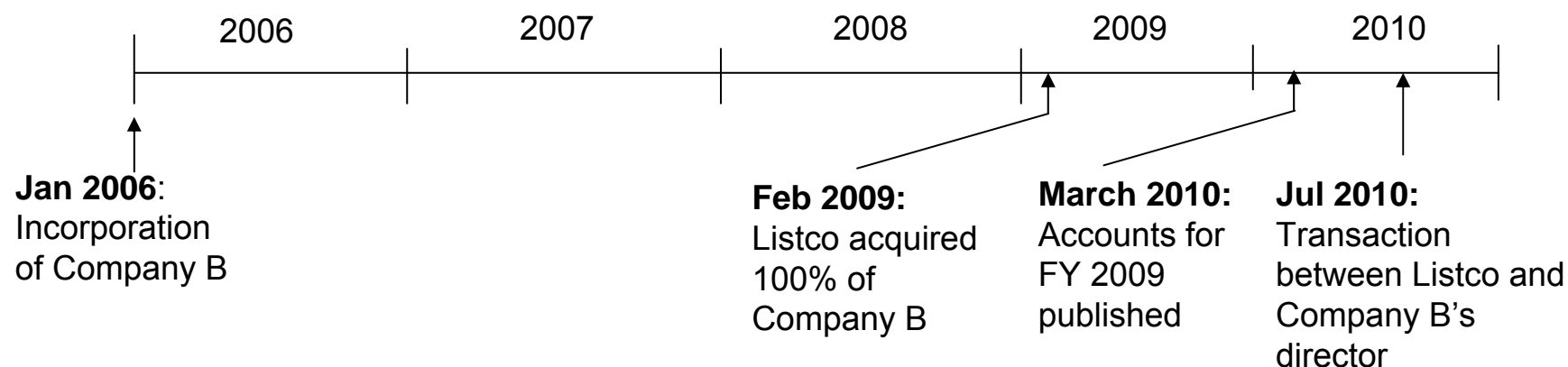
	Percentage ratios for Subsidiary A
2008	6% to 8%
2009	All <5%
2010	4% to 7%

Subsidiary A is “insignificant” at the time of the second transaction based on the three-year test (i.e. 10% for latest 3 financial years)

→ Second transaction with JV Partner exempt

How to determine an “insignificant subsidiary”

Example 2 : Assessment of a recently acquired subsidiary



Can Listco assess the significance of Company B based on its financial figures after the date of acquisition (Feb 2009)?

No. The assessment should be based on financial figures for the latest financial year (i.e. year 2009) or 3 financial years (i.e. years 2007 to 2009).

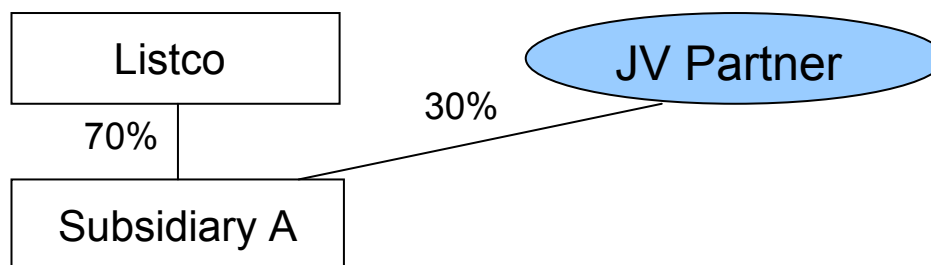
(FAQ Series 10, No. 2)

Size test calculation for assessing a subsidiary's materiality

- Based on 100% of the subsidiary's total assets, profits* and revenue**
 - * means net profits before taxation and minority interest*
 - ** means revenue arising from the principal activities*
- Use figures in the issuer group's published audited accounts for the latest financial year or 3 financial years

Size test calculation for assessing a subsidiary's materiality

Example 3



1 Feb 2010 : Placing of new shares by Listco for cash

1 May 2010 : Transaction – Listco acquires a property from JV Partner



When Listco assesses the significance of Subsidiary A, does it need to adjust the asset ratio for the proceeds from the placing?

Size test calculation for assessing a subsidiary's materiality

Example 3 (cont'd)

No.

Asset ratio calculation:

	Numerator	Denominator
Significance of Subsidiary A (for insignificant subsidiary exemption)	100% of Subsidiary A's total assets in published accounts for latest financial year (or 3 financial years)	Listco group's total assets in published accounts for latest financial year (or 3 financial years)
Materiality of the transaction (for transaction classification)	Value of the property being acquired	Listco group's total assets in published accounts for latest financial year + net proceeds from placing

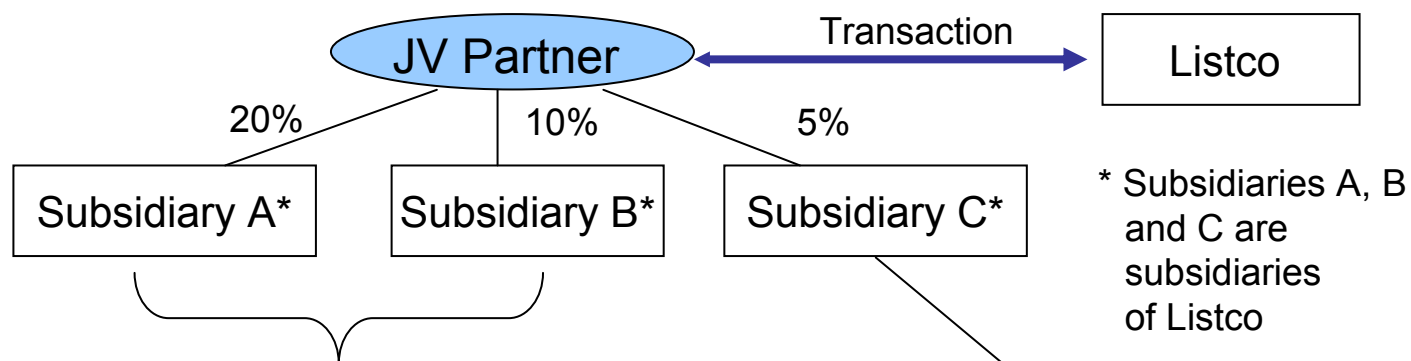
(FAQ Series 10, No.1)

Size test calculation for assessing a subsidiary's materiality

- Aggregation if the person is connected with more than one subsidiary

Size test calculation for assessing a subsidiary's materiality

Example 4



Aggregate the total assets, profits and revenue of Subsidiaries A and B to assess their materiality

Not aggregated because JV Partner's relationship with Subsidiary C does not make the JV Partner a connected person

Size test calculation for assessing a subsidiary's materiality

“Anomalous tests”

- We may disregard a size test calculation if it produces an anomalous result
- We may consider alternative tests prepared by the issuer

Size test calculation for assessing a subsidiary's materiality

Example 5

Percentage ratios for Subsidiary A:

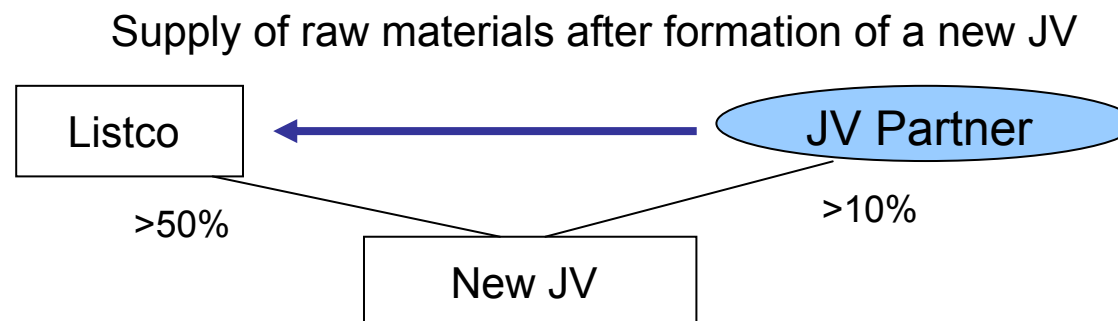
	Assets ratio	Profits ratio	Revenue ratio
2008	4%	5%	9%
2009	5%	20%	30%
2010	8%	8%	9%

- High revenue and profits ratios in year 2009 due to exceptional performance of Subsidiary A in that year
→ Not anomalous

(FAQ Series 10, No.5)

Size test calculation for assessing a subsidiary's materiality

Example 6 : Assessment of a newly established subsidiary which has not prepared its first accounts



Alternative size tests for assessing JV's materiality:

Assets ratio	Listco's total commitment to establish the JV
Profits ratio	N/A
Revenue ratio	N/A

(FAQ Series 10, No.3)

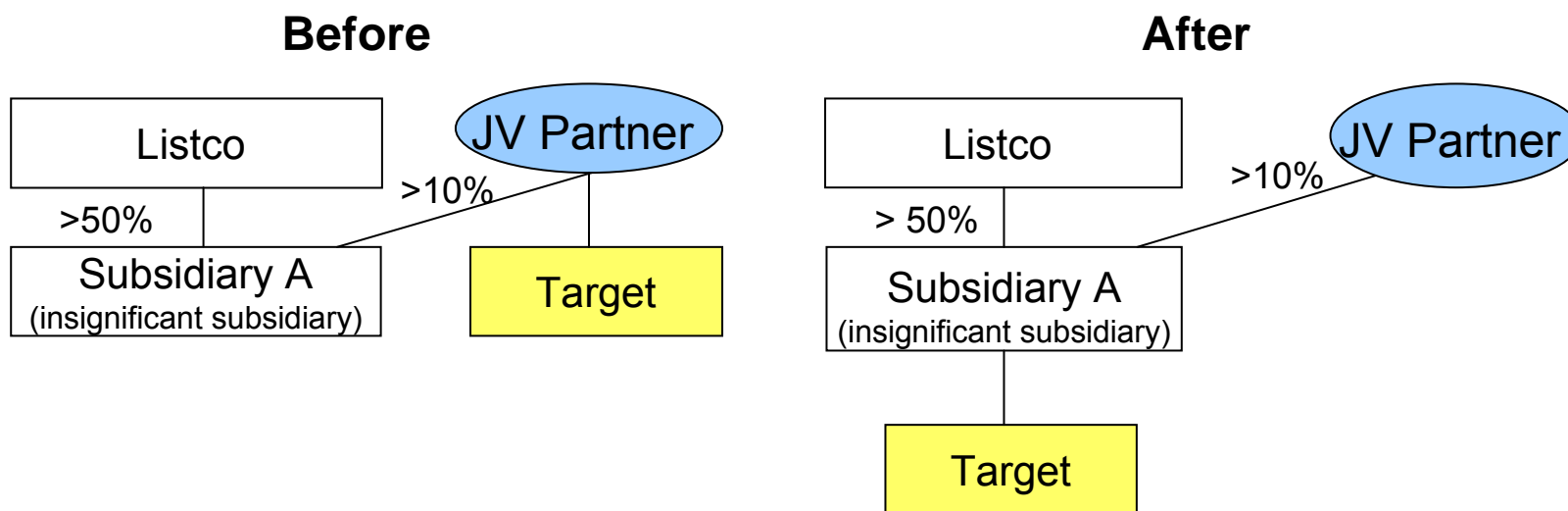
Additional requirement for transactions involving the “insignificant subsidiary”

- If the transaction is of capital nature AND involves the insignificant subsidiary or its assets/ securities

→ Consideration ratio <10%

Additional requirement for transactions involving the “insignificant subsidiary”

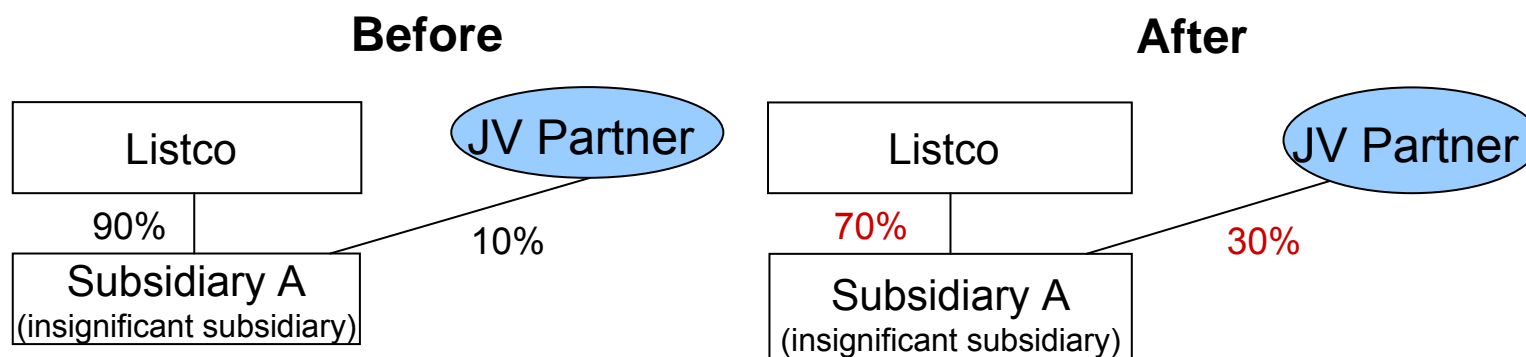
Example 7 : Subsidiary A acquiring Target from JV Partner



- ✓ Consideration ratio <10%

Additional requirement for transactions involving the “insignificant subsidiary”

Example 8 : Listco selling its interest in Subsidiary A to JV Partner



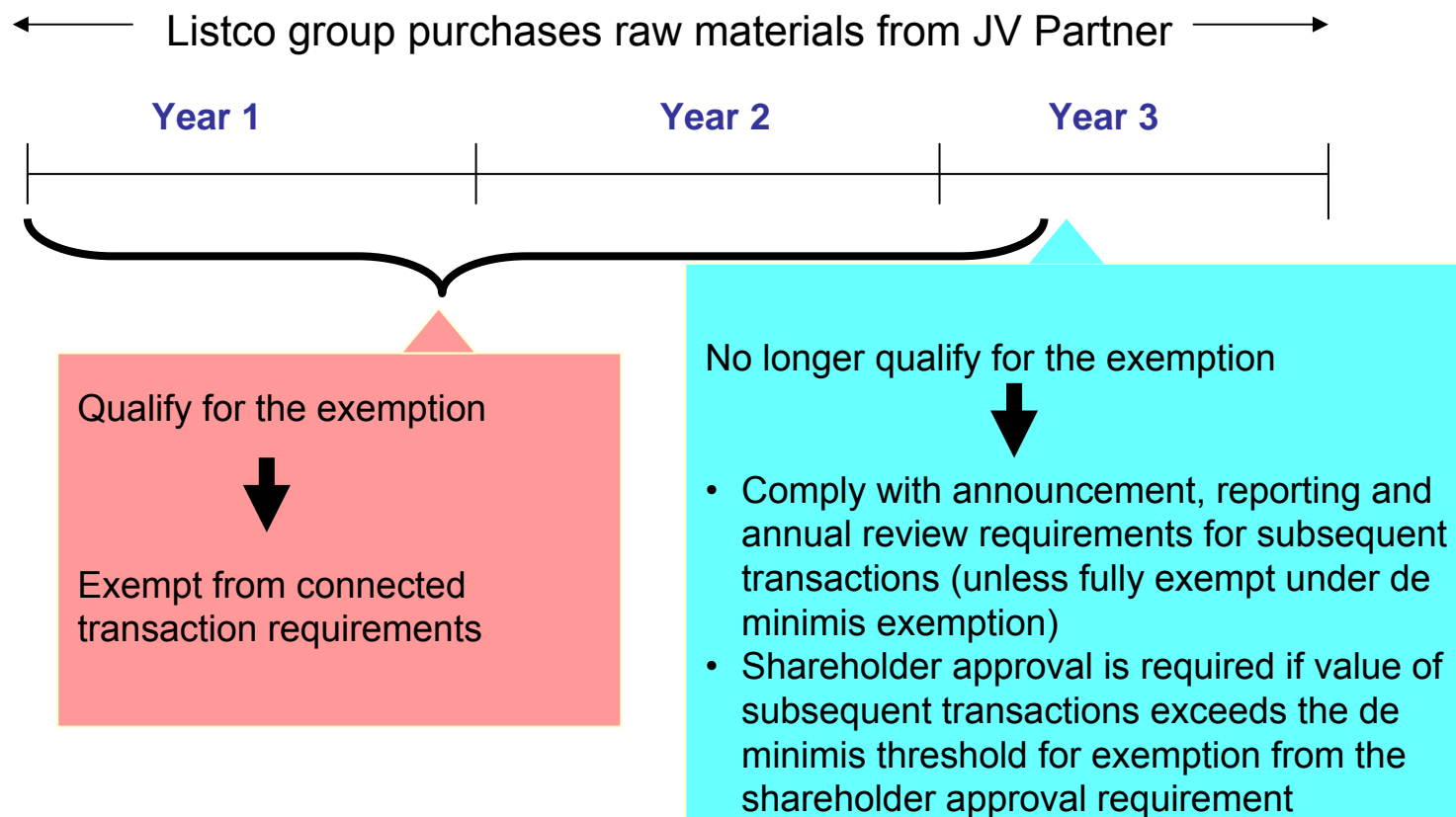
- ✓ Consideration ratio < 10%

Continuing connected transactions

- Connected person meets the exemption conditions at the time of each transaction with the issuer group
- If the connected person no longer qualifies for the exemption for any reason (e.g. the subsidiary is no longer “insignificant” or the connected person is appointed as Listco’s director)
 - comply with **all** applicable connected transaction requirements for subsequent continuing transactions

Continuing connected transactions

Example 9 : Exempted CCT → Non-exempted CCT



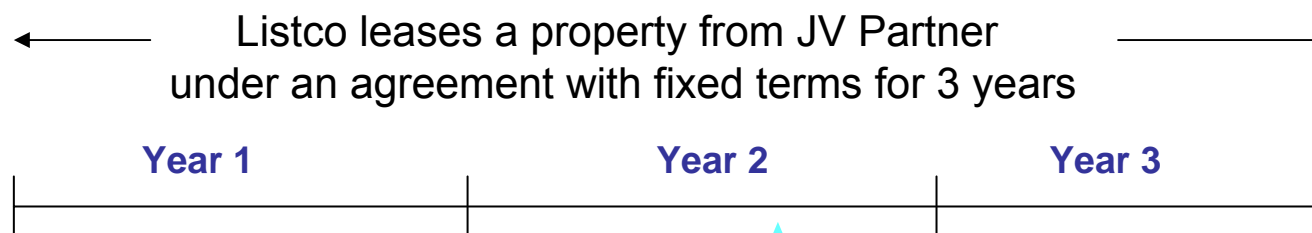
Continuing connected transactions

CCT under an agreement with fixed terms for a fixed period

- Connected person meets the exemption conditions at the time of entering into the agreement → exempted CCT
- If the connected person no longer qualifies for the exemption
 - comply with applicable reporting, annual review and announcement requirements for the CCT under the remaining term
 - shareholder approval is not required

Continuing connected transactions

Example 10 : Exempted CCT → Non-exempted CCT (agreement with fixed terms)



Qualify for the exemption



Exempt from connected transaction requirements

No longer qualify for the exemption



- Comply with announcement, reporting and annual review requirements for subsequent transactions (unless fully exempt under the de minimis exemption)
- Shareholder approval is not required

Continuing connected transactions

Non-exempted CCT → Exempted CCT

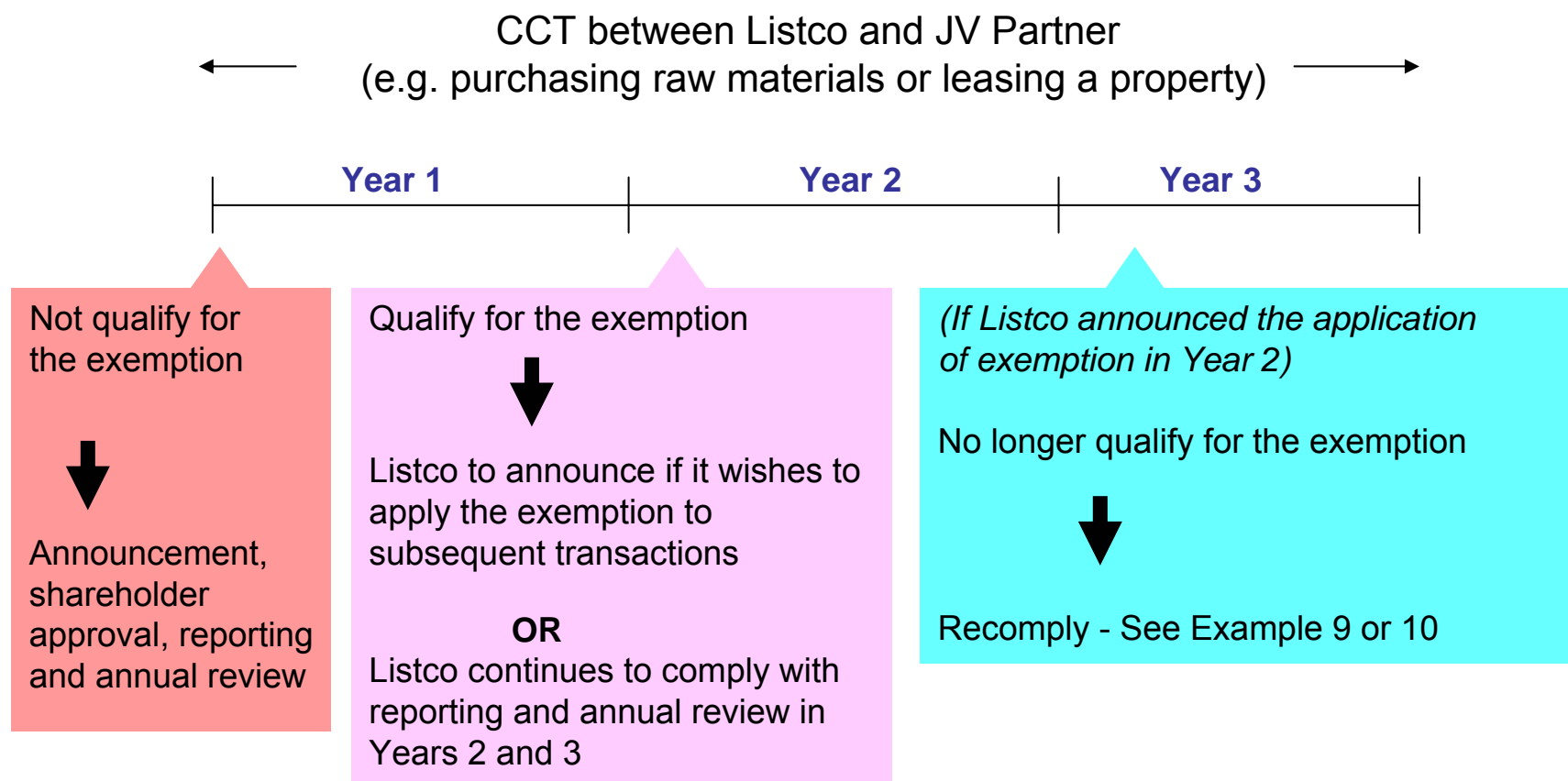
- Connected person does not meet the exemption conditions when it enters into continuing transactions with the issuer group → non-exempted CCT



If the connected person subsequently qualifies for the exemption, can the issuer apply the exemption to the transactions?

Continuing connected transactions

Example 11: Non-exempted CCT → Exempted CCT



(2) De minimis exemptions

De minimis exemptions

Changes include:

- (a) Relax the percentage thresholds
- (b) Remove the restriction on applying the exemptions to an issue of securities by an issuer's subsidiary

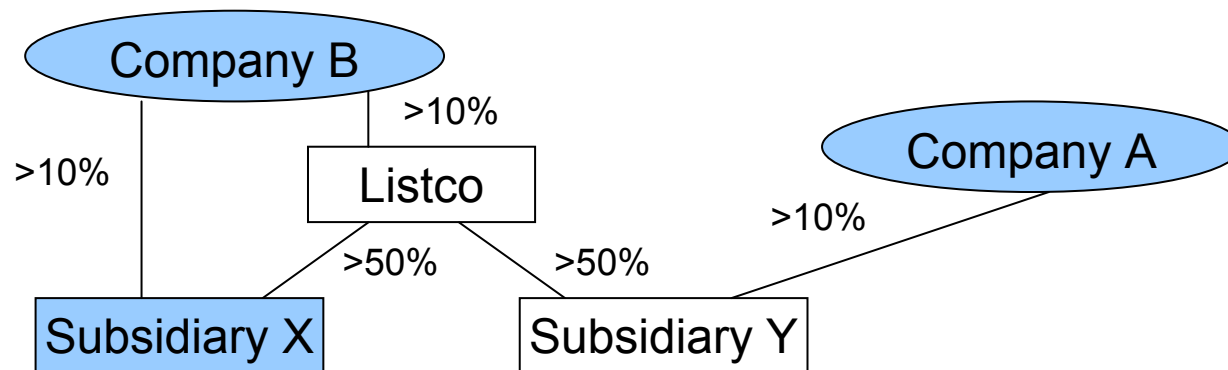
Relaxation of percentage thresholds

Transaction type	Percentage thresholds (other than the profits ratio)	
	Before Rule change	After Rule change
Exempt from shareholder approval	• < 2.5%	• < 5%
	OR	OR
	• < 25% and annual consideration <HK\$10M *	• < 25% and annual consideration <HK\$10M *
Fully exempt	• < 0.1%	• < 1% for transactions with connected persons <u>only at subsidiary level</u>
		OR
		• < 0.1% for other connected transactions
	OR	OR
	• < 2.5% and annual consideration <HK\$1M *	• < 5% and annual consideration <HK\$1M *

* No change to the monetary limits that exempt very small transactions

Relaxation of percentage thresholds

Example 12



Counterparty	Does the new threshold (1%) apply to Listco's transactions with the counterparty?
Company A	Yes, because Company A is a connected person at the subsidiary level only
Company B	No, because Company B is a connected person at the issuer level AND the subsidiary level
Subsidiary X	No, because Subsidiary X is not a connected person at the subsidiary level. It is a connected person because Company B (Listco's substantial shareholder) holds more than 10% interest in it

Issue of securities by issuers' subsidiaries

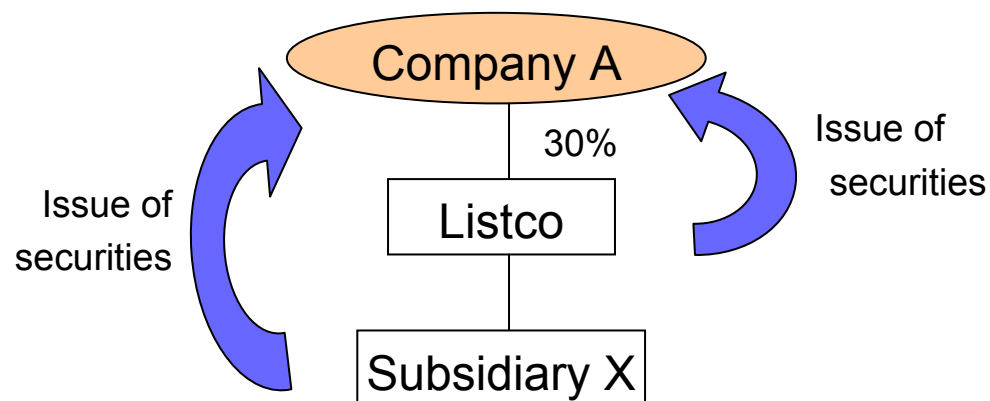
Before Rule change

- De minimis exemptions did not apply to issue of securities by
 - (i) an issuer or
 - (ii) its subsidiaries,to connected persons

Issue of securities by issuers' subsidiaries

After Rule change

- Extend the de minimis exemptions to issue of securities by issuers' subsidiaries to connected persons



- The de minimis exemption will
 - apply to issue of securities by Subsidiary X to Company A
 - not apply to issue of securities by Listco to Company A

(3) Scope of connected persons

Scope of connected persons

Changes include:

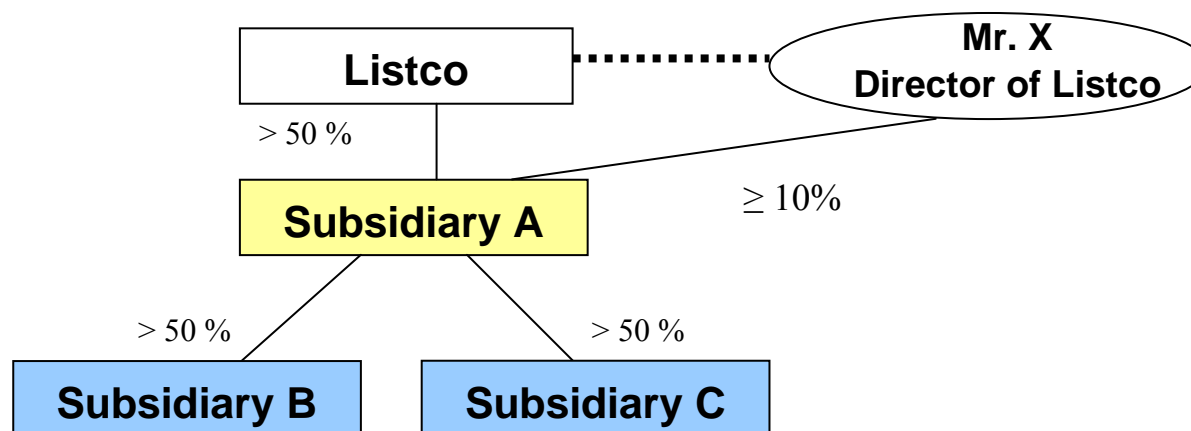
- (a) Remove specific types of persons from the definition of connected person
- (b) Restrict the circumstances in which a non-wholly owned subsidiary is a connected person
- (c) Revise the definition of associate

Remove specific types of connected persons

- Remove the following persons from the definition of connected person
 - Management shareholders of GEM issuers
 - Promoters of PRC issuers
 - “PRC Governmental Bodies” for non-PRC issuers (*exemption applied to PRC issuers only before Rule change*)

Non-wholly owned subsidiary as connected person

Non-wholly owned subsidiary as connected person (Category 1)

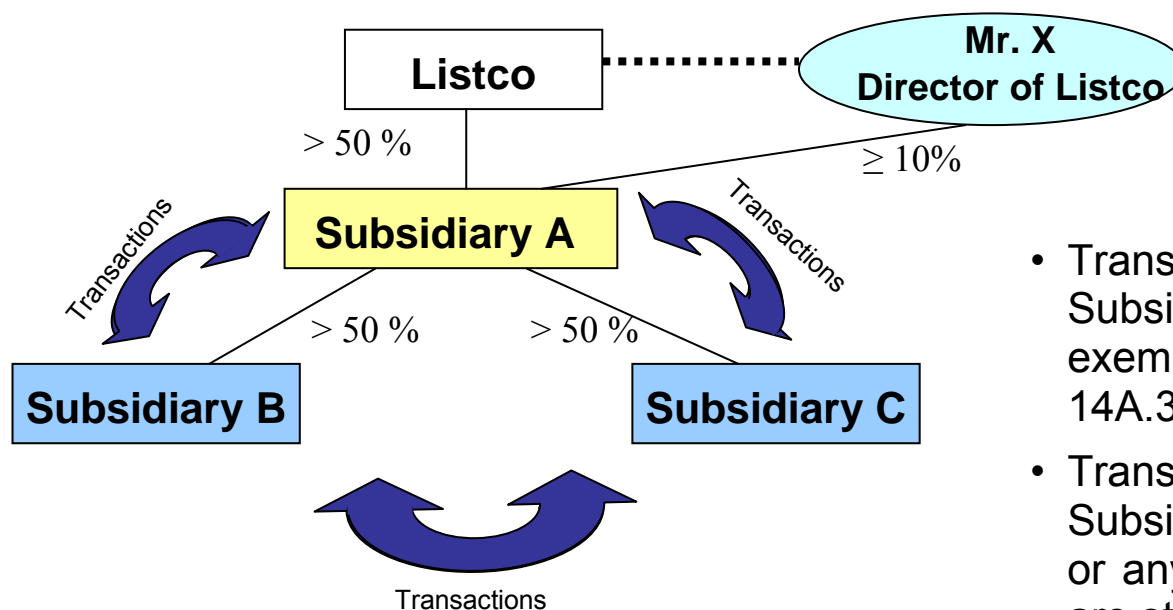


- Subsidiary A is a connected person because Mr. X (a connected person at the issuer's level) holds $\geq 10\%$ interest in Subsidiary A [Rule 14A.11(5)]
- Subsidiaries B and C are connected persons only because they are subsidiaries of Subsidiary A [Rule 14A.11(6)]

Non-wholly owned subsidiary as connected person (Category 1)

Rule change

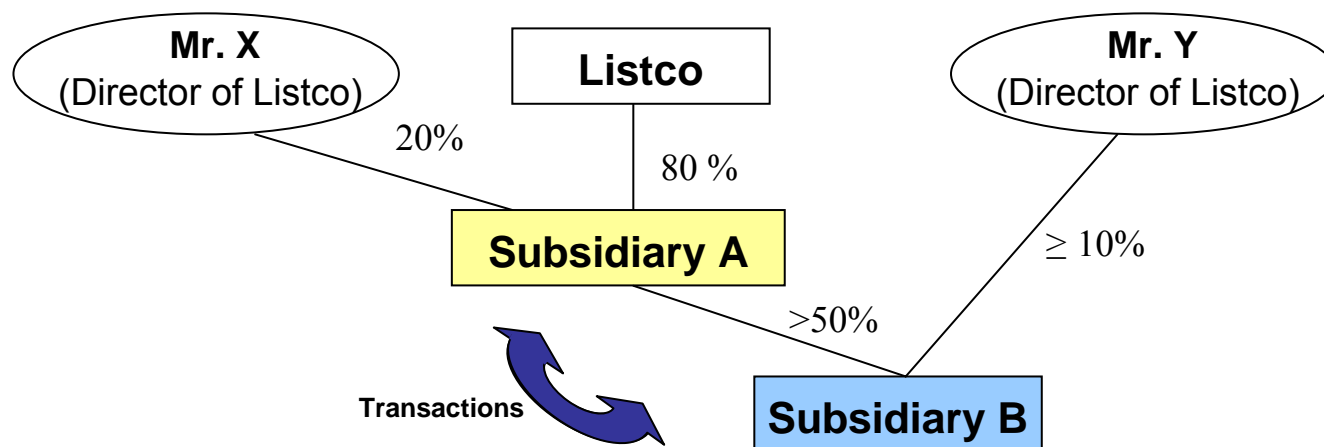
New Rule 14A.31(1A) : Exempt intra-group transactions among a “connected subsidiary” (as defined in Rule 14A.11(5)) and its subsidiaries



- Transactions between any of Subsidiaries A, B and C are exempt under new Rule 14A.31(1A)
- Transactions between (i) Subsidiary A/B/C and (ii) Listco or any other subsidiary of Listco are still connected transactions

Non-wholly owned subsidiary as connected person (Category 1)

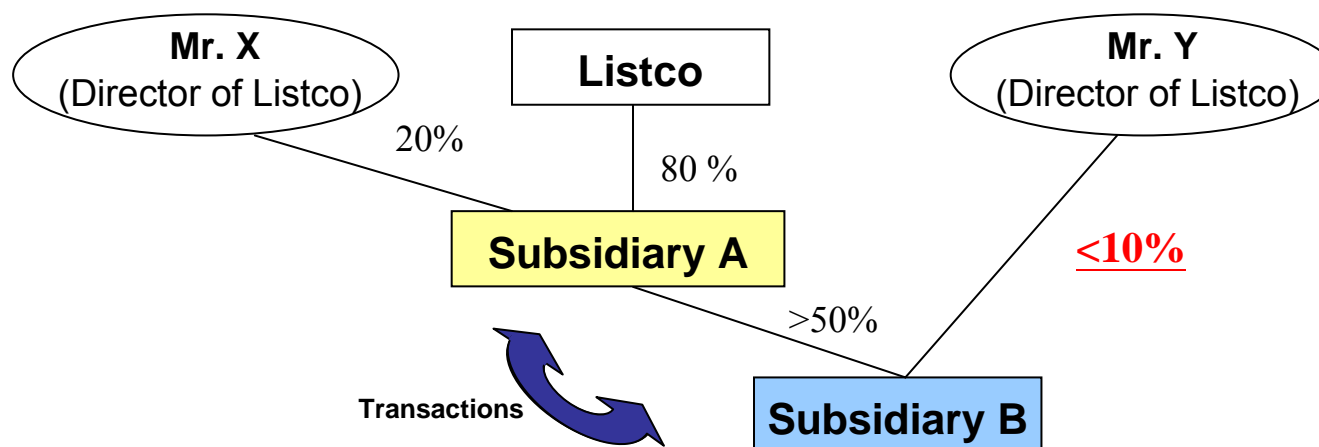
Example 13



- Subsidiary B is a connected person not only because it is a subsidiary of Subsidiary A
 - Subsidiary B is a connected person also because Mr. Y holds more than 10% interest in it
- Transactions between Subsidiary A and Subsidiary B are not exempt under the new Rule 14A.31(1A)

Non-wholly owned subsidiary as connected person (Category 1)

Example 13 (cont'd)



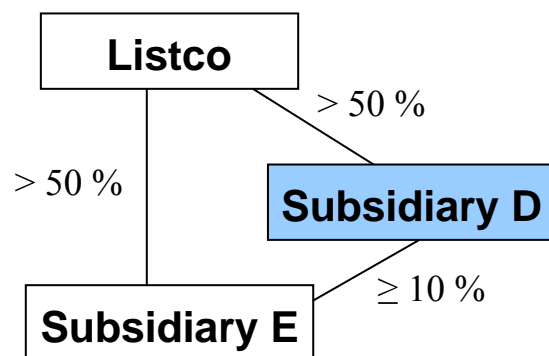
What if Mr. Y holds less than 10% interest in Subsidiary B?

- Subsidiary B is a connected person only because it is a subsidiary of Subsidiary A
- Transactions between Subsidiary A and Subsidiary B are exempt under the new Rule 14A.31(1A)

Non-wholly owned subsidiary as connected person (Category 2)

Rule change

New Rule 14A.12A(1) : Exclude a non-wholly owned subsidiary which is connected only because it is a substantial shareholder of another subsidiary under R14A.11(1)

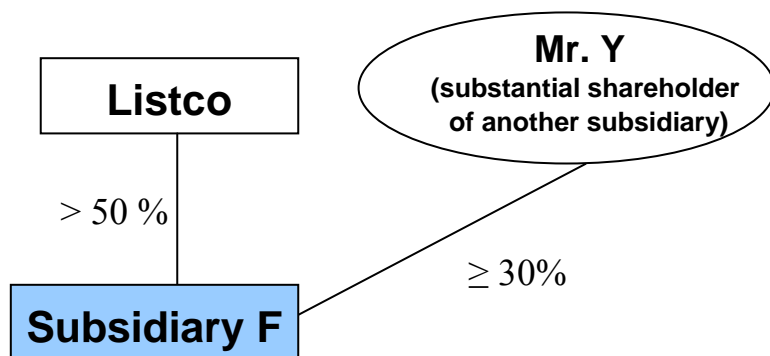


- Subsidiary D is no longer a connected person under the new Rule 14A.12A(1)

Non-wholly owned subsidiary as connected person (Category 3)

Rule change

New Rule 14A.12A(2) : Exclude a non-wholly owned subsidiary which is connected only because it is an associate of a connected person at the subsidiary level under R14A.11(4)



- Subsidiary F is no longer a connected person under the new Rule 14A.12A(2)

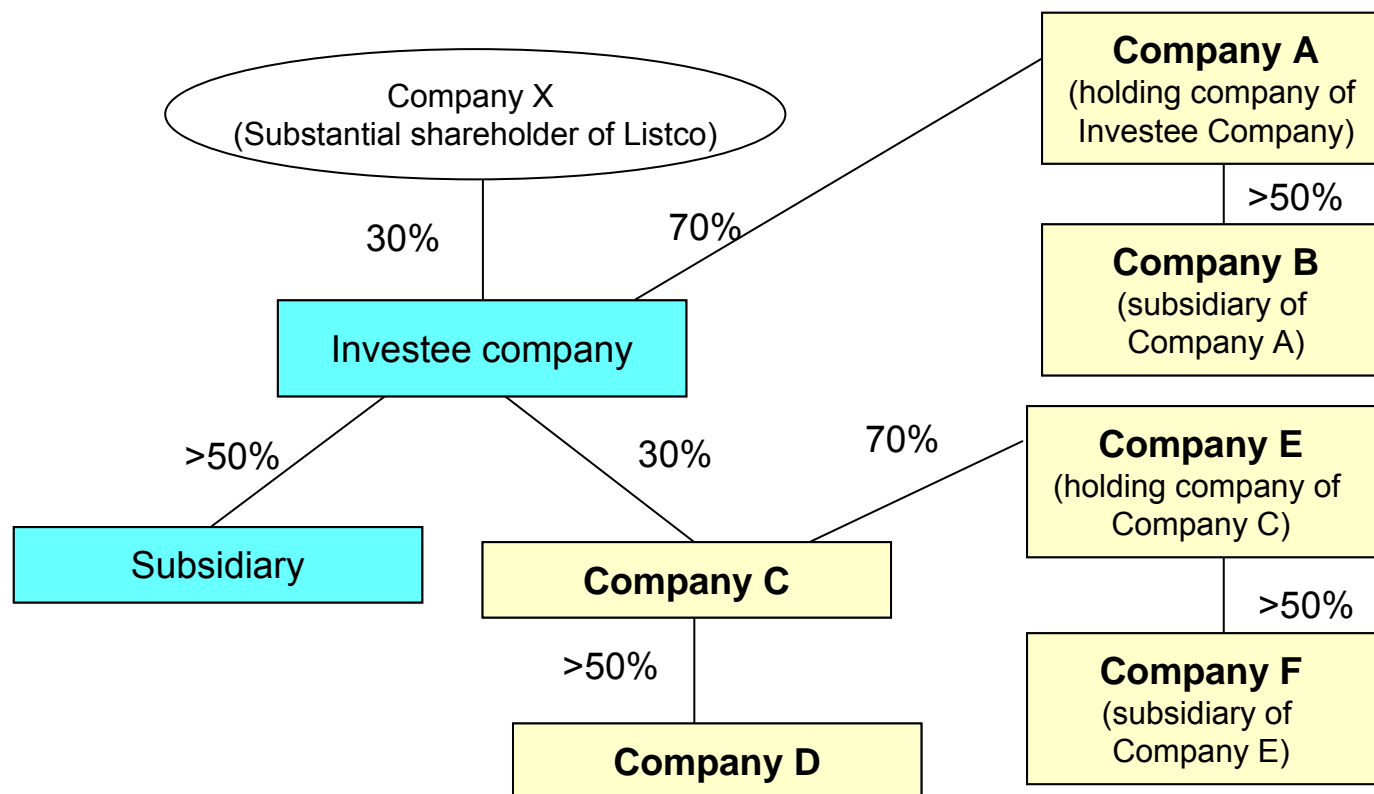
Definition of associate

Definition of associate

Category 1 - Associates of a connected person (individual or corporation) under Rule 1.01:

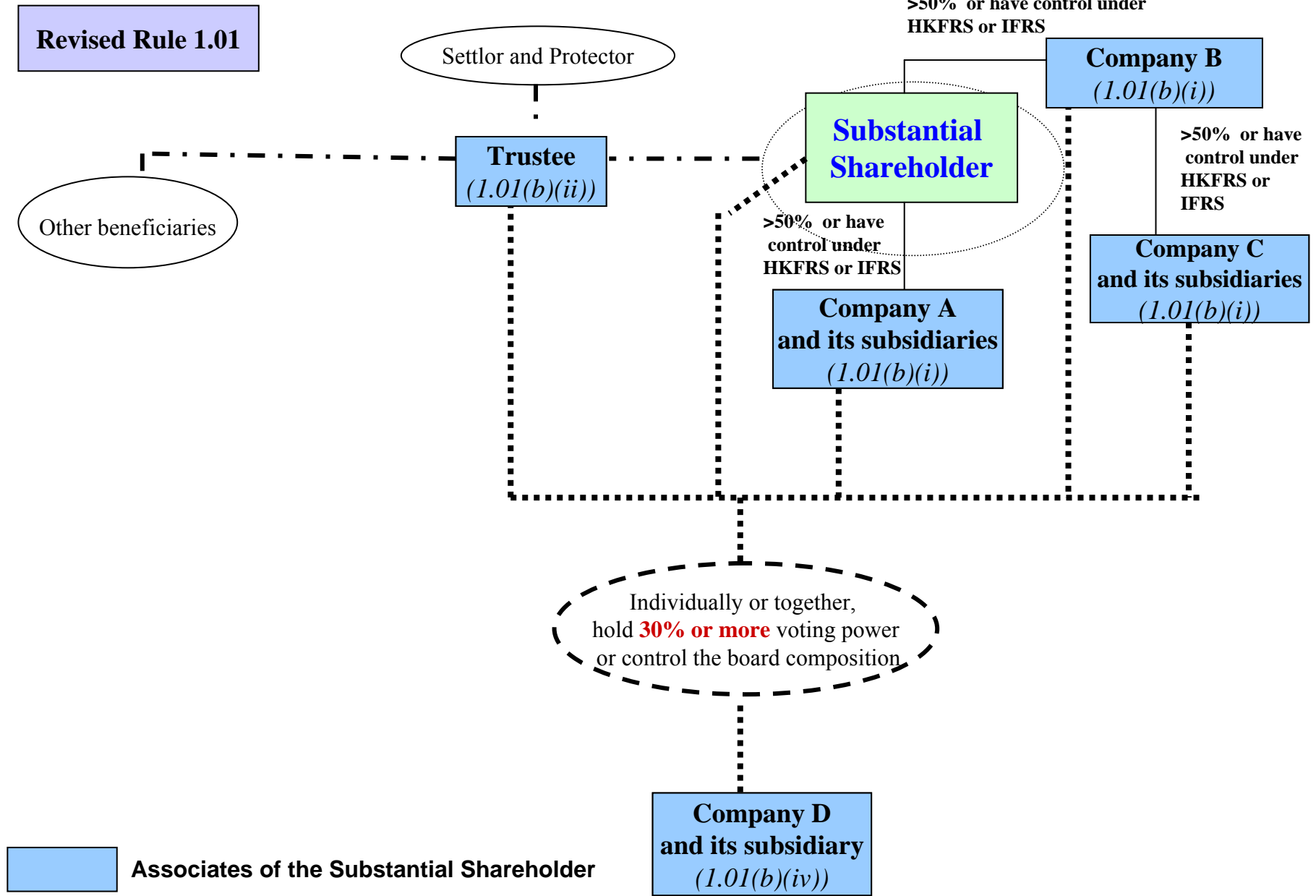
	(1) Individual	(2) Corporation	Rule change
(a) Family interests	Spouse, child under age of 18	N/A	No change
(b) Trustee	Trustee of a trust where the connected person (or any of his family interests) is a beneficiary	Trustee of a trust where the connected person is a beneficiary of the trust	
(c) Group companies	N/A	Subsidiary, holding company, fellow subsidiary	
(d) "Investee company"	<ul style="list-style-type: none"> Company controlled ($\geq 30\%$) by the connected person and/or any of the persons in (a) to (c) Subsidiary of this company 		Removed from the definition
(e) Entities related to an "investee company" controlled (30% to 50%) by the connected person and/or any of the persons in (a) to (c)	<ul style="list-style-type: none"> Holding company of the investee company; and such holding company's fellow subsidiary Company controlled (30% to 50%) by the investee company*; such company's subsidiary, holding company or fellow subsidiary <p><i>* Referring to an investee company controlled (30% to 50%) by the trustee in (1)(b) only</i></p>	<ul style="list-style-type: none"> Company controlled (30% to 50%) by the investee company; such company's subsidiary, holding company or fellow subsidiary 	

Definition of associate



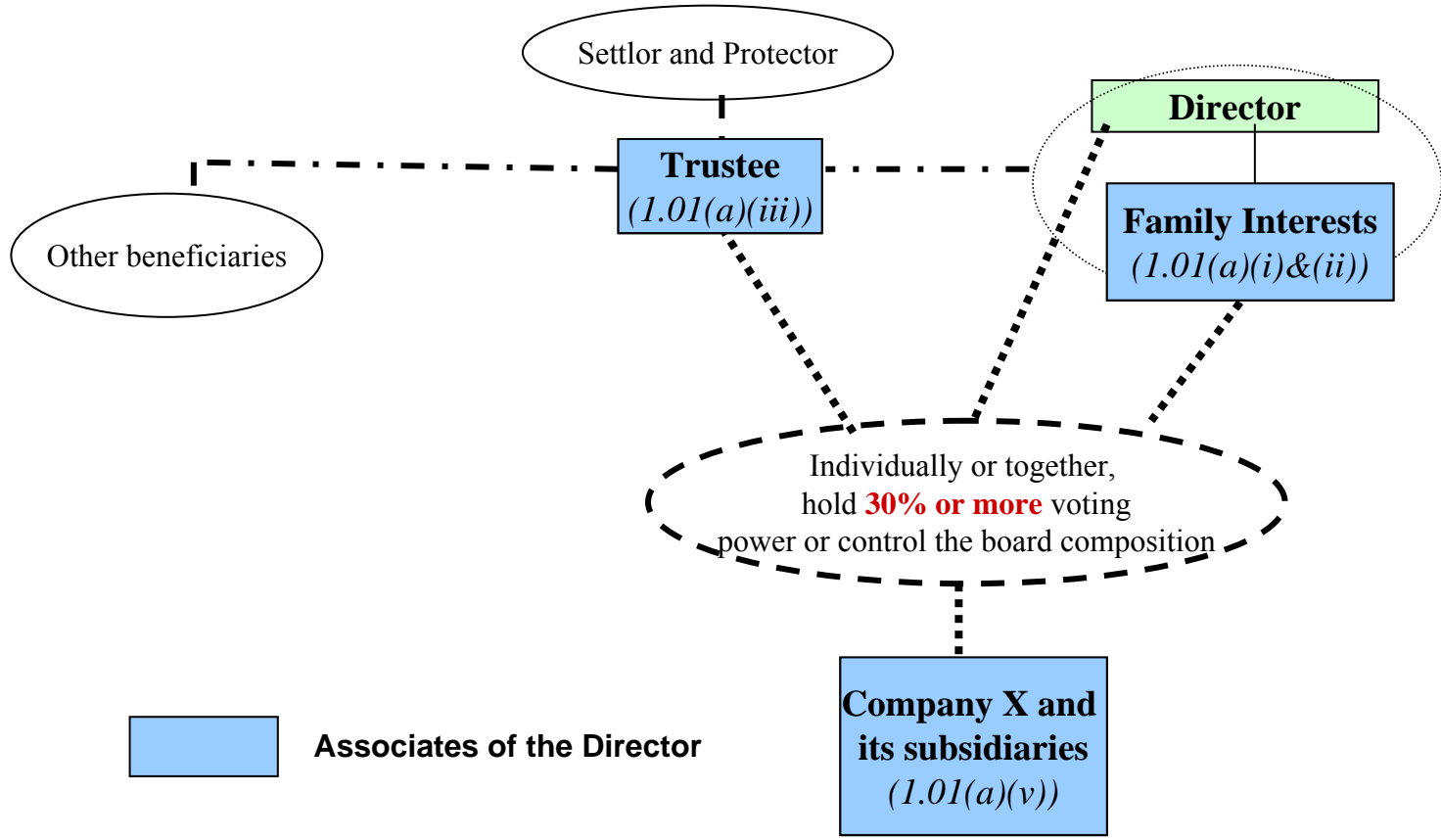
- Companies A, B, C, D, E and F are no longer associates of Company X under the new Rules

Associates – Where the connected person is a corporation



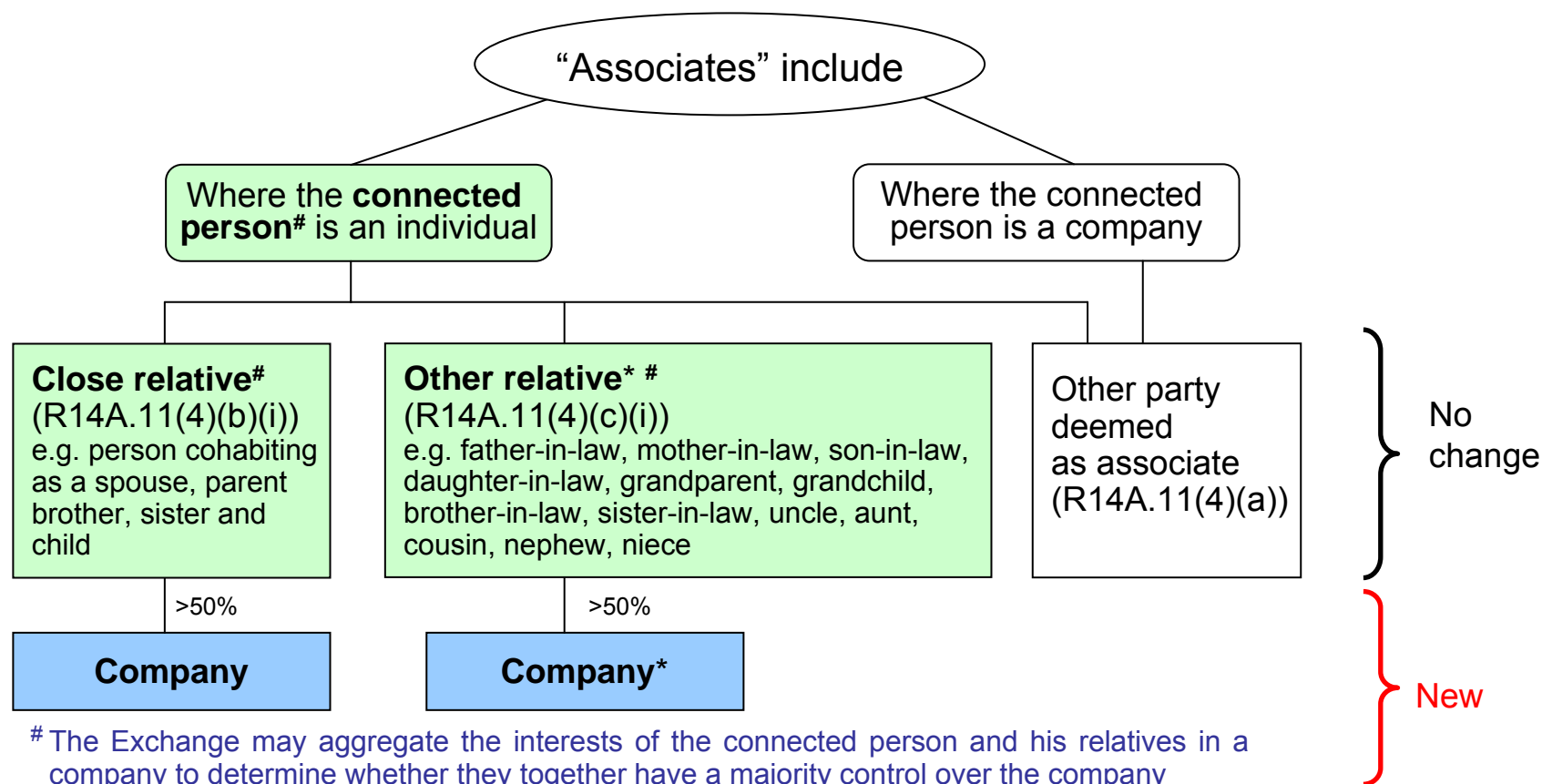
Associates – Where the connected person is an individual

Revised Rule 1.01



Definition of associate

Category 2 - Extended definition of associate in Rule 14A.11(4)

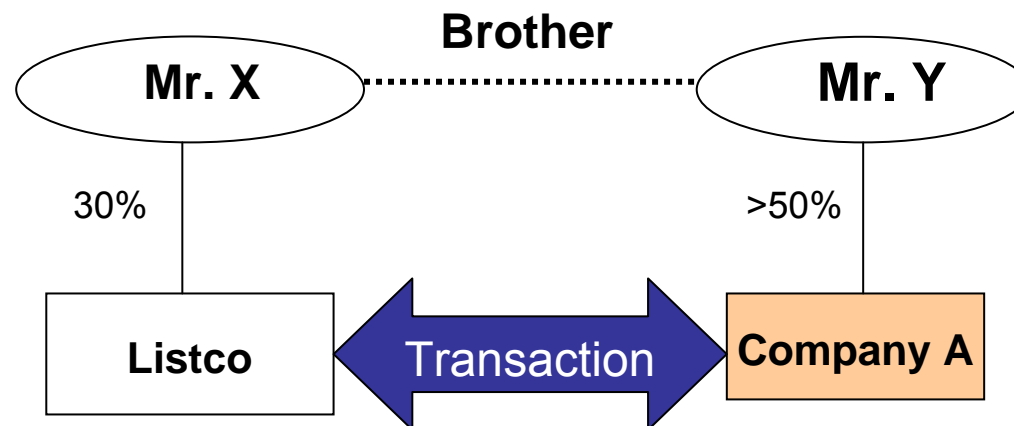


[#] The Exchange may aggregate the interests of the connected person and his relatives in a company to determine whether they together have a majority control over the company

* whose association with the connected person is such that, in the opinion of the Exchange, the proposed transaction should be subject to the connected transaction requirements

Definition of associate

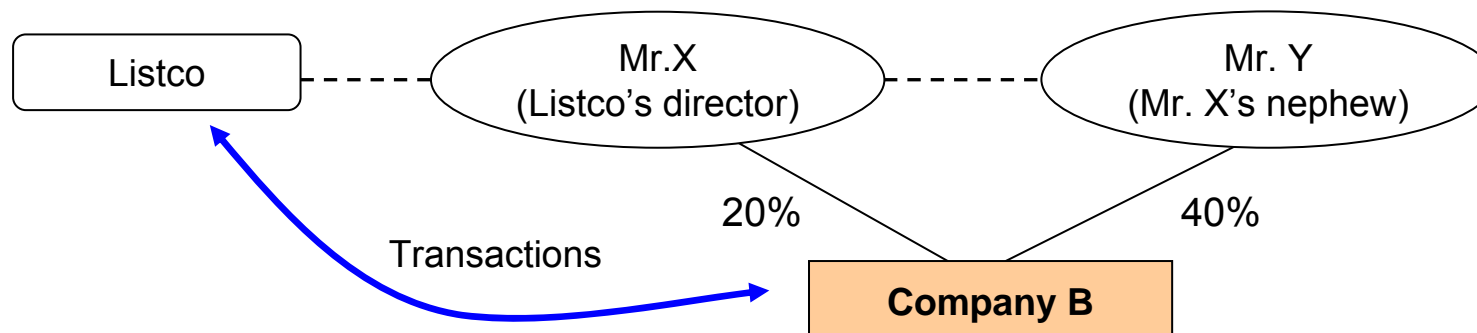
Example 14



- Company A is an associate of Mr. X under the new Rules
- Transactions between Listco and Company A are subject to connected transaction Rules.

Definition of associate

Example 15

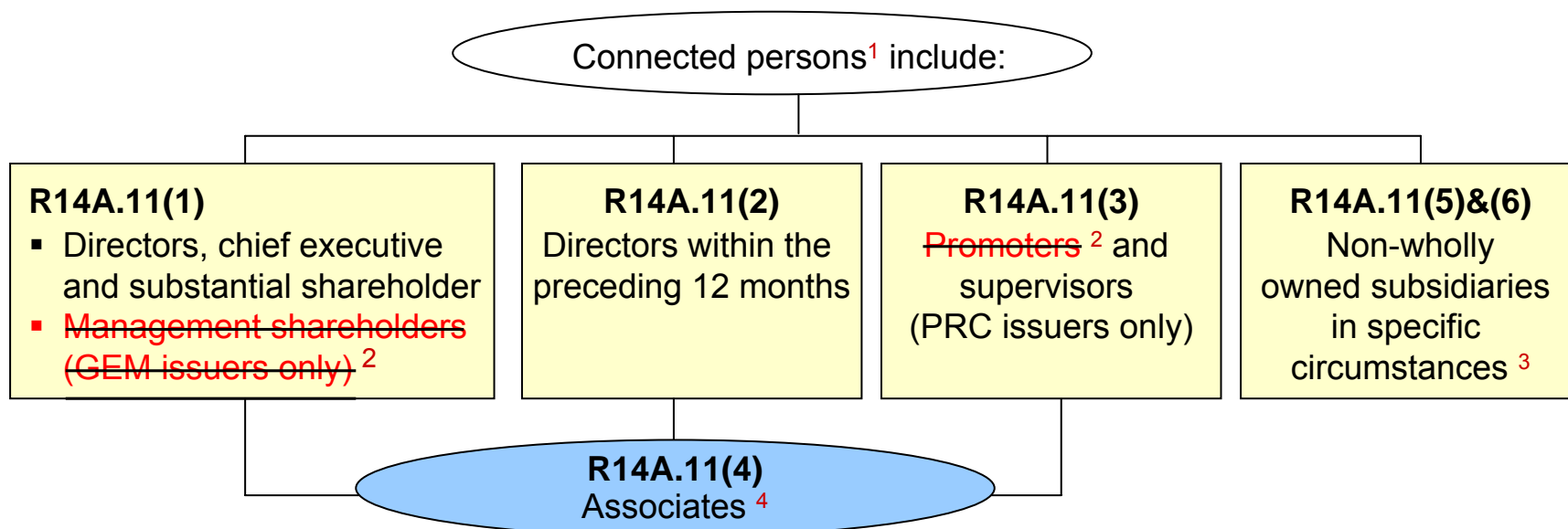


Will Company B be regarded as associate of Mr. X?

- Yes, because Mr. X and Mr. Y together have a “majority control” over Company B

(FAQ Series 10, No.13)

Scope of connected persons after Rule changes



- 1 Connected persons normally exclude a “PRC Governmental Body” under new Rule 14A.12A(2) *(The exemption applied to PRC issuers only before Rule changes. It is now extended to non-PRC issuers.)*
- 2 Persons excluded from the definition of connected person after Rule changes
- 3 New exemptions under Rules 14A.12A(1) and 14A.31(1A) introduced after Rule changes
- 4 (i) Definition revised to exclude entities related to an “investee company” controlled (30% to 50%) by a connected person
(ii) Definition extended to include a company in which a connected person’s relative has a majority control

(4) Other amendments

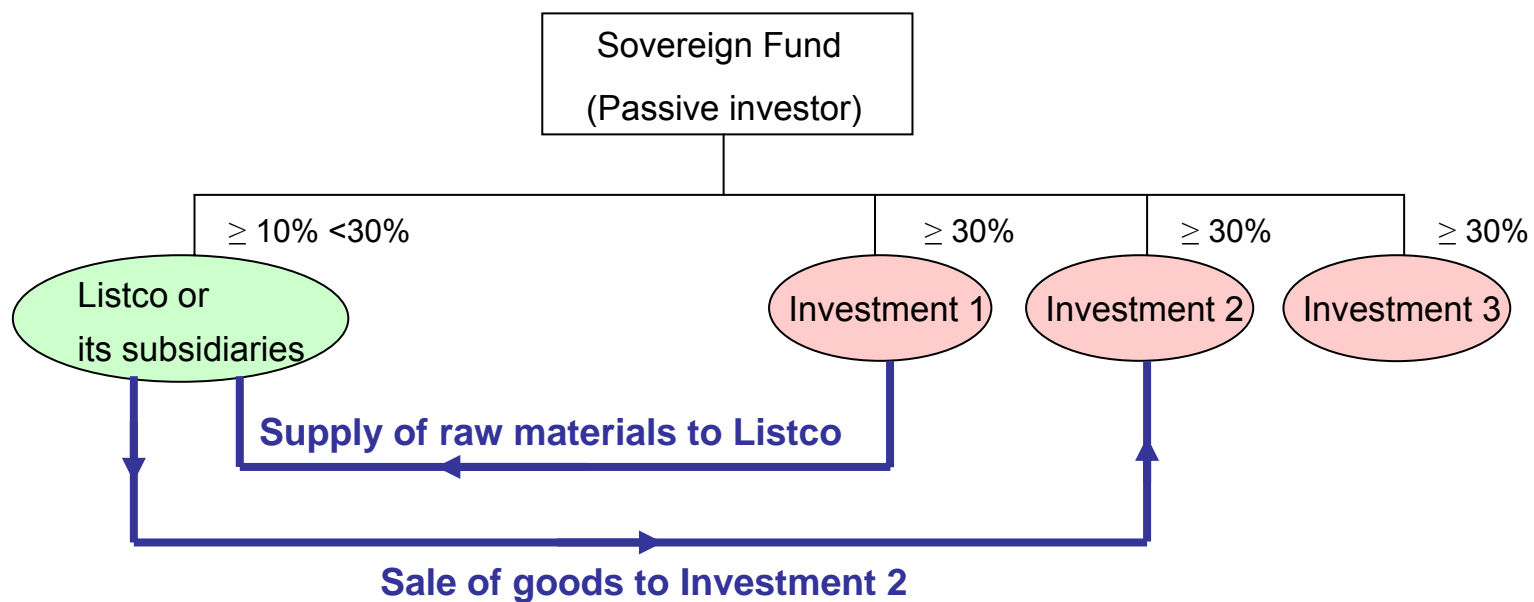
Other amendments

- (a) Passive investor exemption
- (b) Exemption for consumer goods or consumer services
- (c) Exemption for pro-rata financial assistance to connected persons
- (d) Exemption for disposal of subsidiary interests under Rule 14A.13(1)(b)(i)
- (e) Annual review for continuing connected transactions

Passive investor exemption

New Rule

- Exempt revenue transactions with associates of a substantial shareholder which is a “passive investor” in the issuer group



Passive investor exemption

The passive investor must:

- 1) Be a sovereign fund, or an authorised unit trust or mutual fund
- 2) Have a wide spread of investments
- 3) Be connected only because of its substantial interests in Listco group
- 4) Not be a controlling shareholder in Listco group
- 5) Have no board representation or involvement in Listco group's management (including negative control)
- 6) Be independent of other connected persons

Exemption for consumer goods or consumer services

- Exemption applies to issuer acquiring as customer or selling in the ordinary course of business consumer goods or services from or to a connected person → subject to a number of conditions including:
 - Old Rule: Issuer must not acquire goods or services for business use
 - **New Rule:** Issuer may acquire goods or services for business use if there is an open market and transparency in pricing the goods or services

Example:

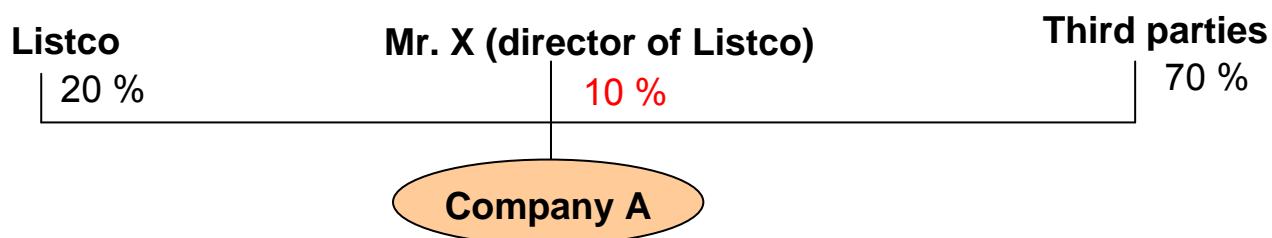
- the prices are published or publicly quoted, or the price labels / price lists are on display at retail stores; and
- the prices apply to other independent consumers

Exemption for pro-rata financial assistance to connected person

Before Rule changes

- Exempt financial assistance by the issuer group on normal commercial terms, pro-rata and on a several basis to:
 - a “commonly held entity” (which is not a connected person)

“Common held entity” is a company in which both the issuer group and a connected person at the issuer level are shareholders and the connected person controls 10% or more of the company



Exemption for pro-rata financial assistance to connected person

After Rule changes

- Exemption applies to pro-rata financial assistance provided by the issuer group to:
 - a common held entity [No change]
 - a connected person in which the issuer group is a shareholder [New]

Scenario 1



Company B

A connected person (associate of Mr. X) AND a commonly held entity

Scenario 2



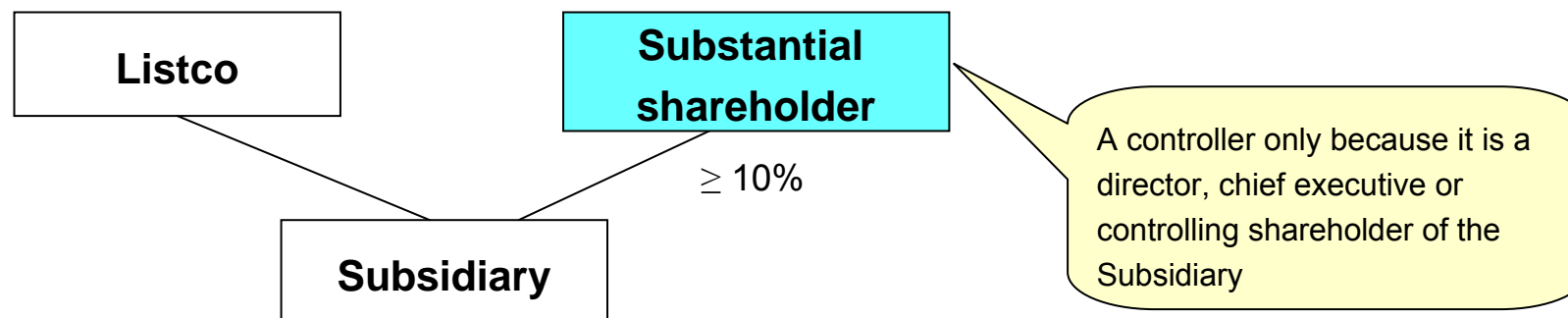
Company C

A connected person (associate of Mr. Y) but not a commonly held entity

Exemption for disposal of subsidiary interests under R14A.13(1)(b)

New Rule

- Exempt disposal of an interest in a subsidiary to an independent third party if:
 - the disposal is a connected transaction under Rule 14A.13(1)(b) only because the subsidiary's substantial shareholder is a controller of this subsidiary (or his/its associate) immediately before the disposal; and

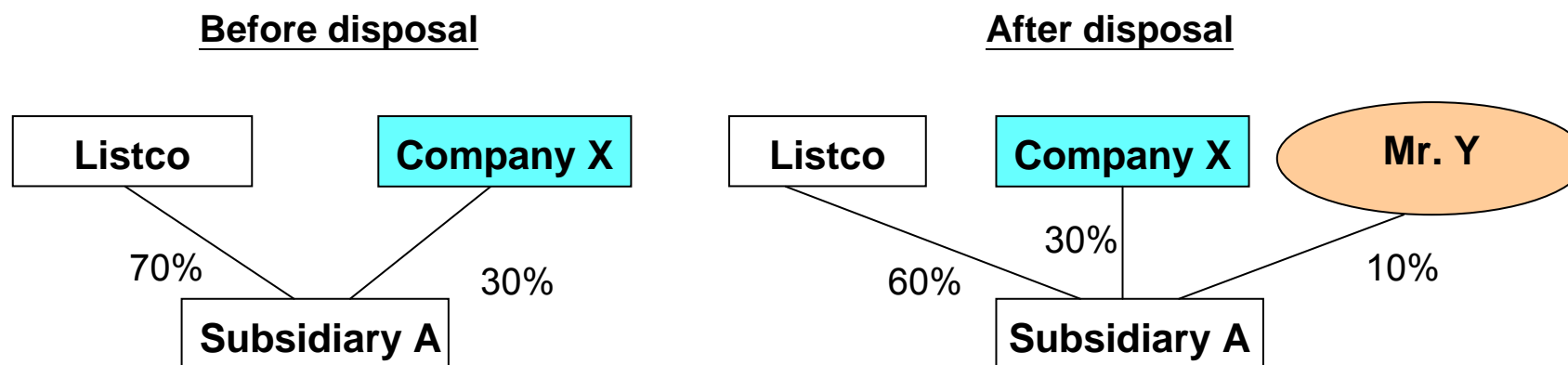


- no change in the substantial shareholder's interest in the subsidiary

Exemption for disposal of subsidiary interests under R14A.13(1)(b)

Example 16

Listco sells its 10% interest in Subsidiary A to Mr. Y (independent)



The new exemption applies because:

- the disposal falls under Rule 14A.13(1)(b)(i) only because Company X is a controlling shareholder of Subsidiary A
- Company X continues to hold 30% interest in Subsidiary A

Annual review for continuing connected transactions

Housekeeping Rule amendment

- Clarify that the annual review requirements apply to all continuing connected transactions (other than fully exempt CCTs)

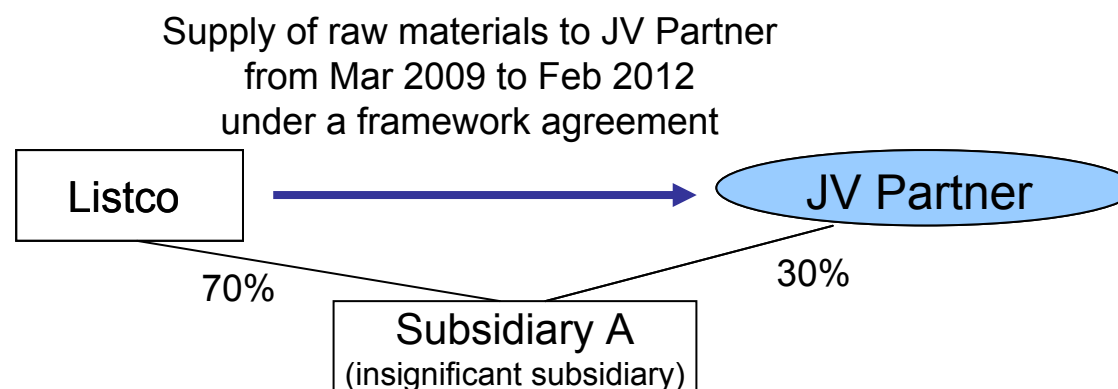
(5) Transitional arrangements

Transitional arrangements

- CCTs under agreements signed before Rule amendments
 - Listco may apply the new / revised Rules to the CCTs conducted after Rule changes

Transitional arrangements

Example 17 (FAQ Series 10, No. 8)

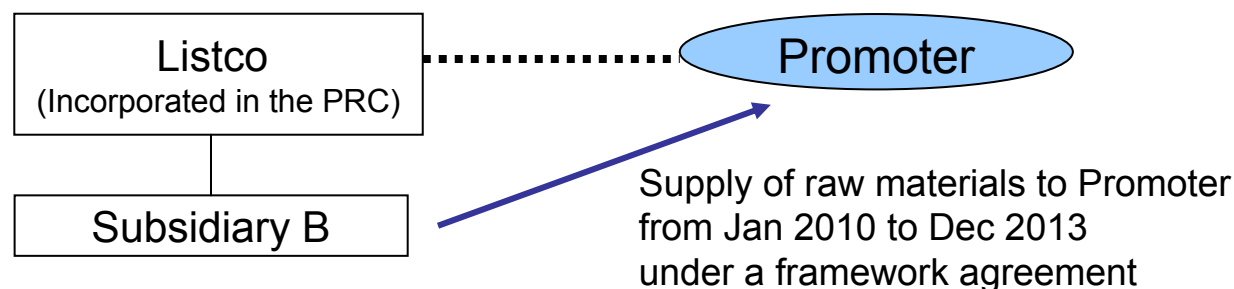


Can Listco apply the insignificant subsidiary exemption to the transactions after Rule changes?

Yes. Listco to announce that it will apply the exemption to subsequent transactions under the agreement.

Transitional arrangements

Example 18



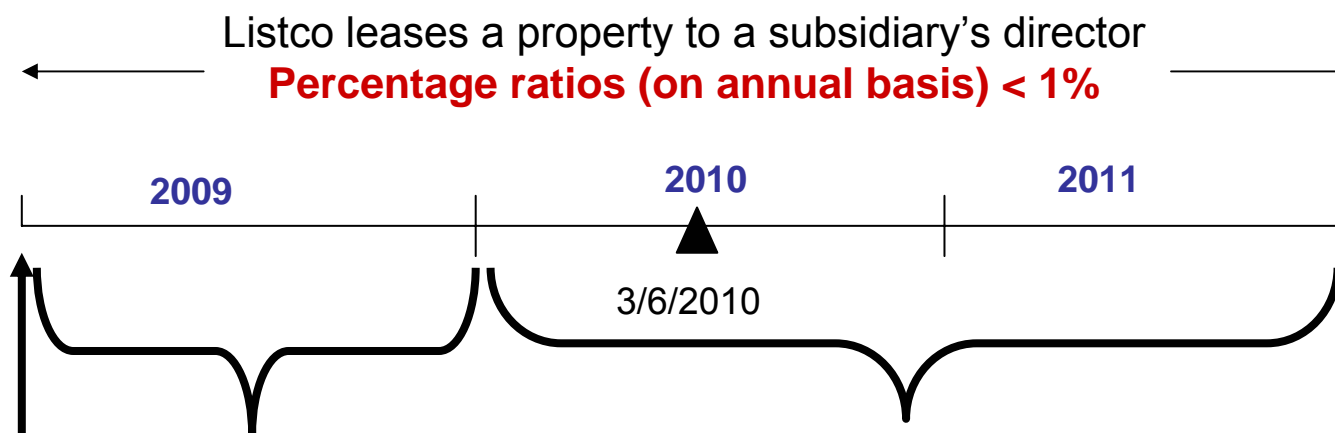
Is Listco still required to comply with the annual review and reporting requirements for the transactions when it prepares its annual report for the years ending on or after 31 December 2010?

No.

(Updated October 2010)

Transitional arrangements

Example 19



Listco announced the transaction when entering into the lease Agreement (Non-exempt Under the then 0.1% threshold)

Annual review and reporting

- Listco to announce application of the exemption
- No annual review and reporting for transactions conducted under the agreement in 2010 and 2011

OR

- Listco continues to comply with annual review and reporting requirements

(Updated October 2010)

(6) Next step

Next step

Further review of connected transaction Rules

- Revising the definition of connected person
 - Whether the definition of connected person at the issuer level is sufficiently broad to cover the kinds of persons that can exert significant influence over an issuer's action
 - Whether to relax the definition of connected person at the subsidiary level
- Improving regulation of revenue transactions with connected persons
- Introducing specific requirements and/or exemptions for different categories of issuers
- Bringing our connected transaction Rules and practices in a closer alignment with those in the Mainland China and other overseas jurisdictions

Thank you