

HKE_x GUIDANCE LETTER

HKE_x-GL73-14 (Published in March 2014) (Rule reference updated in July 2014)

Subject	Guidance on pricing policies for continuing connected transactions and their disclosure
Listing Rules	Main Board Rules <u>14A.51 to 14A.59 and 14A.71 to 14A.72</u>14A.35 to 14A.40 and 14A.45 to 14A.46 GEM Rules <u>20.49 to 20.57 and 20.69 to 20.70</u>20.35 to 20.40 and 20.45 to 20.46

Important note: *This letter does not override the Listing Rules and is not a substitute for advice from qualified professional advisers. If there is any conflict or inconsistency between this letter and the Listing Rules, the Listing Rules prevail. You may consult the Listing Division on a confidential basis for an interpretation of the Listing Rules, or this letter.*

A. Purpose

1. This letter gives guidance on the pricing policies in agreements for continuing connected transactions and their disclosure. Continuing connected transactions are transactions with connected persons carried out on a continuing or recurring basis and are expected to extend over a period of time.

B. Relevant Rules and Requirements

2. Rules 14A.51 to 14A.59~~14A.35 to 14A.40~~ set out the requirements that apply to continuing connected transactions, including, among others:
 - (i) issuers must enter into a written agreement that sets out the terms of the transactions, which must contain the basis for calculating the payments to be made and reflect normal commercial terms;
 - (ii) the period of the agreement must be fixed and reflect normal commercial terms. It must not exceed 3 years, except in special circumstances;
 - (iii) there must be an annual cap which is determined by reference to previous transactions, the basis of which must be disclosed;
 - (iv) where the annual cap exceeds the relevant de minimis threshold, the agreement and the annual cap must be approved by independent shareholders;
 - (v) the transactions should be in the issuer's ordinary and usual course of business, on normal commercial terms (or terms no less favourable to the issuer than terms available to or from independent third parties),

the terms must be fair and reasonable and in the interest of shareholders as a whole; and

- (vi) the transactions must be carried out in accordance with the issuer's pricing policies, in accordance with the agreement, and approved by the board of directors.

3. Rules 14A.55, 14A.56, 14A.71 and 14A.72~~14A.45 to 14A.46 and 14A.37 to 14A.38~~ set out the annual reporting and review requirements, including:

- (i) disclosure in the annual report details of the transactions, including the total consideration and terms, a brief description of the transactions and their purposes, the parties to the transactions and descriptions of their relationships;
- (ii) annual review of the continuing connected transactions by the independent non-executive directors (**INEDs**) and confirmation in the annual report that the transactions have been conducted in accordance with paragraph 2(v) above; and
- (iii) annual negative confirmation by the auditors of matters set out in paragraph 2(vi) above and that the transactions did not exceed the annual cap.

4. The Rules provide a framework for the conduct of continuing connecting transactions, recognizing the practical difficulty if issuers have to comply with the connected transaction Rules each time a transaction is proposed. It provides safeguards against potential abuse through the following:

- the terms of the agreement, including the basis for calculating the payments, should provide a framework for the negotiation of individual transactions under the agreement. This information is disclosed to shareholders for their assessment whether to approve the agreement;
- imposing an annual cap on the aggregate size of the transaction, set by reference to historical transactions and adjusted by the issuer's projections; and
- annual review by the INEDs and auditors, and confirmation in the issuer's annual report, which provides a check and balance to ensure that the transactions under the agreement were conducted in accordance with the criteria set out in paragraphs 2(v) and (vi) above.

C. Guidance

5. Under the current Rules, the shareholders in effect give an issuer a mandate to conduct transactions with connected persons, subject to i) the terms of the agreement which provide a framework for negotiating each transaction, and ii) the annual cap which limits the aggregate size of the transactions. It is important that the terms of the agreement are specific and measurable, and that there are adequate internal controls in place to ensure that the individual transactions are indeed conducted within the framework of the agreement.

a) Pricing Policies

6. The Exchange notes that market practice regarding disclosure about the terms of the agreements vary significantly. In many instances, pricing policy is set out in general terms with no indication of the expected quantum or percentage¹. Without a specific pricing mechanism shareholders cannot properly assess whether to approve the framework agreement, and INEDs and auditors do not have a framework to review the transactions.
7. When entering into agreement with connected persons, issuers should agree on specific pricing terms, such as fixed monetary consideration, a pre-determined formula, or fixed per unit consideration. Examples include:
- provision of management services charged at a fixed sum or a percentage of the issuer's sales or asset value;
 - interest rate to be charged on a revolving loan facility and the maximum loan amount; and
 - sales or purchase of goods at a fixed unit price, or some reference price published from time to time (e.g. government prescribed price, or commodity prices quoted on an exchange). If the pricing of the goods is determined based on a reference price, the issuer should disclose the relevant details, for example, the name of government authority or organization publishing the price, and how and where the price is disclosed or determined, and the frequency of update to the reference price.

¹ Examples of such disclosure include:

- *the transactions will be conducted on normal commercial terms. The consideration will be based on arms' length negotiation with reference to the prevailing market prices. There is no explanation on how to define/ determine "normal commercial terms" or "prevailing market prices".*
- *The transaction will be agreed between the issuer and the connected person on a "cost plus" mechanism. There is no indication of the "plus" in percentage or fixed amount.*
- *The transaction shall be priced in accordance with the following terms: (i) government-prescribed price; (ii) where there is no government-prescribed price, the government-guidance price; (iii) where there is neither a government-prescribed price nor a government-guidance price, the relevant market price; (iv) where none of the above is available or applicable, the price to be agreed between the parties which shall be determined on the basis of reasonable cost plus reasonable profit margin and by reference to the historical price. Some of the above pricing methods (e.g. the government-prescribed price) do not apply to the subject transactions in practice.*

8. If the agreement covers transactions of different nature, the issuer should clearly set out the pricing policy for each type of transactions. It should avoid using generic “boilerplate” pricing mechanism where some of the pricing methods are not applicable to certain categories of transactions (see 3rd point of the example in footnote 2).
9. There may be situations where it is not commercially practical for the issuer to agree with the connected person on specific unit price or contract sum, as it is normal in that industry for the individual transactions to be subject to the pricing conditions at the time each transaction is conducted. In these cases, the issuer would normally conduct the transactions in accordance with its pricing policy and guidelines, which apply to transactions with independent customers as well as connected persons. The following guidelines should be observed when negotiating the terms of the agreement:
 - (i) It would not be sufficient to describe pricing policies in generic terms, such as “prevailing market price” or “prices based on arm’s length negotiations” or “prices on normal commercial terms”.
 - (ii) The Rules require that the transactions must be conducted on normal commercial terms, or on terms no less favourable than terms available to independent parties. To demonstrate this, the issuer should disclose the methods and procedures the management will follow to determine the price and terms of the transactions. Examples include:
 - For sales of off-the-shelf products or standard services, an indicative range of prices for goods/services, or the minimum/maximum mark-up rate for transactions that are charged on a cost-plus basis, and the procedures for reviewing and approving these price lists or guidelines from time to time;
 - For sales of proprietary goods or services, the process for estimating and approving the selling prices for the goods or services, and the procedures to ensure that these prices are no less favourable to the issuer than those offered to, or quoted by, independent customers; and
 - For purchases of goods or services, the procedures for obtaining quotations or tenders from the connected persons and a sufficient number of independent suppliers, the assessment criteria and the approval process. For example, the management would solicit at least two other contemporaneous transactions with unrelated third parties for products in similar quantities to determine if the price and terms offered by a connected person are fair and reasonable and comparable to those offered by unrelated third parties.

- (iii) The issuer should explain why its directors consider that the methods and procedures can ensure that the transactions will be conducted on normal commercial terms and not prejudicial to the interests of the issuer and its minority shareholders.

b) Disclosure of Information

- 10. The issuer should disclose in its announcement and circular (if any) the specific pricing terms or formula set out in the agreement and material information about pricing policies and guidelines (see paragraphs 7 to 9 above).
- 11. The issuer should also disclose in its annual report whether it has followed these policies and guidelines when determining the price and terms of the transactions conducted during the year.

c) Internal Controls

- 12. As explained, an important safeguard involves the annual review by auditors and INEDs, and the annual confirmations that the individual transactions are indeed conducted in accordance with the terms of the agreement, on normal commercial terms (or terms more favourable than terms available to independent parties), and in accordance with the pricing policy of the issuer. It is important for the issuer to ensure that it has an adequate system of controls to safeguard the transactions, and to provide information for the INEDs and auditors to properly review the transactions annually.

d) INED Role

- 13. Under the Rules, the INEDs are obliged to confirm that the terms of the agreement are fair and reasonable at the time the agreement is announced, and make annual confirmations about the transactions entered under the agreement as set out in paragraph 2(v).
- 14. The INEDs should ensure that:
 - (i) the pricing mechanism and the terms of the transactions set out in the agreement are clear and specific;
 - (ii) the annual caps are reasonable taking into account historical transactions and management projections;
 - (iii) the methods and procedures established by the issuer are sufficient to ensure that the transactions will be conducted on normal commercial terms and not prejudicial to the interests of the issuer and its minority shareholders;
 - (iv) appropriate internal control procedures are in place, and its internal audit would need to review these transactions; and

- (v) they are provided by the management with sufficient information for the discharge of their duties.

e) Annual Review by Auditors

15. Under the Rules, the issuer must engage its auditors to report on the continuing connected transactions every year. The auditors may refer to Practice Note 740 “Auditor’s Letter on Continuing Connected Transactions under the Hong Kong Listing Rules” issued by the Hong Kong Institute of Certified Public Accountants for guidance as to their responsibilities and procedures when undertaking the annual review.
