

HKEX GUIDANCE LETTER

HKEX-GL77-14 (Published in May 2014) (Rule reference updated in July 2014)
(Updated in August 2015 and April 2018)

[Updated to clarify, among other things, the requirements related to foreign ownership restriction in paragraph 16 and the Draft FIL (defined below) in paragraphs 22 to 29]

Subject	Guidance on listed issuers using contractual arrangements for their businesses
Listing Rules	Main Board Rules 2.03(3) and 2.03(5) GEM Rules 2.06(3) and 2.06(5)
Related Publications	Listing Decision HKEx-LD43-3

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 Department on a confidential basis for an interpretation of the Listing Rules, or this letter.

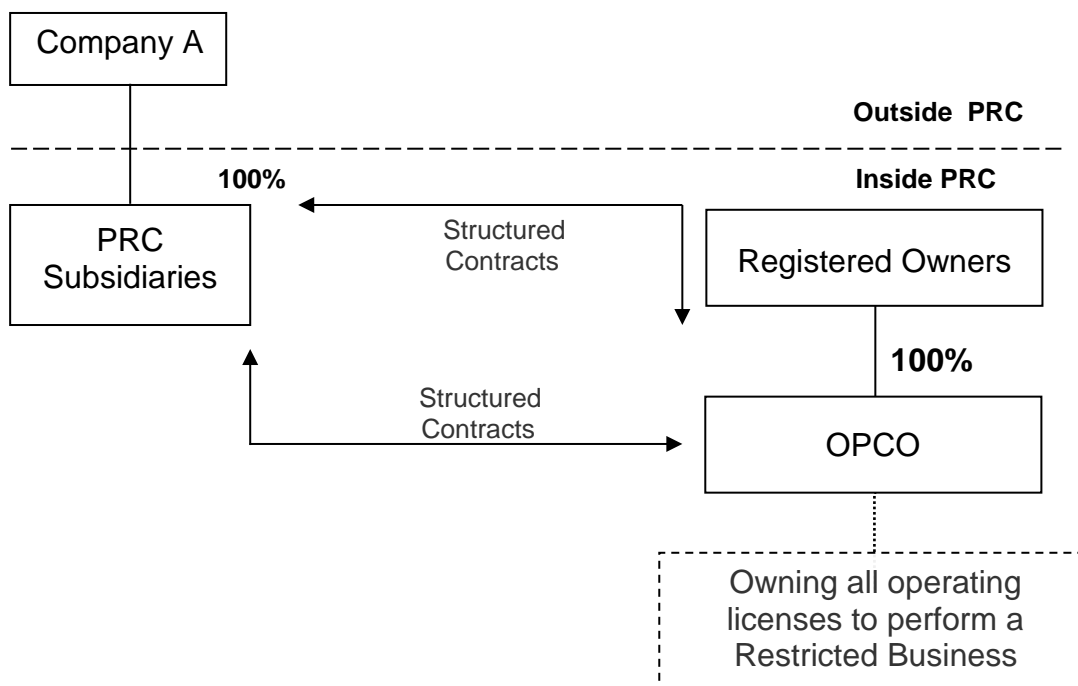
A. Purpose

1. This letter provides guidance to listed issuers using contract-based arrangements or structures (**Contractual Arrangements, also commonly known as structured contracts or VIEs**) to indirectly own and control any part of their businesses. Whilst the guidance below specifically refers to Contractual Arrangements involving an operating company incorporated in the PRC, the spirit of this guidance also applies to similar types of Contractual Arrangements used by companies in other jurisdictions to the extent applicable.
2. Contractual Arrangements generally involve a company (**Company A**) which, through its subsidiaries in the PRC (the **PRC Subsidiaries**), enters into a number of contracts with an operating company (**OPCO**) incorporated in the PRC. OPCO is owned by PRC nationals (the **Registered Owners**) and owns all the operating licenses to perform business in an industry sector that is subject to foreign investment restrictions (the **Restricted Business**).
3. Listing Decision HKEx-LD43-3¹ (**LD43-3**) provides guidance to new listing applicants using Contractual Arrangements for their businesses. This letter follows the guidance in LD43-3 and is applicable to issuers using Contractual Arrangements after listing.

¹ Listing Decision HKEx-LD43-3 <http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/LD43-3.pdf>

B. Contractual Arrangements

4. A brief diagram illustrating a typical structure of the Contractual Arrangements is set out below:



5. The Structured Contracts typically include contracts that are designed to allow Company A and its subsidiaries (the **Group**) to exercise control over the operations of OPCO and enjoy the economic benefits generated by OPCO.

C. Relevant Listing Rules

General principles

6. Rule 2.03 (equivalent GEM Rule 2.06) states that:

“The Listing Rules reflect currently acceptable standards in the market place and are designed to ensure that investors have and can maintain confidence in the market and in particular that: -

...

- (3) *investors and the public are kept fully informed by the listed issuers ... of material factors which might affect their interests;*

...

- (5) *directors of a listed issuer act in the interests of its shareholders as a whole ... ; and*

...”

7. Section C.2 of Appendix 14 to the Rules (equivalent Section C.2 of Appendix 15 to the GEM Rules) states that:

“The board should ensure that the issuer maintains sound and effective internal controls to safeguard shareholders’ investment and the issuer’s assets.”

Disclosure requirements for notifiable and/or connected transactions

8. Under Rules 14.58, 14.59, 14.60 and 14A.68 (equivalent GEM Rules 19.58, 19.59, 19.60 and 20.66), the announcement for a notifiable transaction and/or connected transaction must contain, among others, the following information:

- ...;
- *the reasons for entering into the transactions, the benefits which are expected to accrue to the listed issuer as a result of the transaction and a statement that the director believe that the terms of the transactions are fair and reasonable and in the interests of the shareholders as a whole;*
- *the general nature of the transaction ...;*
- *brief details of the asset(s) being acquired or disposed of, including the name of any company or business or the actual assets or properties where relevant and, if the assets include securities, the name and general description of the activities of the company in which the securities are or were held;*
- ...”

9. Under Rules 14.63 and 14A.69 (equivalent GEM Rules 19.63 and 20.67), the circular for a major (or above) transaction and/or a connected transaction must provide clear and adequate explanation of its subject matter and contain all information necessary to allow the shareholders to make a properly informed decision.

10. Under Rule 14.66(10) Paragraph 29(1)(b) of Appendix 1B to the Rules (equivalent GEM Rule 19.66(10) and Paragraph 29(1)(b) of Appendix 1B to the GEM Rules) state that a circular for a major transaction must contain:

“A statement as to the financial and trading prospects of the group for at least the current financial year, together with any material information which may be relevant thereto, including all special trade factors or risks (if any) which are not mentioned elsewhere in the listing document and which are unlikely to be known or anticipated by the general public, and which could materially affect the profits.”

“... reference to the group is to be construed as including any company which will become a subsidiary of the issuer by reason of an acquisition which has been agreed or proposed since the date to which the latest audited accounts of the issuer have been made up.”

Disclosure requirements for annual reports

11. Paragraph 9 of Appendix 16 to the Rules (equivalent GEM Rule 18.10) provides that an issuer shall include in its financial statements a statement showing:

“(1) the name of every subsidiary, its principal country of operation and its country of incorporation or other establishment, and, in the case of a subsidiary established in the PRC, the kind of legal entity it is registered under the PRC law ...; and

(2) particulars of the issued share capital and debt securities of every subsidiary.

9.1 ...

9.2 If a listed issuer has an excessive number of subsidiaries, the statement need only include details for subsidiaries which, in the opinion of the directors, materially contribute to the net income of the group or hold a material portion of the assets or liabilities of the group.”

12. Paragraph 32 of Appendix 16 to the Rules (equivalent GEM Rule 18.41) states that:

“A listed issuer shall include in its annual report a separate statement containing a discussion and analysis of the group’s performance during the financial year and the material factors underlying its results and financial position. It should emphasize trends and identify significant events or transactions during the financial year under review.”

13. Paragraph 52 of Appendix 16 to the Rules (equivalent GEM Rule 18.83) provides that issuers are encouraged to disclose additional commentary on management discussion and analysis in their interim and annual reports:

“ ...

(v) a discussion on business risks (including known events, uncertainties and other factors which may substantially affect future performance) and risks management policy;

...”

D. Guidance

14. Under Contractual Arrangements, the issuer and its subsidiaries do not have direct ownership of OPCO and rely on the Structured Contracts to control it. In light of the legal issues and potential risks associated with these arrangements, issuers should take necessary actions to ensure the legality and validity of the Structured Contracts and disclose all material and relevant information about the arrangements.

15. The guidance set out below is not exhaustive. Issuers should assess their own situation to decide whether additional actions or disclosures are appropriate to ensure compliance with the Rules.

Factors to consider when adopting Contractual Arrangements

16. When an issuer proposes to acquire or establish a business using Contractual Arrangements which constitutes a notifiable and/or connected transaction, it is expected to observe the following:

- (a) The Structured Contracts should be narrowly tailored to achieve the issuer's business purpose and minimise the potential for conflict with relevant PRC laws and regulations:

- (i) For the avoidance of doubt, Contractual Arrangements may only be used to the extent necessary to address any limits on foreign ownership, except as provided in sub-paragraphs (1) and (2) below. The issuer must otherwise directly hold the maximum permitted interest in the OPCO. For the avoidance of doubt, even if the issuer is able to control OPCO through the direct equity interest held by it in OPCO (e.g. by holding a direct equity interest of more than 50%), the remaining equity interest that is not permitted to be directly held by it may still be held through Contractual Arrangements.

- (1) If the OPCO, as a result of having foreign ownership, is required to obtain approval and fulfill additional eligibility standards ("**Other Requirements**"), the issuer must fulfil such Other Requirements. The issuer must seek and obtain such regulatory approval to directly hold the maximum interest in the OPCO prior to acquiring or establishing a business using Contractual Arrangements unless the approving regulatory authority confirms that it will not or cannot give approval even if the issuer fulfilled the Other Requirements:

- (a) because no procedures or guidance for granting approval are available; or

- (b) for policy reasons.

- (2) If clear procedures or guidance from approving regulatory authority is not available, the issuer can directly hold less than the maximum permitted interest in OPCO if it demonstrates to the satisfaction of the Exchange that it has, as advised by its legal adviser, reasonably assessed the requirements under all applicable rules, committed financial and other resources and implemented all the legal adviser's recommendations prior to acquiring or establishing a business using Contractual Arrangements. A mere intent, undertaking or plan to implement such recommendations is not sufficient.

(Updated in April 2018)

- (ii) The issuer should obtain a PRC legal opinion that the Contractual Arrangements comply with PRC laws, rules and regulations, including those applicable to the business of the PRC Subsidiaries

and OPCO. There should be a positive confirmation from the PRC legal advisers that the Structured Contracts would not be deemed as “concealing illegal intentions with a lawful form” and void under the PRC contract law.

Where the relevant laws and regulations specifically disallow foreign investors from using any agreements or Contractual Arrangements to gain control of or operate a foreign restricted business (e.g. on-game business in the PRC which is subject to GAAP’s Notice 13²), the PRC legal opinion on the Contractual Arrangements must include a positive confirmation that the use of the Structured Contracts does not constitute a breach of those laws and regulations, with support of appropriate regulatory assurance, where possible, to demonstrate the legality of the Contractual Arrangements.

Subject to availability and practicability, appropriate regulatory assurance should be obtained from the relevant regulatory authorities, or the PRC legal adviser should make a statement in its legal opinion to the effect that all possible actions or steps taken to enable it to reach its legal conclusions had been taken.

(b) The issuer should ensure that the Contractual Arrangements:

- include a power of attorney by which OPCO’s shareholders grant to the issuer’s directors and their successors (including a liquidator replacing the issuer’s directors) the power to exercise all rights of OPCO’s shareholders, including the rights to vote in a shareholders’ meeting, sign minutes, file documents with the relevant companies registry. OPCO’s shareholders should ensure that the power of attorney does not give rise to any potential conflicts of interest. Where OPCO’s shareholders are officers or directors of the issuer, the power of attorney should be granted in favour of the issuer and actions in relation to the Contractual Arrangements must be decided by officers or directors of the issuer who are not shareholders of OPCO; ***(Updated in August 2015)***
- contain dispute resolution clauses that:
 - provide for arbitration and that arbitrators may award remedies over the shares or land assets of OPCO, injunctive relief (e.g. for the conduct of business or to compel the transfer of assets) or order the winding up of OPCO;
 - provide the courts of competent jurisdictions with the power to grant interim remedies in support of the arbitration pending formation of the arbitral tribunal or in appropriate cases. The

² “Notice Regarding the Consistent Implementation of the “Stipulations on Three Provisions” of the State Council and the Relevant Interpretations of the State Commission Office for Public Sector Reform and the Further Strengthening of the Administration of Pre-examination and Approval of Internet Games and the Examination and Approval of Imported Internet Games” (Xin Chu Lian [2009] No. 13) published jointly by PRC General Administration of Press and Publication, National Copyright Administration, and National Office of Combating Pornography and Illegal Publications on 28 September 2009 (as amended from time to time).

courts of Hong Kong, the issuer's place of incorporation, OPCO's place of incorporation, and the place where the issuer or OPCO's principal assets are located should be specified as having jurisdiction for this purpose; and

- encompass dealing with OPCO's assets, and not only the right to manage its business and the right to revenue. This is to ensure that the liquidator, acting on the Contractual Arrangements, can seize OPCO's assets in a winding up situation for the benefit of the issuer's shareholders or creditors.
- (c) Where the financial results of OPCO are to be accounted for and consolidated in the issuer's consolidated accounts as if it were a subsidiary of the Group, the issuer should discuss with its auditors or reporting accountants to confirm that it has the right to do so under the prevailing accounting principles.
- (d) It should put in place effective internal controls over the PRC Subsidiaries and OPCO to safeguard its assets held through the Contractual Arrangements.
- (e) It should terminate the Contractual Arrangements as soon as the law allows the business to be operated without them. It should ensure that OPCO's registered shareholders have undertaken to it that, subject to the relevant laws and regulations, they must return to the issuer any consideration they receive in the event that the issuer acquires OPCO's shares when terminating the Contractual Arrangements.
17. The issuer should make disclosure if there is any deviation from the above guidance. The Exchange will consider the circumstances of the case and where necessary for the protection of shareholders, require the issuer to take all necessary actions. In the case of a major or very substantial acquisition, the issuer will need to resolve all of the Exchange's concerns before it can proceed with the transaction³.

Disclosure in announcements and circulars

18. The announcement and circular (if required) must contain sufficient details of the arrangements to enable shareholders to make an informed assessment of the transaction. These may include:

Details of the transaction and the assets being acquired

- (a) the reasons for the use of the Contractual Arrangements, and the matters described in paragraph 16 above;
- (b) details of OPCO's registered shareholders and a confirmation that appropriate arrangements have been made to protect the issuer's

³ Under the Rules, the issuer must submit the draft circular of the transaction (and in the case of a very substantial acquisition, the draft announcement) to the Exchange for review before the document is issued.

interests in the event of death, bankruptcy or divorce of OPCO's registered shareholders to avoid any practical difficulties in enforcing Contractual Arrangements;

- (c) bases why the directors believe that each of the agreements conferring significant control and economic benefits from OPCO to the issuer is enforceable under the relevant laws and regulations;
- (d) the extent to which the issuer has arrangements in place to address the potential conflicts of interest between the issuer and OPCO's registered shareholders, particularly in cases where these shareholders are officers and directors of the issuer;
- (e) corporate structure table for the purpose of illustrating the Contractual Arrangements and facilitating investors' review and understanding of the arrangements;

Financial information

- (f) a separate disclosure of revenue from the businesses under the Contractual Arrangements if the target being acquired generates revenue from other subsidiaries apart from OPCO;

Other disclosures

- (g) the economic risks the issuer bears as the primary beneficiary of OPCO, in what way the issuer shares the losses of OPCO, the circumstances that could require the issuer to provide financial support to OPCO, or other events or circumstances that could expose the issuer to losses;
- (h) a discussion on whether the target being acquired has, to date, encountered any interference or encumbrance from any governing bodies in operating its business through OPCO under the Contractual Arrangements;
- (i) the limitations in exercising the option to acquire ownership in OPCO, include a separate risk factor explaining these limitations, and clarifying that ownership transfer may still subject to substantial costs;
- (j) other risks regarding the nature of the Contractual Arrangements, including that (i) the government may determine that the contracts do not comply with applicable regulations; (ii) the contracts may not provide control as effective as direct ownership; (iii) OPCO registered shareholders may have potential conflicts of interest with the issuer; and (iv) the contracts may be subject to scrutiny of the tax authorities and additional tax may be imposed; and
- (k) details of any insurance purchased to cover the risks relating to Contractual Arrangements, or a prominent disclosure that those risks are not covered by any insurance.

19. The issuer is recommended to publish the Contractual Arrangements on its website to promote transparency.

Disclosure in annual reports

20. An issuer is expected to keep shareholders informed of its business operations through Contractual Arrangements (whether by way of an acquisition or a greenfield project) subsisting during or at the end of the financial period in their annual reports where these operations are in aggregate material (see also Paragraph 9 of Appendix 16 to the Rules (equivalent GEM Rule 18.10)). These should include:
- (a) particulars of OPCO and its Registered Owners, and a summary of the major terms of the Contractual Arrangements;
 - (b) a description of OPCO's business activities and their significance to the Group;
 - (c) appropriate quantitative information including revenue and assets subject to the Contractual Arrangements;
 - (d) the extent to which the Contractual Arrangements relate to requirements other than the foreign ownership restriction;
 - (e) the reasons for using the Contractual Arrangements, the risks associated with the arrangements and the actions taken by the issuer to mitigate the risks;
 - (f) any material change in the Contractual Arrangements and/or the circumstances under which they were adopted, and its impact on the issuer group; and
 - (g) any termination of the Contractual Arrangements or failure to terminate when the restrictions that led to the adoption of the Contractual Arrangements are removed.

Continuing connected transactions

21. If OPCO and/or any of its registered shareholders is, or will become, a connected person of the issuer, the issuer should ensure compliance with Chapter 14A for any continuing transactions with such person contemplated under the Contractual Arrangements unless they are exempt under the Rules.

E. Draft PRC Foreign Investment Law

Background

22. The above guidance is in part based on the conclusion that the Contractual Arrangements comply with PRC laws, rules and regulations, and that the Structured Contracts are legal and binding. This is evident in paragraph 16(a)(ii) above.

23. Following publication of the consultation draft (the “**Draft FIL**”) of the new PRC Foreign Investment Law (the “**FIL**”) by the Ministry of Commerce in January 2015, concerns over the legality and validity of Structured Contracts to hold interests in PRC businesses which are subject to foreign ownership restrictions were heightened. Issuers which use Structured Contracts to hold interests in PRC businesses are encouraged to contact the Exchange in advance to seek informal and confidential guidance on novel issues (**updated in April 2018**)

Measures to be adopted, if any, when issuers propose to acquire or establish VIE businesses that constitute notifiable transactions (added in April 2018)

24. Since there is uncertainty as to the implementation and the wording of the final FIL, an issuer proposing to acquire or establish a VIE business in the PRC should seek PRC legal advice and decide what measures to adopt (if any) to mitigate against any potential risk.
25. Whether or not the issuer decides to adopt any measures, it must disclose in the announcement and circular (if any) for the transaction the reasons for taking that approach.
26. If the issuer decides to adopt certain measures, it must also include an appropriate risk factor in the announcement and circular (if any) for the transaction stating that such measures may not be effective since the FIL has not been finalized and requirements under the final FIL may be different from those set out in the Draft FIL.
27. An issuer proposing to acquire or establish a VIE business should also include the following disclosure in the announcement and circular (if any) for the transaction:
- (a) Description of the Draft FIL and its promulgation status.
 - (b) A risk factor (i) explaining that the Draft FIL is currently in draft form only, (ii) cross referring to the description of the Draft FIL; (iii) stating that if the issuer cannot comply with the final FIL, if and when it becomes effective, it may be required to dispose of its VIE business under the Structured Contracts; and (iv) if the issuer no longer has a sustainable business after such disposal, the Exchange may delist the issuer.
 - (c) A statement that the issuer will disclose, as soon as possible: (i) updates of material changes to the Draft FIL as and when they occur; and (ii) a clear description and analysis of the final FIL as implemented, specific measures taken by the issuer to fully comply with the final FIL supported by a PRC legal opinion and any material impact of the final FIL on the issuer’s operations and financial position.
28. Issuers which have adopted measures to mitigate against any potential risk in light of the Draft FIL should consult the Exchange if they wish to effect any change to the measures.

On-going developments (added in April 2018)

29. The Exchange recognises that the Draft FIL remains subject to change. The

Exchange will continue to monitor developments with respect to the FIL and will update this document accordingly.
