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# Listing Decisions On Pre-IPO Convertible Bond Issues

## Introduction

Hong Kong Exchanges and Clearing Limited (**HKEx**) has published Series 59 of the listing decisions dealing with pre-IPO issues of convertible bonds. The decisions considered whether various terms, including a conversion price at a discount to the IPO offer price and negative covenants granted to the convertible bondholders, were contrary to the principles laid down in Listing Rule 2.03.[[1]](#footnote-24) Terms found to violate Listing Rule 2.03 were required to be removed or modified prior to listing.

In the Series 59 decisions, HKEx objected to terms that "may give rise to concerns that the pre-IPO investors would not have assumed investment risks significantly different from those assumed by public investors, or would be protected from certain types of equity risks after listing in a manner that was significantly different from that assumed by public investors".[[2]](#footnote-25) Based on these decisions, one of the principal factors that HKEx will take into account in considering pre-IPO convertible bond issues is whether the pre-IPO investors took genuine investment risks for their pre-IPO investment. Where, however, pre-IPO investors are found to have taken investment risks that are substantially the same as those taken by the IPO shareholders, the additional rights conferred on them under the terms of the convertible bonds are likely to be considered contrary to the principle of even treatment of shareholders under Listing Rule 2.03.

In listing decision 59-5, convertible bonds were issued approximately 5 months before the submission of the advance booking form. As there was no guarantee at the time of the pre-IPO investment that the listing would proceed, the case was distinguished from earlier cases where payment for the investment was made only after the grant of in-principle listing approval. Accordingly terms relating to the conversion price at a discount to the IPO offer price and rights of redemption which would give the bondholders a fixed percentage of internal rate of return on the principal amount of the convertible bonds being redeemed were allowed to survive the listing.

The purpose of this note is to provide a summary of the Listing Decisions in Series 59 relating to convertible bonds. Listing Decisions 59-1 to 59-7 can be found on the [HKEx website](http://www.hkex.com.hk/eng/rulesreg/listrules/listarchive/listarc_listdec/listdec2007.htm). It should be noted that each listing decision is based on the specific circumstances of the particular case and may not therefore necessarily be a precedent for future cases.

## Background

In reaching the decisions in relation to pre-IPO convertible bond issues, HKEx referred to listing decision 36-1 and listing decisions 55-1, 55-2 and 55-3 in relation to pre-IPO placings.

In listing decision 36-1, issued in October 2003, HKEx stated that as a general principle, pre-IPO placings of shares - even at a discount to the IPO price - should be allowed subject to full disclosure in the prospectus. The placee may however be made subject to a lock-up of his shares. The question of whether a placee should be made the subject of a lock-up is one which is determined by HKEx on a case-by-case basis. It was noted in the decision that the greater the amount of any discount to the IPO price and/or the closer the timing of the placing to the date of the listing application, the more likely it would be that a lock-up would be required. Any shares made the subject of a lock-up will not be counted towards the public float on listing.

However, listing decisions 55-1, 55-2 and 55-3 which were published in June 2006, demonstrate that if HKEx considers the terms of a pre-IPO placing to be contrary to the principles laid down in Listing Rule 2.03 and/or Rule 9.09[[3]](#footnote-28), it will require the relevant terms to be removed prior to listing even if the placing meets the technical requirements regarding disclosure, lock-up and public float as set out in listing decision 36-1. The terms with which HKEx had difficulty in the context of pre-IPO placings related to the following:

1. *Placing price at a discount to the IPO price*  
   HKEx considered that a placing price at a discount to the IPO price would create two different prices for the same securities at listing which could have a disruptive effect on the market at the time of listing. This was considered to be contrary to the fair and orderly principle in List Rule 2.03(2).
2. *Guaranteed exit*  
   Two of the three cases allowed the pre-IPO investor to sell the shares back to the company or the controlling shareholder at an agreed price after listing. HKEx found that the put options gave the Pre-IPO investors rights that were not generally available to the public shareholders and were therefore contrary to the terms of Listing Rule 2.03.
3. *Exit option if listing did not proceed*  
   Two of the cases gave the pre-IPO investor the right to sell the shares back to the company or the controlling shareholder if the listing did not proceed. One of those cases also allowed the pre-IPO investor to defer payment of its investment until after in-principle listing approval had been granted. HKEx considered that the combined effect of the deferred payment feature and the put option if the listing did not proceed effectively meant that the pre-IPO investor took no equity investment risk. This was said to be different from a conventional pre-IPO investment where the pre-IPO investor would be exposed to equity investment risk before the IPO.
4. *Timing*  
   HKEx found that the cases were to be distinguished from the situation in listing decision 36-1 where the pre-IPO placing was conclusively completed before the listing. In listing decision 55-2, terms of the pre-IPO placing which were conditional on milestones of the listing approval process were found to be contrary to Listing Rule 2.03. In listing decision 55-1, proposals to substantially amend the terms of the pre-IPO placing after the grant of in-principle listing approval were also found to violate the no dealing requirement under Listing Rule 9.09.

## Convertible Bond Decisions

The following is a summary of listing decisions 59-2, 59-4, 59-5 and 59-6 which were published in August 2007.

### 1. Listing Decision 59-2: Convertible Bonds giving Guaranteed Discount to the IPO Price and a Negative Pledge

#### Facts

A few months prior to filing a formal listing application, Company A issued mandatory and non-mandatory convertible bonds with the following terms:

1. The mandatory convertible bonds would be convertible into shares of Company A at 90.25% of the IPO price immediately before the global offering. The non-mandatory convertible bonds would be convertible into shares at 104% of the IPO price 180 days after the listing of Company A. The convertible bonds were listed on a foreign stock exchange.
2. A negative pledge not to commit any of the following without the prior consent of the convertible bondholders:
   1. create any additional lien, encumbrance or security interest on Company A's assets and revenues;
   2. engage in consolidations, mergers and amalgamations involving substantially all the assets of Company A;
   3. incur additional indebtedness other than in the ordinary course of business of Company A; and
   4. issue any shares or other securities.

#### Analysis

HKEx considered that the guaranteed discount to the IPO price and the apparent preferential investment terms by way of the negative pledge might give rise to concerns that the pre-IPO investors would not have assumed investment risks significantly different from those assumed by public investors, or would be protected from certain types of equity risks after listing in a manner that was significantly different from that assumed by public investors.

HKEx commented that the guaranteed discount price given to holders of the mandatory convertible bonds would create two different prices for the same securities at listing, which could have a disruptive effect on the market. It referred to listing decision 55-1 and its determination that the terms of the pre-IPO placing in relation to a guaranteed discount to the IPO offer price were contrary to the principles of Listing Rule 2.03.

With respect to the negative pledge, HKEx commented that such a low redemption premium as 4% meant that the non-mandatory convertible bonds should be considered in substance to be equivalent to the equity securities offered at IPO. The redemption premium was not great enough for the convertible bonds to be seen as a class of debt securities separate from the underlying equity. Hence the investment risks assumed by the convertible bondholders were substantially the same as those assumed by the public investors.

The negative pledge was considered to be contrary to the principles of Listing Rule 2.03 as it amounted to additional rights which were available to holders of the non-mandatory convertible bonds but not to the other shareholders of Company A.

#### Decision

HKEx determined that the guaranteed discount to the IPO price for the mandatory convertible bonds and preferential investment terms of the non-mandatory convertible bonds would violate the fair and orderly principle and the general principle of even treatment of shareholders under the Listing Rule 2.03, and should be removed prior to Company A's listing on the Exchange.

### 2. Listing Decision 59-4: Grant of Veto Rights to Investors of Convertible Instruments

#### Facts

Prior to listing, Company A had issued convertible instruments which gave the investors veto rights over the following major corporate matters upon the listing of Company A on the Exchange:

1. the making of any petition or passing of any resolution for winding-up, or the making of an application for an administrative order in respect of any member of the group;
2. any amendment to the memorandum or articles of association (or equivalent constitutional document) of any member of the group or alteration of the name of any member of the group;
3. the carrying on of any business other than the business being carried on by the group, or carrying on any business outside the PRC by any member of the group; and
4. the amalgamation or merger by any member of the group with any other company or legal entity.

HKEx considered whether the grant of such rights would violate the requirement to treat all holders of listed securities fairly and equally under Listing Rule 2.03(4).

#### Analysis

HKEx found that the veto rights were additional rights which would be available to the investors of the convertible instruments but not to the other shareholders of Company A. HKEx noted that such veto rights may be typical of private equity investments, as submitted by the sponsor, but pointed out that Company A would no longer be a private equity investment after listing.

#### Decision

HKEx considered that the veto rights granted to investors of the convertible instruments conferred additional rights to the investors that were not otherwise available to minority shareholders and thus would violate the general principle of even treatment of shareholders under Listing Rule 2.03(4). It was made a condition of listing that the veto rights should not survive after the listing of Company A.

### 3. Listing Decision 59-5: Special Rights available only to Bondholders

#### Facts

Approximately 5 months before the submission of the advance booking form, Company A issued convertible bonds, which included the following features:

1. *Conversion price reset*  
   If the 60-trading-day volume weighted average sales 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 the 60-trading-day volume weighted average market price.
2. *Conversion price at a discount to the IPO Offer Price*  
   The bondholders could convert the convertible bonds into ordinary shares at a conversion price of 85% of the final IPO offer price within a period of 5 years from the listing date. The discount was intended to compensate the bondholders for the investment risk involved.
3. *Redemption and early redemption*  
   On a date 2 years before the maturity date of the convertible bonds, the bondholders had the option to require Company A to early redeem the outstanding convertible bonds at a price which would allow the bondholders to receive a fixed percentage of internal rate of return (**IRR**) on the principal amount of the convertible bonds being redeemed. Upon maturity, all outstanding convertible bonds would become immediately payable by Company A at a price which would give the bondholders the same fixed percentage of IRR.
4. *Controlling shareholder's guarantee*  
   The controlling shareholder of Company A had guaranteed to compensate the bondholders if:
   1. The group did not meet a predetermined net profit target for the upcoming 2 financial years: or
   2. Upon sale of the convertible bonds or Company A's shares, the IRR to the bondholders was less than 10%.

The guarantee was a private arrangement between the controlling shareholder and the bondholders which was reached on an arm's length basis and did not involve Company A.

HKEx considered whether the terms of the convertible bonds would be in compliance with the general principle to treat all holders of listed securities fairly and equally under Listing Rule 2.03.

#### Analysis and Decision

HKEx noted that some of the features of the convertible bonds were more usual for listed issuers in financial distress rather than in pre-IPO investment situations. In considering these features, HKEx aimed generally to protect minority shareholders. HKEx made the following points:

1. *Conversion price reset*  
     
   Convertible bonds with a conversion price reset mechanism are often referred to as "toxic convertibles", where the conversion price is the lower of a fixed price and a floating market price. Due to the nature of the conversion price reset mechanism, bondholders could hold up to 99.98% in the issued share capital of Company A, leaving minority shareholders with the remaining 0.02%. HKEx considered this to be inconsistent with Listing Rule 2.03. The extreme financing terms being imposed on minority shareholders also raised questions about whether Company A was suitable for listing. HKEx determined that the terms giving rise to the "toxic" feature were inconsistent with Listing Rule 2.03 and should be removed.
2. *Conversion price at a discount to the IPO Offer Price*  
     
   HKEx noted that the bondholders invested in Company A approximately 5 months before submission of the advance booking form and that there was no assurance that Company A's listing would proceed. In this respect, HKEx considered that the bondholders' investment could be distinguished from the scenario described in listing decision 55-1, where the pre-IPO investment would only be completed after in-principle listing approval had been granted. The discount to the IPO offer price was therefore allowed.
3. *Redemption and early redemption*  
     
   HKEx noted the sponsor's submission that the IRR on the principal amount of the convertible bonds was 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 investors did not take any risk and the investment money was not paid yet. The redemption provisions were therefore allowed.
4. *Controlling shareholders guarantee*  
     
   HKEx had no comment, as this was a private arrangement between the controlling shareholder and the bondholders.
5. *Lock-up and Public float*  
     
   HKEx noted that even after removing the "toxic" element, the terms of the convertible bonds were the most aggressive set of terms seen in a new listing applicant. As the terms of the convertible bonds were not available to all other shareholders, HKEx determined that any shares issued and to be issued to the bondholders upon conversion of the convertible bonds should be subject to a lock-up period of six months from the date of listing Company A and would not be counted as public float during the lock-up period.  
     
   HKEx also required that 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.
6. *Disclosures in the prospectus*  
     
   Given the complexity of the convertible bonds and their terms, additional information was required to be disclosed in the Financial Information and Risk Factors sections of the prospectus to explain the impact of the convertible bonds on Company A, including if Company A was called upon to redeem the convertible bonds before the maturity date.  
     
   HKEx also required that additional information should be disclosed in Company A's interim and annual reports to inform investors of the dilution impact on Company A's shares in the event that all outstanding convertible bonds were converted as at the end of the relevant period.

### 4. Listing Decision 59-6: Special Rights available to Pre-IPO Investor

#### Facts

Prior to Company A's listing application, Company A issued convertible bonds to a pre-IPO investor. The pre-IPO investor was entitled under the terms of the bonds to convert the bonds at any time before the expiration of 6 months from the listing date. The pre-set conversion price represented a discount of more than 50% to the mid-point of the offer range. If not converted earlier, the bonds would be deemed to be converted 6 months after the listing date. On conversion of the bonds, the shares held by the pre-IPO investor would be subject to a lock-up for 6 months from the date of listing. Company A would still meet the public float requirement if such shares were not counted as "public".

The terms of the convertible bonds provided that for so long as the convertible bonds were outstanding or the pre-IPO investor held Company A's shares, the consent of the pre-IPO investor was required for any of the following:

1. a declaration of dividend by any member of the group;
2. the creation of any mortgage, encumbrance or security arrangement of any kind over all or part of the group's business, undertakings or assets;
3. the sale, lease or transfer of a substantial part of the group's business or assets;
4. any amendments to the group's constitutional documents; and
5. any change in its executive Directors.

The convertible bonds also gave the pre-IPO investor the right to nominate a non-executive director to the board of Company A, pursuant to which Director X's appointment to the board had been approved by Company A's shareholders prior to listing.

#### Analysis

HKEx considered that the deep discount of the conversion price vis-à-vis the IPO price meant that it was more than likely that the convertible bonds would be converted. It thus determined that the pre-IPO investors had not assumed greater risks than those the IPO investors would assume. Accordingly the additional rights given to the pre-IPO investor under the terms of the convertible bonds relating to the negative pledge and the right to nominate a non-executive director were considered contrary to the principles of Listing Rule 2.03.

HKEx did not require Director X to resign, as his appointment to the board had been agreed by shareholders of Company A for his added value in improving corporate governance and ability to offer strategic business and financial imput. In addition, he was appointed as a non-executive director and would not take part in day-to-day management of the company. If a conflict arose between the decision of Company A's board and the rights of the pre-IPO investor, Director X would be obliged to abstain from voting pursuant to Listing Rule 3.08. However, in the event that Director X resigned, the right of the pre-IPO investor to nominate a non-executive director to represent its interest in Company A would no longer exist.

#### Decision

Based on the facts and circumstances that:

1. the special rights available only to the pre-IPO Investor were removed;
2. the other arrangements of the subscription agreement met the technical requirements stipulated in Listing Decision 36-1;
3. Director X would abstain from voting should there be a conflict between the decisions of Company A's board and the rights of the pre-IPO Investor; and
4. Director X would undertake to fulfil fiduciary duties and duties of skill, care and diligence as required under Listing Rule 3.08, including to act in the interests of the company as a whole,

HKEx determined that the issue could be addressed by way of disclosure in the prospectus.

### 5. LD59-7: Company holding Convertible bonds in company listing on GEM

#### Facts

Company A entered into a memorandum of understanding with Company B prior to listing on the GEM board, under which Company B would subscribe for certain amounts of redeemable convertible bonds of Company A. The convertible bonds would be converted into shares of Company A upon the share offer becoming unconditional. Upon conversion of the bonds, Company B would hold more than 10% of the shares of Company A. Based on the estimated total issued share capital of Company A at the time of listing, that shareholding interest would translate into shares of Company A being issued at a price equal to the lowest point of the offer price range or at a discount of around 20% to the highest point of the offer price range.

HKEx considered whether Company B would be regarded as a member of the public at the time of listing and whether shares held by it should be subject to a lock-up in the case where Company B was entitled to hold more than 10% of the shares in Company A upon conversion of the bonds.

#### Analysis

The HKEx noted that upon conversion of the convertible bonds, Company B would be within the definition of substantial shareholder and thus would be a connected person under the GEM Listing Rules. In addition, Company B would be regarded as a significant shareholder as it would hold more than 10% of the shares of Company A on conversion of the bonds. On that basis, HKEx determined that Company B would not be considered as a member of "the public" and that shares held by Company B would be subject to a lock-up at the time of listing and for the duration of the applicable lock-up period under the GEM Listing Rules.

HKEx also determined that in line with listing decision 36-2, Company A's prospectus should include relevant information relating to the details of the arrangement, the contribution by Company B, the benefits which the issue of the convertible bonds to Company B were expected to bring to Company A, and the justification of the conversion price.

[Details of all Listing Decisions](http://www.hkex.com.hk/listing/listdec/listdec.asp) can be found on the HKEx website.

The purpose of this note is to provide a summary only of certain listing decisions in relation to pre-IPO placings and convertible bond issues. Specific advice should be sought in any particular situation.

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1. Listing Rule 2.03 requires that the issue and marketing of securities is conducted in a fair and orderly manner and that all holders of listed securities are treated equally. [↑](#footnote-ref-24)
2. See listing decision 59-2 at paragraph 5. [↑](#footnote-ref-25)
3. Listing Rule 9.09 prohibits dealings in the securities for which listing is sought by any connected person of the issuer from the time of submission of the application for listing until listing is granted. [↑](#footnote-ref-28)