HKEx LISTING DECISION
Cite as HKEx-LD59-5 (August 2007) (Updated in September 2010) (Withdrawn in October 2012; Superseded by GL43-12)

Summary	
Name of Parties	Company A and its subsidiaries (the 'Group') - a Main Board listing applicant Bondholders - pre-IPO investors who subscribed convertible bonds ('CBs') issued by Company A prior to the IPO
Subject	Whether certain special rights available only to the Bondholders under the terms of the CBs 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
Listing Rules	Listing Rule 2.03(2), (4) and (5) Listing Rule 8.04 Listing Decisions HKEx-LD36-1 (October, 2003) and HKEx-LD55-1 (June 2006)
Decision	The Exchange determined that: • the conversion price reset feature of the CBs should be removed to be consistent with the principles of Listing Rule 2.03; • any shares issued and to be issued to the Bondholders upon conversion of the CBs should be subject to a lock-up period of six months from the date of listing of Company A and would not be counted as part of the public float during the lock-up period; • Company A should not issue any shares to the Bondholders if this would result in less than 25% of the issued shares being held in public hands following the conversion; • given the complexity of the CBs and their terms, additional information should be disclosed in the Financial Information and Risk Factors sections of the Prospectus to explain the impact of the CBs on Company A, including if Company A was called upon to redeem the CBs before the maturity date; and • additional information should be disclosed in Company A's interim and annual reports to enable investors to be aware of the dilution impact on Company A's shares in the event that all outstanding CBs were converted as at the

	relevant year end or period end.

SUMMARY OF FACTS

1. Approximately five months before submission of the advance booking form[1], Company A issued the CBs to the Bondholders. Certain salient features of the CBs were as follows:

   Conversion price reset

   a. if the 60-trading-day volume weighted average sale price of Company A's shares prior to each anniversary of the listing date was less than 75% of the IPO price, the conversion price would be adjusted to equal to the 60-trading-day volume weighted average market price.

   Conversion price at a discount to the IPO Offer Price

   b. the Bondholders could, within a period of five years from the listing date, convert the CBs into the ordinary shares of Company A at a conversion price of 85% of the final IPO offer price.

      The reason for the discount was to compensate the Bondholders for the investment risks involved.

   Redemption and early redemption

   c. on a date two years before the maturity date of the CBs, the Bondholders had the option to require Company A to redeem early the outstanding CBs at a price which would enable the Bondholders to receive a fixed percentage of internal rate of return ("IRR") on the principal amount of the CBs being redeemed. Upon maturity, all outstanding CBs shall become immediately payable by Company A at a price which would enable the Bondholders to receive the same fixed percentage of IRR.

      The Bondholders' investment was intended to provide a return to them calculated with reference to the time value of money. The CBs were structured such that the longer the period the Bondholders were required to wait to recover their investment, the greater return they would receive to compensate for the opportunity cost of their funds being tied up.

   Controlling shareholder's guarantee

   d. the controlling shareholder of Company A had guaranteed to compensate the Bondholders in the following events:

      - the Group would not meet a predetermined net profit target for the upcoming two financial years; or

- upon the sale of the CBs or Company A's shares, the IRR to the Bondholders was less than 10%.

The controlling shareholder's guarantee as provided in the CBs was a private arrangement between the Bondholders and the controlling shareholder. Such arrangement was reached on arm's length basis and did not involve Company A.

2. Assuming the conversion price reset mechanism was triggered and all CBs were converted at par value (i.e. the lowest price permitted under the relevant law), the Bondholders would hold 99.98% of the issued share capital in Company A on a fully diluted basis.

THE ISSUE RAISED FOR CONSIDERATION

3. Whether certain special rights available only to the Bondholders under the terms of the CBs 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.

APPLICABLE LISTING RULES OR PRINCIPLE

4. Listing Rules 2.03(2), (4) and (5) require that:

> (2) the issue and marketing of securities is conducted in a fair and orderly manner and that potential investors are given sufficient information to enable them to make a properly informed assessment of an issuer;
>
> (4) all holders of listed securities are treated fairly and evenly;
>
> (5) directors of a listed issuer act in the interests of its shareholders as a whole – particularly where the public represents only a minority of the shareholders;

5. Listing Rule 8.04 requires both the issuer and its business to be suitable for listing in the opinion of the Exchange.

6. Listing Decision HKEx-LD36-1 (October 2003) ('HKEx-LD36-1') states the following regarding pre-IPO placing:

> 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.

7. The Exchange reviewed the rationale of its earlier decision made in HKEx-LD36-1 when considering the case in HKEx-LD55-1 (published in June 2006) and observed that:

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However, the Exchange considered that the scenario contemplated in HKEx-LD36-1 was a ‘simple’ scenario where a pre-IPO placing was conclusively completed before listing with price and commitments affixed on the relevant parties.

THE ANALYSIS

8. In coming to its decision in the present case, the Exchange took into consideration the facts and circumstances of the case and the rationale for the decisions in previous cases including HKEx-LD36-1 and HKEx-LD55-1.

9. The Exchange noted that some of the features of the CBs were more typical for listed issuers in financial distress rather than in pre-IPO investment situations. In reviewing these features, the Exchange generally sought to ensure the protection of minority shareholders as contemplated under Listing Rule 2.03.

Conversion price reset

10. Convertible bonds with a conversion price reset mechanism incorporated were commonly referred to as “toxic convertibles” where the conversion price was the lower of a fixed price and a floating market price. The floating market price mechanism normally allowed conversion to be at a discount to the market price at the time of conversion. Effectively the conversion ratio was based on fluctuating market prices to determine the number of shares to be issued on conversion. As the share price declined, the market price based conversion formulae would lead to more shares to be issued, hence greater dilution and greater potential for share price reduction which worked in a spiral.

11. In the worst case scenario, the Bondholders could hold up to 99.98% in the issued share capital of Company A, leaving minority shareholders with the remaining 0.02% issued share capital in Company A. The Exchange was of the view that this was inconsistent with Listing Rule 2.03 which requires all holders of listed securities to be treated fairly and equally. The Exchange also considered it raised questions whether Company A was suitable for listing given the extreme financing terms being imposed upon minority shareholders.

12. The Exchange determined that the terms giving rise to the "toxic" feature of the CBs should be removed given that it was considered to be in consistent with the principle of Listing Rule 2.03.

Conversion price at a discount to the IPO Offer Price

13. The Exchange noted that the Bondholders invested in Company A approximately five months before the advance booking form[1] was submitted. There was no assurance that Company A's listing would take place. In this respect, the Exchange considered that the Bondholders' investment could be distinguished from the scenario described in Listing Decision HKEx-LD55-1 where in that case, the investment of the pre-IPO investor would be completed after approval in principle by the Listing Committee and shortly before listing.

Redemption and early redemption

14. The Exchange noted the sponsor's submission that the IRR on the principal amount of the CBs to be redeemed was the compensation and income for the investment and risk undertaken by the Bondholders. The early redemption could be distinguished from the "exit clause" of some precedent cases where the bondholders did not undertake any risk and the investment money was not paid yet. In this case, the monies had been paid to Company A by the Bondholders.

Controlling shareholder's guarantee

15. Having considered the sponsor's submission and that a separate agreement would be entered into by the controlling shareholder of Company A and the Bondholders as to all the arrangements relating to the controlling shareholder's guarantee, the Exchange had no comment on the private arrangements between the controlling shareholder and the Bondholders.

Public float and disclosures in the Prospectus

16. The Exchange noted that the terms of the CBs were, as a whole, the most aggressive set of terms seen in a new listing applicant even after removing the "toxic" element. Given that those terms of the CBs were not available to all other shareholders, the Exchange determined that any shares issued and to be issued to the Bondholders upon conversion of the CBs should be subject to a lock-up period of six months from the date of listing of Company A and would not be counted as public float during the lock-up period. Company A was also required to state in the Prospectus that it would not issue any shares to the Bondholders if this would result in less than 25% of the issued shares being held in public hands following the conversion.

17. The Exchange also determined that the following additional disclosure should be made in the Prospectus:

    a. to provide a qualitative analysis on the cash flow and cash position in the event of CBs redemption;

b. to include detailed disclosure on the various terms and impact of the discount and early redemption, including the monetary amount that Company A was required to pay to the Bondholders on the assumption of redemption upon maturity or early redemption, so as to enable the Bondholders to receive the required percentage of IRR;

c. to include disclosure on the maximum number of shares that would be converted and the corresponding change in shareholding in the Risk Factors section;

d. to include disclosures on the expected source of cash inflows upon listing; and

e. to disclose the triggering prevailing share price for conversion at which it would be financially more advantageous for the Bondholders to convert.

18. The Exchange also requested that the Prospectus to disclose Company A's confirmation that it would provide periodic updates in its annual and interim reports. The updates are to include the following information:

a. the number of shares that may be issued upon full conversion of the outstanding CBs;

b. the dilutive impact on the then issued share capital of Company A and respective shareholdings of the substantial shareholders of Company A;

c. the dilutive impact on earnings per share;

d. the analysis on the financial and liquidity position of Company A at the relevant point in time, discussing its ability to meet its redemption obligations under the CBs;

e. the number of shares that may be issued and the dilutive impact on shareholdings and earnings per share assuming that the Bondholders had elected to have all their interests under the CBs paid in kind; and

f. the analysis on the price of the shares of Company A that would result in a situation where, absent other factors which may affect the share price, the Bondholders would be indifferent in whether to convert or redeem the CBs.

THE DECISION

19. The Exchange determined that:

a. the conversion price reset feature of the CBs should be removed to be consistent with the principles of Listing Rule 2.03;

b. any shares issued and to be issued to the Bondholders upon conversion of the CBs should be subject to a lock-up period of six months from the date of listing of Company A and would not be counted as part of the public float during the lock-up period;

c. Company A should not issue any shares to the Bondholders if this would result in less than 25% of the issued shares being held in public hands following the conversion;

d. given the complexity of the CBs and their terms, additional information should be disclosed in the Financial Information and Risk Factors sections of the Prospectus to explain the impact of the CBs on Company A, including if Company A was called upon to redeem the CBs before the maturity date; and

e. additional information should be disclosed in Company A's interim and annual reports to enable investors to be aware of the dilution impact on Company A's shares in the event that all outstanding CBs were converted as at the relevant year end or period end.

Note:

1. The term "advance booking form" has been replaced by the "listing application form" after the rule amendments in November 2009. (Added in September 2010)