

# Specific Listing Issues

**Planning**, executing, and managing an initial public offering ("IPO") can be a challenging task. The better prepared a company is, the more efficient and less costly the process will be. It is therefore of paramount importance for potential issuers to identify issues in advance and resolve them at an early stage of an IPO.

There are many issues and challenges that may arise according to the specific circumstances of the listing, the nature of the company and its industry, in particular in the midst of potential reform to the Hong Kong stock market. This chapter discusses the potential reform and some of the specific listing issues that may be encountered by potential issuers.

## New Listing Regime for Biotech Companies

### Background

Back in February 2018, The Stock Exchange of Hong Kong Limited ("SEHK") issued a consultation paper titled "A Listing Regime for Companies from Emerging and Innovative Sectors" (the "Consultation Paper")<sup>1</sup> to set out proposals to expand the existing listing regime to facilitate the listing of companies from emerging and innovative sectors, subject to appropriate safeguards. On 24 April 2018, SEHK published the consultation conclusions (the "Consultation Conclusions")<sup>2</sup> in respect of the Consultation Paper. The overwhelming majority of responses supported SEHK's proposal in the Consultation Paper in general. As a result, the listing rules and relevant guidance letters have been amended and introduced as appropriate, and have come into effect on 30 April 2018.

### What is meant by "Biotech Company" ?

A "Biotech Company" refers to a company primarily engaged in the research and development ("R&D"), application and commercialisation of biotech products. In the Consultation Paper, SEHK proposed to allow the listing of Biotech Companies that do not meet the financial eligibility tests under Chapter 8 of the existing listing rules (including companies with no revenue or profit) whilst providing appropriate investor protection from the risks associated with such companies. SEHK proposed to do so through the introduction of a new Chapter 18A in the listing rules (the "Chapter 18A"), supplemented with guidance letter titled "Suitability for Listing of Biotech Companies" ("GL1")<sup>3</sup> to set out the factors that the SEHK will take into account when determining an applicant's eligibility and suitability to list under that chapter. The overwhelming majority of respondents supported SEHK's proposals regarding the introduction of Chapter 18A for biotech companies. In brief, SEHK decided to implement substantially all its proposals in the Consultation Paper with some amendments.



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1. Consultation Paper - A Listing Regime for Companies from Emerging and Innovative Sectors (February 2018), The Stock Exchange of Hong Kong  
2. Consultation Conclusions - A Listing Regime for Companies from Emerging and Innovative Sectors (April 2018), The Stock Exchange of Hong Kong  
3. HKEX-GL92-18 (April 2018)

## Suitability of Biotech Companies to List

An applicant must demonstrate to SEHK's satisfaction that it is both eligible and suitable for listing as a Biotech Company<sup>4</sup>. In GL1, SEHK sets out the features which a Biotech Company needs to demonstrate:

- (i) it must have developed at least one core product<sup>5</sup> beyond the concept stage;
- (ii) it must have been primarily engaged in R&D for the purposes of developing its core product(s);
- (iii) it must have been engaged with R&D of its core product(s) for a minimum of 12 months prior to the listing;
- (iv) it must have as its primary reason for listing the raising of finance for R&D to bring its core product(s) to commercialisation;
- (v) it must have registered patent(s), patent application(s) and/or intellectual property in relation to its core product(s)<sup>6</sup>;
- (vi) if the applicant is engaged in R&D of pharmaceutical or biologic products, it must demonstrate that it has pipeline of those potential products; and
- (vii) it must have been previously received "meaningful third party investment" from at least one "sophisticated investor" at least six months before the date of the proposed listing (which must remain at IPO).

In response to some respondents' comments, SEHK made amendments in the GL1 to the effect that an applicant must demonstrate some R&D progress of any core product that is in-licensed or acquired. SEHK will also review any change in ownership of the applicant in the 12 months prior to the date of the listing application in assessing the suitability of the applicant for listing.

In particular, in relation to the item (vii) contained in the suitability list above, SEHK defined a "sophisticated investor" to be an investor that SEHK considers to be sophisticated by reference to factors such as net asset or assets under management, relevant investment experience and the investor's knowledge and expertise in the relevant field. For the avoidance of doubt, the SFO definition of a "professional investor" is separate and different to the definition of a Sophisticated Investor<sup>7</sup>.

Likewise, in relation to the definition of "meaningful investment", SEHK rejected the notion of "bright line" tests as to what would constitute a "meaningful investment". Instead, SEHK will examine the nature of the investment, the amount invested, the size of the stake taken up and the timing of the investment to determine, on a case by case basis, whether it believes the investment to be "meaningful"<sup>8</sup>.

4. LR18A.03(1)

5. A core product includes biotech product that is required by applicable laws, rules or regulations to be evaluated and approved by a competent authority based on data derived from clinical trials (i.e. on human subjects) before it could be marketed and sold in the market regulated by that competent authority.

6. SEHK proposed in the Consultation Paper that such patents should be "durable". Some respondents questioned why SEHK required a Biotech Company listing applicant to have "durable" patents. They stated that the term "durable" does not have any legal meaning with regards to patents and maintaining the requirement may cause unnecessary uncertainty and confusion. As a result, SEHK has removed the word "durable" from the requirements.

7. Some respondents asked SEHK to provide more guidance on the meaning of "sophisticated investor" and "meaningful investment". In response, SEHK agreed that it should look to the investment experience of the senior management or management team of the investor for the purpose of its assessment of whether an investor is a sophisticated investor. Having said that, SEHK rejected the notion of "bright line" tests for a sophisticated investor.

8. In the GL1, SEHK sets out some examples of sophisticated investor which includes "a dedicated healthcare or Biotech fund or an established fund with a division/department that specialises or focuses on investments in the biopharmaceutical sector" and "a major pharmaceutical/healthcare company". For the definition of "meaningful investment", SEHK has also set out in GL1 a number of illustrative examples including but not limited to "an investment of not less than 5% of the issued share capital of the applicant at the time of listing (for an applicant with a market capitalization between HK\$1.5 billion to HK\$3 billion)" and "an investment of not less than 3% of the issued share capital of the applicant at the time of listing (for an applicant with a market capitalization between HK\$3 billion to HK\$8 billion)".

## Conditions of Listing

Under the proposed listing regime, company which seeks to apply for listing as a Biotech Company must have a minimum expected market capitalisation at the time of listing of HK\$1.5 billion and must have been in operation in its current line of business for at least two financial years prior to listing under substantially the same management<sup>9</sup>.

Further, the applicant is required to have available working capital to cover at least 125% of the group's costs for at least the next 12 months (after taking into account the proceeds of the new applicant's initial listing). These costs must substantially consist of (a) general, administrative and operating costs; and (b) R&D costs<sup>10</sup>, which must be included in the calculation of sufficiency of working capital for Biotech Companies irrespective of whether such costs are capitalised<sup>11</sup>.

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9. LR18A.03(2)

10. LR18A.03(4)

11. Note 2 to LR18A.03

## Post-Listing Requirements and Restrictions

On top of the aforementioned conditions of listing, SEHK has also introduced a list of requirements and restrictions on the Biotech Companies listed under the new listing regime, the examples of which are set out in the table below:

Requirements	Listing Rule Reference	Details
Enhanced Disclosure Requirements	18A.04, 18A.05 and 18A.07	A biotech company is required to provide prominent warning statements, enhanced risk disclosures and ongoing disclosures regarding their R&D activities in its interim and annual reports.
Identification	18A.11	The applicant must be prominently identified through a unique stock marker “B” at the end of its stock name. This measure would no longer be appropriate once a biotech company had developed into a profit-making and/or revenue-generating business.
Restriction on Cornerstone Investors	18A.06	<p>With regards to the calculation of public float by reference to the subscription by cornerstone investors, SEHK decided to provide some flexibility in this regard for companies which satisfy the minimum HK\$1.5 billion market capitalisation requirement.</p> <p>In short, for companies who satisfy the HK\$1.5 billion market capitalization requirement, they should ensure that a portion of the total number of its issued shares with a market capitalization of at least HK\$375 million (representing 25% of HK\$1.5 billion market capitalisation) are held by the public at the time of its initial listing, which is exclusive of subscriptions by existing shareholders at IPO and subscriptions through cornerstone investments. As long as the applicant is able to meet this requirement, SEHK accepts that cornerstone investments and subscriptions by existing shareholders could be included in the determination of a Biotech Company’s public float, provided that the existing shareholders or cornerstone investors are not core connected persons or otherwise not recognised by SEHK to be members of the public in accordance with Rule 8.24.</p>



Restriction on Material Change of Business	18A.10	Biotech companies listed under Chapter 18A would not be allowed to effect any acquisition, disposal or other transaction or arrangement that would result in a fundamental change to its principal business without SEHK's prior consent. SEHK suggests that such prior consent will normally be given if the Biotech Company could satisfy SEHK that it is engaging in a legitimate business expansion or diversification that forms part of its business strategies. This measure would no longer be appropriate once a restriction company had developed into a profit-making and/or revenue-generating business.
Profit-Forecast Memorandum	9.11(10)	Profit forecast memorandum is still required as SEHK believes that it would still provide useful information on the manner in which losses are accounted for by the applicant.

## Listing with Weighted Voting Rights (“WVR”) Structures

### Background

In the Consultation Paper, SEHK proposed to implement a new Chapter 8A setting out the qualifications for listing of companies with a WVR structure and the safeguards required for protecting investors on an ongoing basis. The overwhelming majority of respondents supported SEHK's proposals regarding the introduction of Chapter 8A for issuers with WVR structures. In brief, SEHK decided to implement substantially all its proposals in the Consultation Paper with some amendments.

### What is meant by “WVR” ?

WVR means that the voting power attached to a share of a particular class that is greater or superior to the counterpart attached to an ordinary share, or other governance right or arrangement disproportionate to the beneficiary's economic interest in the equity securities of the issuer.

## Permissible WVR Structure

### Requisite Features that the WVR Structure must Possess

For the purpose of listing under the new regime for WVR structure, the WVR structure should be attached to a specific class of shares which must be unlisted and the WVRs attached to them must confer to a beneficiary enhanced voting power only in relation to the resolutions tabled at the issuer's general meetings (other than matters required to be decided on a one-share, one-vote basis). The rights attached to WVR shares must be the same in all other respects to those attached to the issuer's ordinary shares other than with regards to voting rights<sup>12</sup>. The voting power attached to WVR shares should be capped to not more than ten times of the voting power of ordinary shares<sup>13</sup>.

A listed issuer's WVR structure must enable non-WVR shareholders to cast at least 10% of the votes that are eligible to be cast on resolutions at the listed issuer's general meetings. Non-WVR shareholders holding at least 10% of the voting rights on a one-share one-vote basis (or such lower threshold as required under the laws of incorporation of the issuer) must be able to convene a general meeting and to add resolutions to the meeting agenda<sup>14</sup>. In particular, the following key matters must be decided on a one-share one-vote basis (i.e. WVR beneficiaries would not be able to exercise WVRs on the following matters<sup>15</sup>):

- (a) changes to the issuer's constitutional documents, however framed;
- (b) variation of rights attached to any class of shares;
- (c) the appointment or removal of an independent non-executive director;
- (d) the appointment or removal of auditors; and
- (e) the voluntary winding-up of the issuer.

The intention of SEHK is to protect non-WVR shareholders from resolutions that amend the constitutional documents of the company being passed by WVR beneficiaries on the basis of their WVRs. It is not SEHK's intention to enable non-WVR shareholders to remove or modify an issuer's WVR structure through a change to its constitutional documents. In response to some concerns expressed by the respondents, SEHK added a note to Rule 8A.24 to clarify the intention of the Rule and of the rights of shareholders.

12. LR8A.07 & 08

13. LR8A.10

14. LR8A.09

15. LR8A.24

## Eligibility to act as WVR Beneficiaries

Beneficiaries of WVR would be restricted to those individuals who were directors of the issuer at listing and remain directors afterwards. The WVRs attached to a beneficiary's shares would lapse permanently if a WVR beneficiary: (a) died; (b) ceased to be a director; (c) was deemed by SEHK to be incapacitated; or (d) was deemed by SEHK to no longer meet the requirements of a director set out in the listing rules<sup>16</sup>.

SEHK would deem a beneficiary of WVRs to no longer meet the requirements of a director if SEHK believed the person no longer has the character and integrity commensurate with the position (for example, conviction of offence involving fraud and dishonesty, disqualification order)<sup>17</sup>.

In particular, in the event that a WVR beneficiary transferred his beneficial interest or economic interest in those shares, or the voting rights attached to them, to another person, the WVRs attached to such WVR beneficiary's share would lapse permanently<sup>18</sup>. SEHK would consider an arrangement to hold WVR shares through a limited partnership, trust, private company or other vehicle (for example, for estate and/or tax planning purposes) as acceptable and would not cause the WVRs attached to the beneficiary's shares to lapse provided that SEHK was satisfied that such an arrangement did not result in a circumvention of the restriction against the transfer of WVRs to another person. A beneficiary would be permitted to put in place, or make amendments to, such a holding arrangement post-listing as long as the amended arrangements also complied with this requirement.

## Conditions for Listing with WVR Structure

Applicants would be required to establish that they are both eligible and suitable for listing with a WVR structure. [8A.04] SEHK considers all circumstances in exercising its discretion to find an applicant suitable to list with a WVR structure. SEHK would retain absolute discretion to reject an application for listing with a WVR structure even if the applicant met these requirements to ensure that only "bona fide" candidates who fit the target profile are listed. SEHK also reserves the right to reject an applicant on suitability grounds if its WVR structure was an extreme case of non-conformance with governance norms (for example if the ordinary shares would carry no voting rights at all). The table below sets out some examples of the conditions for listing under the new listing regime for WVR structure:

Listing Requirement	Relevant Listing Rule(s)	Details
Expected Market Capitalisation	8A.05 and 8A.06	In addition to satisfaction of the relevant criteria under Rule 8.05, SEHK limits applicants permitted to list with WVR structures to those companies that had an expected market capitalisation at listing of not less than HK\$10 billion. If an applicant with a WVR structure had an expected market capitalisation at listing of less than HK\$40 billion, SEHK also requires the applicant to have at least HK\$1 billion of revenue in its most recent audited financial year.
Minimum and Maximum Economic Interest at Listing	8A.12	<p>Minimum: All the beneficiaries of a company's WVR structure to collectively beneficially own a minimum of at least 10% of the underlying economic interest in the applicant's total issued share capital at the time of listing.</p> <p>Maximum: After considering the potential need for applicants to conduct post listing funding and engage in post listing employee-incentive scheme, SEHK has decided not to impose the maximum shareholding restriction at listing.</p>

16. LR8A.17

17. Note to LR8A.17

18. LR8A.18

## Post Listing Restriction and Limitations

The table below sets out some examples of such restrictions and limitations which apply to companies listed with WVR structures:

Restriction and Limitation	Relevant Listing Rule(s)	Details
Conversion of WVR shares into Ordinary Shares	8A.14, 8A.21 and 8A.40	<p>A beneficiary of WVR shares would be able to convert his shares into ordinary shares on a voluntary basis or as mandated by the Rules (e.g. on transfer to another person). SEHK proposed to require such conversions to occur on a one-to-one ratio.</p> <p>As part of their initial listing application and whenever new WVR shares are to be issued, issuers with WVR structures must seek from SEHK:</p> <ul style="list-style-type: none"> <li>(a) approval of the issue of WVR shares; and</li> <li>(b) prior approval of the listing of shares that are issuable upon conversion of the WVR shares.</li> </ul> <p>An issuer with a WVR structure must disclose any dilution impact of a potential conversion of WVR shares into ordinary shares in its listing documents and in its interim and annual reports.</p>
Informing Investors for Circumstances when WVR will Cease	8A.41	<p>SEHK agrees with the respondents' comments that an issuer with a WVR structure should inform investors of the circumstances under which the WVRs would cease. Accordingly, an issuer with a WVR structure must disclose in its listing documents and in its annual and interim reports <b>all</b> the circumstances in which the WVRs attached to its shares <b>will</b> cease.</p>

Enhanced Disclosure Requirements	8A.37, 8A.38, 8A.39 and 8A.42	<p>Issuers with WVR structures are to be prominently identified through a unique stock marker “W” at the end of their stock name.</p> <p>An issuer with a WVR structure must include the warning “a company controlled through weighted voting rights” and describe the WVR structure, the issuer’s rationale for having it and the associated risks for shareholders prominently on the front page of all its listing documents, periodic financial reports, circulars, notifications and announcements required by the Rules. The warning of “a company controlled through weighted voting rights” must also be prominently disclosed on the documents of title for the listed equity securities of an issuer with a WVR structure.</p> <p>An issuer with a WVR structure must also identify the beneficiaries of its WVR structure in its listing documents and its interim and annual reports.</p>
Enhanced Corporate Governance	8A.31 – 8A.34, 8A.36	<p>In response to respondents’ comments, SEHK amended Rule 8A.31 to require issuers with WVR structures to establish a Corporate Governance Committee comprised of a majority of INEDs and chaired by an INED.</p> <p>An issuer with a WVR structure must include a summary of the work of its Corporate Governance Committee in the Corporate Governance Report that it discloses in its half-yearly and annual report in compliance with the listing rules.</p> <p>An issuer with a WVR structure must engage a compliance adviser on a permanent basis and consult with this adviser on any matters related to its WVR structure, transactions in which the beneficiaries of WVRs in the issuer have an interest and where there is a potential conflict of interest between Non-WVR Shareholders and beneficiaries of WVRs in the issuer.</p> <p>Directors and senior management of an issuer with a WVR structure are required by the Rules to undergo appropriate training on WVR and its associated risks.</p>

## Enforcement against Non-compliant Listed Issuer

Breach of the listing rules by a company listed on SEHK with a WVR structure would be enforced in the same way as a breach of listing rules by any other company listed on SEHK. Depending on the circumstances, the Listing Committee would be asked to make appropriate directions for remedial action or a direction for a WVR beneficiary to give up the WVRs carried by his or her shares, to be carried out within a specific timeframe.

If the Listing Committee decided that a WVR issuer or a WVR beneficiary had breached any rule set out in Chapter 8A, SEHK may direct a trading halt or suspend dealings of the WVR issuer's shares; impose disciplinary sanctions, or withhold its listing approval (in the case of an issuance of listed securities) or its clearance for the issuance of a shareholders' circular (in the case of a material transaction requiring a circular)<sup>19</sup>. Where prescribed majorities are set for shareholders' resolutions (e.g. special or ordinary thresholds), in the event that a WVR beneficiary casts his/her votes whilst in contravention of the listing rules, such resolutions would not, for the purposes of the listing rules and in calculating the requisite majorities, be counted. It would remain the issuer's obligation to ensure that only persons vote in the manner in which they are entitled to vote<sup>20</sup>.

## Red Chip Listing

### What is meant by "Red Chip" and "H-Share" ?

People's Republic of China ("PRC") businesses listed on SEHK include "H-share companies" and "red chip companies". H-share companies are joint stock companies incorporated in the PRC which have received approval from the China Securities Regulatory Commission ("CSRC") to list in Hong Kong, whereas red chip companies refer to the companies which are incorporated outside the PRC (usually in Hong Kong, the Cayman Islands or Bermuda) but with most of their businesses in the PRC, and which are usually controlled by PRC entities. Listing a PRC business in Hong Kong is generally more complicated than listing a Hong Kong business as relevant PRC approvals may be required for the reorganisation and the listing process.

### Circular 10 - A Hurdle to overcome for Red Chip Listings

Historically, the PRC regulatory process for the reorganisation and the listing of red chip companies was simpler than that for H-share issuers. Nevertheless, following the introduction of the "Regulations Concerning the Merger and Acquisition of Domestic Enterprises by Foreign Investors" (commonly known as "Circular 10" or the "M&A Rules") in August 2006, the listing process for red chip companies has become increasingly complicated.

Circular 10 was promulgated by the Ministry of Commerce ("MOFCOM"), the State-owned Assets Supervision and Administration Commission, the State Administration of Taxation, the State Administration for Industry and Commerce, CSRC and the State Administration of Foreign Exchange on 8 August 2006. It came into effect on 8 September 2006 and was amended by MOFCOM on 22 June 2009. By virtue of Circular 10, MOFCOM's approval is required at various stages of a red chip listing, including:

- the establishment of a special purpose vehicle ("SPV") outside the PRC by a PRC domestic enterprise for the purpose of an overseas listing of the interest in a PRC domestic enterprise;<sup>21</sup> and
- the acquisition of the businesses or assets of a PRC domestic enterprise by the SPV.<sup>22</sup>

In addition, Circular 10 reinstated the requirement to obtain CSRC approval for a proposed red chip listing,<sup>23</sup> which was previously removed when CSRC's practice of issuing a no-objection letter was phased out in 2003. Moreover, under the framework of Circular 10, companies which are successfully listed overseas must repatriate proceeds within a pre-determined time frame to the PRC. Even if an enterprise has obtained a listing approval, failure to complete the overseas listing within 12 months of such approval would result in the enterprise reverting to its original shareholding structure.

19. LR8A.03

20. LR8A.25

21. Article 42 of Circular 10

22. Article 11 of Circular 10

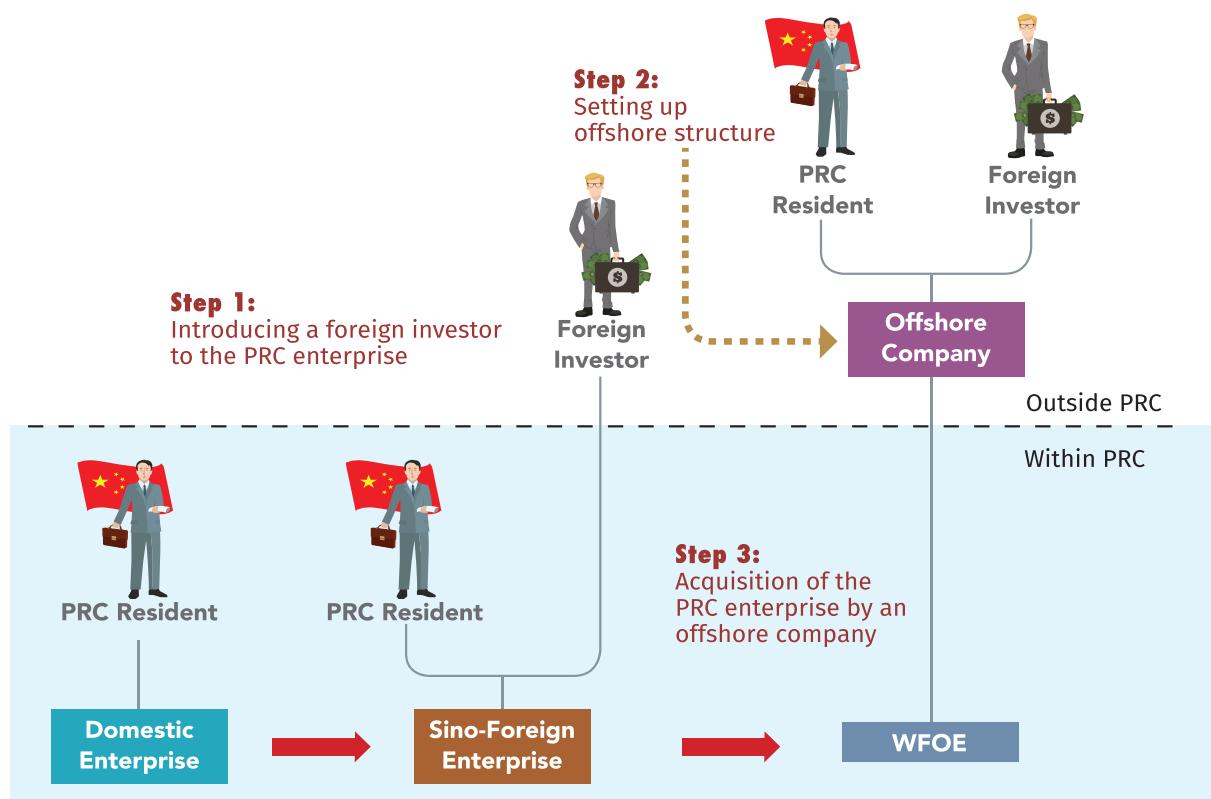
23. Article 40 of Circular 10

## Breakthroughs in Red Chip Listing

It was originally perceived that the stringent requirements and restrictions under Circular 10 would curb the overseas listing of those PRC enterprises of which red chip structures were not consummated before the implementation date of Circular 10 (that is, 8 September 2006). However, in the past decade, we have witnessed various ingenious reorganisation plans adopted by different PRC enterprises to oust the application of Circular 10 on their listings in Hong Kong, for example, by establishing a variable interest entity ("VIE") structure, through the acquisition of a red chip structure established prior to 8 September 2006, or through obtaining a foreign identity by the PRC business owner, etc. Each of these reorganisation plans has its own shortcomings and limitations.

In 2012, a breakthrough was achieved in the innovation of red chip listings, leading red chip listings into a new era. In the listing of China Zhongsheng Resources Holdings Limited (now known as Add New Energy Investment Holdings Group Limited) (Stock Code: 2623) in 2012, the red chip structure was developed by introducing a foreign investor to the relevant PRC domestic enterprise, thereby transforming the domestic enterprise into a Sino-foreign enterprise and subsequently a wholly foreign-owned enterprise ("WFOE"). As this enterprise only commenced the building of its red chip structure in 2010, that is, after the implementation date of Circular 10, its successful listing is said to have turned Circular 10 into a paper tiger. A similar approach was adopted in the listing of China Tianrui Group Cement Company Limited (Stock Code: 1252).

A diagram summarising the key reorganisation steps involved in these cases is set out below for illustrative purposes:



After the listing of China Zhongsheng Resources Holdings Limited, it was originally perceived that the foreign investor concerned should hold at least 25% of the equity interest of the relevant PRC enterprise so as to ensure that Circular 10 would not apply. However, it may not be easy to find foreign investors who are interested in acquiring 25% of the business, and not many PRC business owners are willing to sell 25% equity of their business to third parties before listing. In 2014, the listing of Jiashili Group Limited (Stock Code: 1285) ("Jiashili") provided a solution to these problems.



In the reorganisation of Jiashili, a foreign investor who is a Singapore citizen acquired, through a SPV, only 1% of the equity interest of the relevant PRC enterprise ("1% Acquisition"). The PRC enterprise was then transformed into a Sino-foreign joint venture with the ratio of foreign investment of less than 25%, and subsequently a WFOE. According to the prospectus of Jiashili, the local MOFCOM has verbally confirmed that:

- Article 11 of Circular 10 (that is, where a domestic company or enterprise, or a domestic natural person, through an overseas company established or controlled by him/her/it, acquires a domestic company which is related to or connected with him/her/it, approval from MOFCOM is required) shall not apply to the 1% Acquisition; and
- after the 1% Acquisition, the PRC enterprise would be converted into a Sino-foreign joint venture and further acquisition of its equity interest should not be subject to Circular 10.

The listing of Jiayi Household International Holdings Limited (Stock Code: 1495) in November 2015, which involves the acquisition of 3.43% of the equity interest of the relevant PRC enterprise by a foreign investor, is another example adopting a similar reorganisation plan.

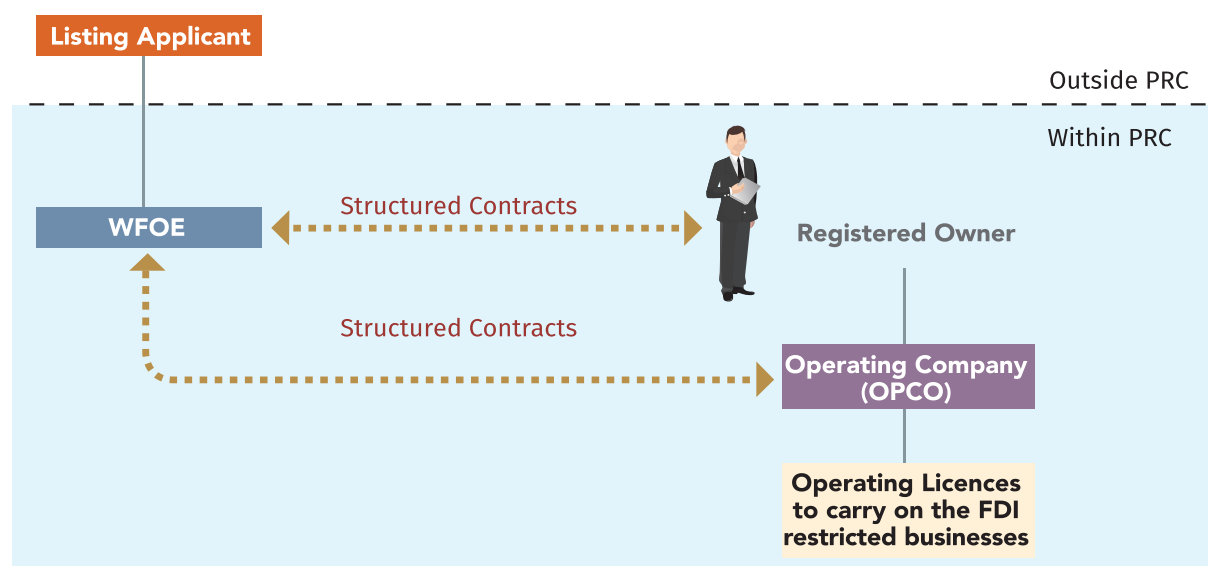
In light of these cases, PRC domestic enterprises could achieve their offshore listings more easily.

## Feasibility of VIE Structures under Close Examination

### What is a VIE structure?

People's Republic of China ("PRC") businesses listed on SEHK include "H-share companies" and "red chip companies". H-share companies are joint stock companies incorporated in the PRC which have received approval from the China Securities Regulatory Commission ("CSRC") to list in Hong Kong, whereas red chip companies refer to the companies which are incorporated outside the PRC (usually in Hong Kong, the Cayman Islands or Bermuda) but with most of their businesses in the PRC, and which are usually controlled by PRC entities. Listing a PRC business in Hong Kong is generally more complicated than listing a Hong Kong business as relevant PRC approvals may be required for the reorganisation and the listing process.

### Typical VIE/structured contract arrangement



VIE structures have long been used by foreign parties to indirectly invest in sectors in the PRC in which foreign direct investment ("FDI") is restricted. In addition, VIE structures have been adopted to enable PRC businesses in those FDI restricted sectors to list offshore. Coined as a "Sina structure" after Sina.com successfully listed its value-added telecom business on NASDAQ in 2000 by adopting a VIE structure, VIE structures have been replicated in other sectors such as publications, broadcasting, media, mining and internetbased businesses. In essence, a VIE structure refers to a structure whereby a fully or partially foreign-owned entity established in the PRC has control over a PRC domestic enterprise which holds the necessary licence(s) to operate in a FDI restricted sector. By virtue of various contractual arrangements, the de facto control over the operation and management as well as the economic benefits of the PRC domestic enterprise are shifted to the foreign-owned entity. In various red chip listings adopting VIE structures, Circular 10 was interpreted by the relevant issuers to be inapplicable as no acquisition of the relevant PRC domestic enterprises was involved.

## Can a VIE structure be listed in Hong Kong?

Since there is no express endorsement of VIE structures by the PRC authorities, the legality of VIE structures is questionable. In 2010 and 2011, the Shanghai Subcommission of the China International Economic and Trade Arbitration Commission ("CIETAC") granted two arbitral awards, in which the CIETAC invalidated some VIE agreements on the grounds that they violated express provisions of PRC laws that prohibit foreign investors from controlling and participating in the FDI restricted businesses and constituted "concealing illegal intentions with a lawful form".<sup>24</sup> Further, in June 2013, the PRC Supreme People's Court ruled in a dispute involving Chinachem Financial Services Limited that the relevant entrustment agreements were void on similar grounds.<sup>25</sup> In light of these arbitral awards and judgment, there was an uncertainty as to whether VIE structures could continue to be listed in Hong Kong.

The uncertainty has now been lifted as different enterprises adopting VIE structures successfully listed in Hong Kong from 2012 to 2017.<sup>26</sup> SEHK also published a guidance letter and two listing decisions to clarify that the listing of VIE structures would continue to be allowed on a case-by-case basis after full consideration of the reasons for adopting such arrangements, subject to certain disclosure requirements.<sup>27</sup> The standard of review adopted by SEHK is summarised as follows:

<b>Scope of contractual arrangement</b>	The contractual arrangements should be narrowly tailored to achieve the applicant's business purposes and minimise the potential for conflict with relevant PRC laws and regulations. <sup>28</sup>
<b>Compliance assurance</b>	SEHK would review the legal and compliance history (if any) of the listing applicant, its management systems and corporate governance practices, its records in protecting shareholder interests and its financial resources, to ensure compliance with the applicable laws and regulations. <sup>29</sup>

24. "Shanghai CIETAC's findings on VIE case raises plenty of questions", China Business Law Journal, December 2012/January 2013 issue

25. "Supreme court judgment again touches sensitive VIE nerve", China Business Law Journal, July/August 2013 issue

26. Examples include NNK Group Limited (Stock Code: 3773) listed in January 2016, Virscend Education Company Limited (Stock Code: 1565) listed in January 2016, China Art Financial Holdings Limited (Stock Code: 1572) listed in November 2016, and Wisdom Education International Holdings Company Limited (Stock Code: 6068) listed in January 2017

27. HKEX Guidance Letter GL77-14, HKEX Listing Decision LD33-2012 and HKEX Listing Decision LD43-3

28. Paragraph 16(a) of HKEX Guidance Letter GL77-14 and paragraph 13(b) of HKEX Listing Decision LD43-3

29. Paragraph 13(c) of HKEX Listing Decision LD43-3

<b>Compliance assurance</b>	<p>Subject to availability and practicability, appropriate regulatory assurance should be obtained from the relevant regulatory authorities. In the absence of such regulatory assurance, the applicant's legal counsel is required to make a statement to the effect that in its legal opinion all possible actions or steps taken to enable it to reach its legal conclusions had been taken. In consultation with the applicant and the sponsor, other relevant forms of assurance could be considered.<sup>30</sup></p> <p>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, the PRC legal advisers' opinion on the structured contracts must include a positive confirmation that the use of the structured contracts does not constitute a breach of those laws and regulations or that the structured contracts will not be deemed invalid or ineffective under those laws or regulations, e.g. not being deemed as "concealing illegal intentions with a lawful form" and void under the PRC contract law<sup>31</sup>. Where possible, the legal opinion must be supported by appropriate regulatory assurance to demonstrate the legality of the structured contracts.<sup>32</sup></p>
<b>Requirements other than foreign ownership restriction</b>	<p>Where restricted businesses are involved, the use of structured contracts is permitted only to address the foreign ownership restriction, for example, the restriction that foreign investors can only operate the restricted businesses under joint ventures with the foreign portion of the total investment and shareholding below 50%. For requirements other than the foreign ownership restriction, an applicant should demonstrate to the satisfaction of SEHK that it has, upon advice from its legal advisers, reasonably assessed the requirements under all applicable rules and have taken all reasonable steps to comply with them before listing.<sup>33</sup></p>
<b>Requirements of structured contracts</b>	<p>The structured contracts should include a power of attorney and appropriate dispute resolution clauses which provide for arbitration and the courts of competent jurisdictions with power to grant interim remedies in support of the arbitration pending formation of the arbitral tribunal or in appropriate cases, and encompass dealing with the assets of the operating company so as to protect the rights of the listing applicant and its successors (including the liquidators).<sup>34</sup></p> <p>The power of attorney granted by the operating company's shareholders to the applicant's directors and their successors (including a liquidator replacing the applicant's directors) should include the power to exercise all rights of the operating company's shareholders (e.g. the rights to vote in a shareholders' meeting, sign minutes, file documents with the relevant companies registry). The operating company's shareholders should ensure that the power of attorney does not give rise to any potential conflicts of interest. Where the operating company's shareholders are officers or directors of the applicant, the power of attorney should be granted in favour of other unrelated officers or directors of the applicant.<sup>35</sup></p>

30. Paragraph 16(a)(ii) of HKEX Guidance Letter GL77-14 and paragraph 13(d) of HKEX Listing Decision LD43-3

31. Paragraph 16(a)(ii) of HKEX Guidance Letter GL77-14

32. Paragraph 16(a)(ii) of HKEX Guidance Letter GL77-14 and paragraph 18A of HKEX Listing Decision LD43-3

33. Paragraph 16(a)(i) of HKEX Guidance Letter GL77-14 and paragraph 16A of HKEX Listing Decision LD43-3

34. Paragraph 18(c) of HKEX Listing Decision LD43-3

35. Paragraph 16(b) of HKEX Guidance Letter GL77-14

<b>Disclosure requirements</b>	<p>HKEX Listing Decision LD43–3 sets out a list of matters which should be disclosed in the prospectus.<sup>36</sup> The prospectus should include at least the following structured contracts–related risk factors:</p> <ul style="list-style-type: none"> <li>• the government may determine that the structured contracts do not comply with applicable regulations;</li> <li>• the structured contracts may not provide control as effective as direct ownership;</li> <li>• the domestic shareholders may have potential conflicts of interest with the applicant; and</li> <li>• structured contracts may be subject to scrutiny of the tax authorities and additional tax may be imposed.<sup>37</sup></li> </ul>
<b>Others</b>	<p>SEHK requires any applicant using structured contracts and its sponsor to unwind the structured contracts as soon as the law allows the business to be operated without them.<sup>38</sup></p>

## Impact of the Draft PRC Foreign Investment Law on Listings of VIE structure

MOFCOM published a consultation draft of the new PRC Foreign Investment Law on 19 January 2015 (the "Draft PRC Foreign Investment Law"), raising concerns over the legality and validity of VIE structures. Under the Draft PRC Foreign Investment Law, the definition of "foreign investor" includes PRC domestic entities that are actually controlled by non-Chinese individuals, enterprises incorporated in other jurisdictions, foreign government authorities and international organisations, and the definition of "foreign investment" is extended to cover all forms of control over a PRC domestic entity by foreign individuals or entities, particularly indirect control without equity ownership.<sup>39</sup> Therefore, VIE structures will be subject to the new PRC Foreign Investment Law. The draft PRC Foreign Investment Law sets out the legal consequences of engaging in a business within the "prohibited category" of the Foreign Investment Catalogue through a VIE structure.<sup>40</sup>

MOFCOM has addressed, in the explanatory notes to the draft PRC Foreign Investment Law, the issue of existing VIE structures and proposed three options:<sup>41</sup>

1. existing VIE structures to be preserved by filing the details of the structured contract with MOFCOM to confirm that the actual controller is a Chinese investor or a group of Chinese investors;
2. existing VIE structures to be preserved by filing an application to and obtaining approval from MOFCOM upon MOFCOM's confirmation that the actual controller is a Chinese investor or a group of Chinese investors; or
3. existing VIE structures to file an application to MOFCOM for market access approval and MOFCOM to decide whether to grant such approval on a case-by-case basis taking account of the identity of the ultimate controller of the VIE structure.

In view of the draft PRC Foreign Investment Law, SEHK encourages issuers with existing VIE structures and potential issuers which intend to list VIE structures to seek informal and confidential guidance from SEHK at the earliest possible opportunity.<sup>42</sup> Therefore, potential issuers with VIE structures who decide to press on with their listing plans ahead of the potential legislative change in the PRC should keep track of the regulatory development and seek competent legal advice.

36. Paragraphs 19 and 20 of HKEX Listing Decision LD43-3

37. Paragraph 20 of HKEX Listing Decision LD43-3

38. Paragraph 18(b) of HKEX Listing Decision LD43-3

39. Articles 11 and 15 of the Draft PRC Foreign Investment Law

40. Articles 144, 147 and 148 of the Draft PRC Foreign Investment Law

41. Paragraph 3(3) of the Explanatory Notes to the Draft PRC Foreign Investment Law

42. Paragraph 23 of HKEX Guidance Letter GL77-14 and paragraph 22 of HKEX Listing Decision LD43-3

## Special Concern with Listings on the Growth Enterprise Market ("GEM") of SEHK

### Problems with GEM Listings

The SFC and SEHK have expressed grave concern over the price swings of GEM stocks after listing in recent years. According to the Statement on Recent GEM Listing Applicants published by the SFC on 13 March 2017, out of 45 GEM listings in 2016, 36 were listed by way of placing only. The average first day share price change (as against the offer price) for the placing-only GEM IPOs was an increase of 656%, with the highest one increasing by 2005%. Out of the 36 placing-only listings in 2016, 30 experienced a 100% or more increase in share price on their trading debut, nine of which saw their prices tumble by more than 90% from their first day closing price as at 31 January 2017, and another 10 saw their prices drop by between 50% and 90% as of the same date.

In addition, the regulators raised concern about the highly concentrated shareholdings and small shareholder bases of GEM stocks. The SFC noted the shareholdings of the top 25 placees for the placing-only GEM listings in 2016 ranged from 70.0% to 99.6% of the total number of placing shares.

### Guideline and Joint Statement issued by the SFC and SEHK

On 20 January 2017, the SFC issued a guideline to sponsors, underwriters and placing agents involved in the listing and placing of GEM stocks and a joint statement<sup>43</sup> with SEHK regarding the price volatility of GEM stocks.

The joint statement reminds new listing applicants of the relevant regulatory requirements concerning placing arrangements and the requirements relating to open markets in the securities for which listing is sought, adequate spread of shareholders, and the minimum prescribed percentage of shares that must be in the public hands under the Rules Governing the Listing of Securities on GEM (the "GEM Listing Rules"). In particular, when ensuring that there is an open market in the securities for which listing is sought, a listing applicant should:

1. take due care to decide, in consultation with the sponsor, among other things:
  - a. the method of listing, in particular, whether the new applicant should adopt an offer for subscription by or sale to the public in addition to a placing tranche;
  - b. the target investor type and placee mix (for example, the new applicant may indicate its preference for a percentage of shares to be allocated to long term investors rather than short term investors or institutional investors rather than retail investors);
  - c. the overall strategy and allocation basis with a view to achieving an open market and an adequate spread of shareholders and to ensure the percentage of shares in public hands meets the relevant requirements under the GEM Listing Rules. This will generally include selecting an appropriate number of underwriters or placing agents taking into account their client base, competence, resources and track record, as well as their allocation strategy;
  - d. any preferential treatment (financial or otherwise) afforded to placees and the relevant disclosure in the listing document; and
2. retain proper documentation as to the above matters;
3. seek assistance from the underwriters and placing agents to adopt an appropriate strategy and allocation basis with a view to achieving an open market and avoiding any undue concentration in the holdings of its shares;
4. list all the underwriters and placing agents appointed and their contact details in the prospectus to provide additional information to investors about available distribution channels.<sup>44</sup>

43. Joint Statement regarding the Price Volatility of GEM Stocks issued by the SFC and SEHK dated 20 January 2017

44. Paragraph 18 of the Joint Statement regarding the Price Volatility of GEM Stocks issued by the SFC and SEHK



## Recent Enforcement Actions against GEM Listings

Subsequent to the issue of the joint statement by the SFC and SEHK, the regulators have taken actions against different GEM listing applicants, in particular those placing-only GEM listings. Three IPOs were postponed and lapsed due to enquiries made by the regulators in relation to the open market requirements.<sup>45</sup> One was suspended after its first morning of trading as the SFC raised doubt as to whether there was an open market in the trading of the shares given the significant rise in price." One was postponed and lapsed due to enquiries made by the regulators pursuant to section 6(2)(d) of the Stock Market Listing Rules,<sup>46</sup> which grants the SFC power to object to a listing on the ground that it would not be in the public interest for the securities to be listed.

While there is no objection to the regulators taking action to instil confidence in the market, severe regulatory measures without setting clear guidance to the market seems to do more harm than good. One of the strengths of the Hong Kong stock market is a clear set of objective listing qualifications. Grey law approach in listing regulation is not welcomed.

## Suitability for Listing

### Seven Sins

SEHK has raised concerns that the controlling shareholders of a number of listed issuers either changed or have gradually sold down their interests shortly after the regulatory lockup period following listing, probably due to the perceived premium attached to the listing status of the issuers. Such disposals may invite speculative trading activities, lead to opportunities for market manipulation, insider trading and unnecessary volatility in the market, and may enable backdoor listings. In June 2016, SEHK published a guidance letter (HKEX-GL68-13A) (the "Guidance Letter") identifying seven characteristics of listing applicants which would raise concerns regarding the suitability for such listings and will be subject to a more focused review by SEHK. The seven characteristics have been dubbed the "Seven Sins".



45. Announcements of My Heart Bodibra Group Limited (Stock Code: 8297) dated 3 February 2017 and 27 February 2017, respectively; announcements of Speed Apparel Holdings Limited (Stock Code: 8183) dated 7 February 2017 and 27 February 2017, respectively; and announcements of Hao Bai International (Cayman) Limited (Stock Code: 8431) dated 13 February 2017 and 27 February 2017, respectively

46. Announcements of XiangXing International Holding Limited (Stock Code: 8157) dated 27 February 2017 and 30 March 2017, respectively

## Addressing the Seven Sins

In most GEM listings, SEHK would expect the listing applicants to provide an analysis on their suitability for listing with reference to the Guidance Letter HKEX–GL68–13A. Here are some points to note by the listing applicants:

### Small market capitalisation

Listing applicants should compare the market capitalisation of their proposed listings with the market norm.

### Only marginally meet the listing eligibility requirements

A GEM listing applicant should have an adequate trading record of at least two financial years comprising a positive cash flow generated from operating activities in the ordinary and usual course of business before changes in working capital and taxes paid of at least HK\$20 million in aggregate for the two financial years immediately preceding the issue of the listing document.<sup>47</sup> Listing applicants should consider if their operating cash flow is well above the listing requirement. In particular, listing applicants should note that SEHK may disregard the income tainted by material non-compliance incidents.

### Involve fund raising disproportionate to listing expenses

Listing applicants should consider if the size of the proposed fund raisings and the proportions of listing expenses to the fund to be raised are appropriate and in line with the market.

### Involve a pure trading business with a high concentration of customers

Listing applicants should note that a pure trading business is unlikely to be regarded by SEHK as suitable for listing in Hong Kong. For businesses with high concentration of customers, SEHK will take into account the following factors in determining whether the reliance would have impacts on suitability for listing:

- a. whether the applicant's business model can be easily changed to reduce the level of reliance, e.g. by finding substitute customers;
- b. whether the applicant has plans to diversify its business focus to reduce its reliance;
- c. whether the whole industry landscape is dominated by a few players;
- d. whether the reliance is mutual and complementary; and
- e. whether the applicant is capable of maintaining its revenue in the future in light of the reliance.<sup>48</sup>

### Asset-light businesses where a majority of the assets are liquid and/or current assets

Listing applicants should consider if the asset ratios of their businesses are in line with the nature of the industries in which they operate as well as their market comparables.

47. Rule 11.12A(1) of the GEM Listing Rules

48. HKEX Listing Decision LD107-1



**Involve a superficial delineation of business from the parent whereby the applicant's business is artificially delineated from the parent by geographical area, product mix or different stages of development**

In pre-IPO reorganisation, it is common for a listing applicant to exclude the business which is not in line with the listing business from the listing group structure. SEHK may have concern if there is a superficial delineation of business from the excluded business. In particular, listing applicants should note that excluding a business from the listing group on the grounds that the excluded company has material non-compliance issues or that it is trading at a loss would not be legitimate reasons in the eyes of the regulators.

**Have little or no external funding at the pre-listing stage**

Generally speaking, SEHK expects all listing applicants to be able to finance their business activities through internally generated funds from its ordinary course of business and available banking facilities. Listing applicants should also consider whether it would be beneficial to introduce pre-IPO investors.

## Update of the Guidance Letter – Beyond the Seven Sins

SEHK has observed that the market has begun to use the list of characteristics set out in the Guidance Letter (as set out above) as a “checklist” against which to determine an applicant’s suitability for listing, which was not the intention of SEHK. Therefore, it has updated the Guidance Letter to reiterate that the characteristics set out in the Guidance Letter are not a “checklist” for potential shell companies, that exhibiting none of those characteristics does not necessarily mean that a listing applicant is suitable for listing, and it is the responsibility of the listing applicant and its sponsor(s) to demonstrate that the listing applicant is not solely seeking to monetize the premium attached to a listing status.

In determining whether an applicant is suitable for listing, SEHK retains the use of its broad discretion. If the applicant is unable to demonstrate the commercial rationale for listing, it may be found unsuitable for listing irrespective of the nature and financial standing of the business operated by the applicant. Moreover, if specific facts and circumstances reasonably suggest that an applicant is likely to invite speculative trading upon listing or is likely to be acquired for its listing status, such applicant may be found to be unsuitable for listing.

Even if some controlling shareholders or major shareholders voluntarily provided lock-up undertakings to the applicant that extend beyond the requirements under the Listing Rules to demonstrate their commitment to develop the business after listing, these longer lock-up undertakings do not in and of themselves address the concerns of SEHK.

SEHK emphasized that once an issuer is listed, it must ensure that it and its business continues to be suitable for listing. Under Main Board Listing Rules 6.01(4) and GEM Rule 9.04(4), SEHK may cancel an issuer’s listing if it considers that the issuer or its business is no longer suitable for listing. Listing applicants should note that SEHK closely monitors the developments of listed issuers. It may have concerns about the suitability of an issuer or its business for continued listing, e.g. if the issuer’s activities are found to deviate significantly from its original business model or strategy or the commercial rationale for its listing set out in its original listing application.

## Other Suitability Issues

The Listing Rules provide that both the listing applicant and its business must, in the opinion of SEHK, be suitable for listing.<sup>49</sup> While there is no hard and fast rule in determining what would render a listing applicant and its business not suitable for listing, SEHK has issued a number of guidance letters and listing decisions to give guidance in this regard. Apart from the Seven Sins discussed above, SEHK would more likely raise concerns on suitability for listing in the following circumstances:

- suitability of director or controlling shareholders is in doubt, in particular in the case where the past record or conviction raises serious concern on an individual's integrity, and the individual is likely to exert substantial influence on the applicant after listing;<sup>50</sup>
- systemic, intentional and/or repeated breaches of laws and regulations by an applicant, e.g. non-compliant bill financing;<sup>51</sup>
- deteriorating financial performance subsequent to the track record period, or significant drop in forecast profit rendering the track record results not indicative of future performance;<sup>52</sup>
- heavy reliance on parent group for certain important functions such as sales and procurement functions, or financial and operational reliance on the applicant's parent;<sup>53</sup>
- dependence on the parent when there are overlapping directors, the applicant and its parent are in the same industry sector, and there are inadequate arrangements to manage conflicts of interest and delineation of businesses;<sup>54</sup>
- the applicant derives a significant portion of its turnover and net profit from transactions with closely related parties and connected persons;<sup>55</sup>
- heavy reliance on major customers;<sup>56</sup>
- a captive business model, i.e. the sourcing of the applicant's principal raw materials and its principal customer channel are dominated by the same party;<sup>57</sup>
- gambling business not satisfying the requirements in SEHK's announcement entitled "Gambling Activities Undertaken by Listing Applicants and/or Listed Issuers" and the Listing Committee Report 2006;<sup>58</sup>
- contractual arrangements not satisfying the conditions set out in the HKEx Listing Decision LD43-3;<sup>59</sup>
- reliance on unrealised fair value gains to meet profit requirements;<sup>60</sup> and
- unsustainable business model.<sup>61</sup>

Listing applicants with the above characteristics should consult professional advisers in advance in planning their listings.

49. Rule 8.04 of the Main Board Listing Rules and Rule 11.06 of the GEM Listing Rules

50. Paragraph 3.2(1) of HKEX Guidance Letter GL68-13 and HKEX Listing Decision LD96-1

51. Paragraph 3.2(2) of HKEX Guidance Letter GL68-13, HKEX Listing Decision LD50-5, HKEX Listing Decision LD97-1 and HKEX Listing Decision LD19-2011

52. Paragraph 3.2(3) of HKEX Guidance Letter GL68-13, HKEX Listing Decision LD73-2013 and HKEX Rejection Letter RL19-07

53. Paragraph 3.2(4)(i) of HKEX Guidance Letter GL68-13, HKEX Listing Decision LD46-1, HKEX Listing Decision LD46-2, HKEX Listing Decision LD51-1, HKEX Listing Decision LD69-1, HKEX Listing Decision LD30-2012 and HKEX Rejection Letter RL12-06

54. Paragraph 3.2(4)(ii) of HKEX Guidance Letter GL68-13, HKEX Listing Decision LD51-3 and HKEX Rejection Letter RL21-07

55. Paragraph 3.2(4)(iii) of HKEX Guidance Letter GL68-13, HKEX Listing Decision LD8-2 and HKEX Listing Decision LD92-1

56. Paragraph 3.2(4)(iv) of HKEX Guidance Letter GL68-13 and HKEX Listing Decision LD107-1

57. Paragraph 3.2(4)(v) of HKEX Guidance Letter GL68-13 and HKEX Rejection Letter RL20-07

58. Paragraph 3.2(5) of HKEX Guidance Letter GL68-13 and HKEX Rejection Letter RL25-09

59. Paragraph 3.2(6) of HKEX Guidance Letter GL68-13 and HKEX Listing Decision LD43-3

60. Paragraph 3.2(7) of HKEX Guidance Letter GL68-13

61. Paragraph 3.2(8) of HKEX Guidance Letter GL68-13, HKEX Listing Decision LD37-2012 and HKEX Listing Decision LD92-2015

• *Practical Tips* •



There are legally and practicably acceptable solutions to different listing issues. Early consultation with good legal advisors would avoid complications in the listing process.



**Disclaimer**

The law and procedure on this subject are very specialised and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

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