

# Hong Kong Capital Markets Update

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## Revised HKEx Guidance on Pre-IPO Investments

The Hong Kong Stock Exchange (the “Exchange” or “HKEx”) recently published three updated guidance letters regarding pre-IPO investments (collectively, the “Pre-IPO Investment Guidance”), namely:

- GL29-12** [Interim Guidance on Pre-IPO Investments](#)
- GL43-12** [Guidance on Pre-IPO Investments](#)
- GL44-12** [Guidance on Pre-IPO Investments in Convertible Instruments](#)

The updates aim at providing market practitioners with more clarity on the principles applied by the Exchange in reviewing pre-IPO investments. It does not change the longstanding principle that the issue and marketing of securities must be conducted in a fair and orderly manner and that all holders of securities must be treated fairly and equally.

Pre-IPO investment refers to the acquisition of shares from a listing applicant or its shareholder by a new or existing shareholder prior to an IPO of the company. Pre-IPO investments may take different forms, e.g. the subscription of convertible securities which can be converted into ordinary shares of the company on the date of the IPO (or later) or redeemed for cash in certain situations. Pre-IPO investments are often made on more favourable terms compared to IPO investors in order to reflect the different amount of risk assumed.

If a pre-IPO investment is made too close in time to an IPO, the risk assumed by the pre-IPO investor may not necessarily be significantly different to an IPO investor. This would thus contravene the principle of fair and equal treatment and may therefore result in either an extension of the listing timetable or a retraction of the pre-IPO investment.



### KPMG Observations: Updated guidance at a glance

- “120 Day Delay” rule – 28 Day/180 Day Requirement is revised to 28 Day/120 Day Requirement
- Treatment of divestments
- Treatment of special rights
- The Pre-IPO Investment Guidance does not apply to shares exchanged as part of a corporate restructuring in connection with the listing or shares awarded to directors or employees of the listing applicant as part of a defined share award scheme
- Private arrangements among shareholders are generally not subject to the Pre-IPO Investment Guidance except for those specifically disallowed

#### “120 Day Delay” rule

In light with the principle of fair and equal treatment of shareholders, the Exchange will generally delay the first day of trading of the listing applicant’s securities until **120 clear days** after the later of completion or divestment of the last pre-IPO investment (“120 Day Delay” rule) if:

- the pre-IPO investment is completed:
  - (a) within 28 clear days before the date of the first submission of the first application form (“First Filing”) and the relevant Pre-IPO investor remains as a shareholder at the First Filing; or
  - (b) on or after the date of First Filing and before the listing date;
  - (a.k.a. the “28 Day/120 Day Requirement”)
- the pre-IPO investment is divested on or after the date of First Filing, regardless of when the pre-IPO investment is made or whether the divestment is pursuant to a contractual right.

<sup>1</sup> Clear days exclude (i) the day of the pre-IPO investment completion, (ii) the day of the submission of listing application form & (iii) the first day of trading of securities.

Consistent with the Exchange's previous guidance, pre-IPO investments are considered completed when the funds are irrevocably settled and received by the listing applicant (or existing shareholders).

With the clarified guidance, the "delay window" in certain cases has been shortened from the previous 180 clear days requirement ("28 Day/180 Day Requirement") to 120 clear days.

### Treatment of divestments

Divestments on or after the date of the First Filing are generally considered to be highly disruptive to the listing process and are now subject to a "120 Day Delay" regardless of when the pre-IPO investment was made or whether divestment is pursuant to a contractual right.

Divestment rights include put options, redemption or repurchase rights granted by the listing applicants and controlling shareholders to the pre-IPO investors or call options permitting the listing applicants or the controlling shareholders to repurchase shares of the pre-IPO investors are now required to terminate before the date of First Filing, except for those rights only exercisable if the listing does not take place and such rights will terminate upon listing.



### KPMG Observations: Pre-IPO investment call options

To protect the interest of controlling shareholder(s) in the listing applicant, in some instances, the controlling shareholder(s) may wish to include a call option in the pre-IPO investment agreement to repurchase the shares from the pre-IPO investor(s) subject to the event of certain conditions (e.g. disposal of pre-IPO investments by the investors to third party buyers).

Since the Pre-IPO Investment Guidance expressly prohibits the existence of such call option on or after the First Filing, rather the controlling shareholder(s) may consider alternative arrangement such as a "right of first refusal" where the pre-IPO investors must first offer to sell the pre-IPO investments to the controlling shareholder or the listing applicant before proposing a sale to a third party. Listing applicant and its controlling shareholder(s) are suggested to seek legal advice in designing the alternative arrangement that fits their own facts and circumstances.



### Illustrative examples on "120 Day Delay" rule

Company A is contemplating an IPO on the HK Main Board with a tentative timetable set forth below. Prior to an IPO, Company A would like to (i) allot new shares to several new investors and (ii) terminate the unconditional put option held by an existing shareholder in light of the Pre-IPO Investment Guidance.

#### (i) Allotment of new shares to several new investors

Shares issued to new investors prior to an IPO is subject to the "120 Day Delay" rule.

With reference to the Pre-IPO Investment Guidance, if Company A is planning a listing on 30 November 20x1, the completion of last pre-IPO investment should be 28 clear days before the First Filing on 31 August 20x1 (i.e. on or before 2 August 20x1). Otherwise, the listing date will be postponed by 120 clear days after the completion of the last pre-IPO investment. For example, if the last pre-IPO investment is completed on 12 August 20x1, with 120 clear days added on, the earliest listing date for Company A would be 11 December 20x1.

#### Proposed listing timetable:

<b>First Filing date</b>	31 August 20x1
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<b>Listing date (the first day of trading of securities)</b>	30 November 20x1
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#### (ii) Termination of the unconditional put option held by an existing shareholder

Under the Pre-IPO Investment Guidance, the unconditional put option held by the existing shareholder must be terminated before First Filing or otherwise it may be subject to a "120 Day Delay".

Under the proposed timetable, termination of unconditional put option must be completed before the First Filing on 31 August 20x1 (i.e. on or before 30 August 20x1), otherwise, the listing date will be postponed by 120 clear days. For example, if the put option is terminated on 5 September 20x1, the earliest listing date would be 120 clear days thereafter, i.e. 4 January 20x2.

### Special rights attached to pre-IPO investments

Generally, any special rights that do not extend to all other shareholders (the “Special Rights”) are not permitted to survive after listing as these contravene to the general principle of fair and equal treatment of all shareholders.

The Pre-IPO Investment Guidance provides specific examples (see Appendix 1) of Special Rights commonly attached to the pre-IPO investments and the Exchange’s guidance on whether they are permitted to survive after listing. The Exchange’s treatment on any specific Special Rights will depend on the facts and circumstances of each listing application.

### Special rights among the shareholders

The Exchange clarifies that private arrangements, such as rights granted by one shareholder to another or agreements among the shareholders, are generally not subject to the Pre-IPO Investment Guidance except for those which are specifically disallowed therein.

For example, agreement to provide a fixed rate of return to the pre-IPO investor and settled by a shareholder may survive upon listing provided they are not based on a discount to the IPO price or a discount to the market capitalisation of the company upon listing. However, any adjustments to pre-IPO investments based on discounts to the IPO price or market capitalisation of the company upon listing may not survive regardless of whether they are settled by the listing applicant or the shareholder(s).

### Lock up arrangements

Pre-IPO investors are normally required to enter into lock-up arrangements with respect to their pre-IPO shares for a period of six months or more. These shares are counted as part of the public float provided the investor is a member of the public under the listing rules.

### Prospectus disclosures

Pre-IPO investments must be fully disclosed in the prospectus, details of which include: name of each pre-IPO investor, their respective beneficial owner, background, strategic benefits they would bring to the company, relationship with the listing applicant and/or any connected persons of the applicant. In addition, the prospectus must disclose the date of the investment, considerations and the basis of the investment, payment date, discount to the IPO price, use of proceeds and the shareholding held by each investor upon listing. Material Special Rights, which will survive after listing, and whether the shares held by the pre-IPO investor will be subject to lock-ups together with the reasoning of such actions, are also required to be disclosed in the prospectus.



### KPMG Observations: Reminder to potential listing applicants

Potential listing applicants should be mindful of the requirements set out in the Pre-IPO Investment Guidance as it may result in delays in the listing timetable or a retraction of such investments if the pre-IPO investment is considered too close to an IPO.

The general principle of fair and equal treatment of shareholders restricts a company’s ability to offer Special Rights to pre-IPO investors unless such rights are receded on listing. It is therefore critical to structure the terms of the pre-IPO investments properly from the outset to avoid any negative impact on the listing process. A re-negotiation, if necessary, with pre-IPO investors to modify the investment terms may be a lengthy process, potential listing applicants are recommended to carry out an extensive review of their pre-IPO investment agreements to identify any Special Rights attached which are not permitted to survive upon listing sufficiently in advance of the IPO submission.

Listing applicants are encouraged to consult their professional advisers and/or the Exchange in advance if they are unsure whether the Special Rights attached to the pre-IPO investments can survive upon listing.

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If you have any questions about the matters discussed in this publication, please feel free to contact the following partners in our Capital Markets Advisory Group.

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**Appendix 1 - Special Rights commonly attached to the pre-IPO investments**

*The following is a summary of examples discussed in the Pre-IPO Investment Guidance on the Special Rights commonly attached to pre-IPO investments in shares and convertible instruments of a listing applicant and the respective Exchange's guidance as to whether they would be allowed to survive listing:*

Special Rights	Permitted	Must terminate upon listing
<b>Price adjustments</b>	Terms that provide a fixed rate of return to the pre-IPO investor (which effectively reduce the price per share) and settled by a shareholder provided that they <u>are not based</u> on (1) a discount to the IPO price; or (2) a discount to market capitalization of the shares at IPO.	Terms which adjust the purchase price <u>based</u> on a discount to the IPO price or discount to the market capitalization of the shares may not survive listing regardless of whether they are settled by the applicant or a shareholder.
<b>Divestment rights</b>	A divestment right (e.g. put options, redemption or repurchase rights) granted by the listing applicant or the controlling shareholder to the pre-IPO investor or right (e.g. call options) permitting the listing applicant or the controlling shareholder to repurchase shares of the pre-IPO investor (together, the "Divestment Right") which is exercisable only when the listing does not take place is permitted and such right must be terminated upon listing.	Except for the divestment right exercisable if a listing does not take place and must be terminated upon listing, any other divestment rights must be terminated before the date of the first filing or otherwise it will be subject to the "120 Day Delay".
<b>Director nomination/appointment rights</b>	Any agreement among the shareholders to nominate and/or vote for certain candidates as directors are generally not subject to the Pre-IPO Investment Guidance.  Any rights available to all shareholders subject to certain qualifications stipulated in the listing applicant's constitutive documents (e.g. holding a certain minimum interest) may survive after listing as such right is available to all shareholders that fulfil such criteria.	Any right granted by the listing applicant to nominate or appoint a director must terminate upon listing as such a right is not generally available to other shareholders. Any director nominated or appointed by a pre-IPO investor need not resign at listing unless required under the listing applicant's articles of association.
<b>Other nomination rights</b>	Rights to nominate senior management and committee representatives (other than directors and board committee members) granted to pre-IPO investors by the listing applicant or the controlling shareholder(s) are permitted to survive upon listing provided that all such appointments are subject to the decision of the board.	-
<b>Veto rights</b>	-	Any contractual right to veto the listing applicant's major corporate actions (e.g. a petition or resolution for winding-up, change in the business, or an amalgamation or merger by any member of the applicant group with any other company or legal entity, etc.) must be terminated upon listing.
<b>Information rights</b>	Information rights can only survive after listing if the pre-IPO investor is only entitled to receive published/public information.	-

Appendix 1 - Special Rights commonly attached to the pre-IPO investments (Continued)

Special Rights	Permitted	Must terminate upon listing
<b>Anti-dilution rights</b>	<p>Exercise of anti-dilution rights by the pre-IPO investors before and in connection with an IPO is permissible if:</p> <ul style="list-style-type: none"> <li>(i) the allocation is necessary in order to give effect to the pre-existing contractual rights of the pre-IPO investors;</li> <li>(ii) full disclosure of the pre-existing contractual entitlement of the pre-IPO investors and the number of shares to be subscribed by the pre-IPO investors will be made in the listing document and the allotment results announcement; and</li> <li>(iii) the additional shares will be subscribed at the IPO offer price.</li> </ul>	Except the permitted scenario, anti-dilution rights may not survive after listing to be in line with the listing rules on pre-emptive rights.
<b>Financial compensation</b>	Any financial compensation which is/will be settled by a shareholder and does not link to the market price or capitalisation of the shares.	Any financial compensation which is/will be settled by the listing applicant or compensation that is linked to the market price or market capitalisation of the shares must be terminated upon listing.
<b>Prior consent for certain corporate actions/ changes in articles</b>	-	<p>Any right that requires the prior consent of the pre-IPO investor for certain corporate actions must be terminated upon listing. Examples of these actions include:</p> <ul style="list-style-type: none"> <li>(i) a declaration of dividend by any member of the listing applicant group;</li> <li>(ii) the sale, lease or transfer of a substantial part of the listing applicant's business or assets;</li> <li>(iii) any amendments to the listing applicant's constitutional documents; and</li> <li>(iv) any change in executive directors.</li> </ul>
<b>Exclusivity rights and no more favourable terms</b>	The exclusivity rights and no more favourable terms may survive after listing if the investment terms are modified to include an explicit "fiduciary out" clause so that directors are allowed to ignore the terms if complying with them would constitute a breach of their fiduciary duties.	Without an explicit "fiduciary out" clause in the investment terms, any restriction on the listing applicant to issue or offer any shares, options, warrants and rights to any direct competitor of the pre-IPO investor or to other investors on terms more favourable than the terms on which the shares are issued to them must be terminated upon listing.
<b>Right of first refusal and tag-along rights</b>	<p>Any right of first refusal granted by the controlling shareholder such that the controlling shareholder must first offer to sell shares to the pre-IPO investor at the same price and on the same terms and conditions as proposed sales of shares to another investor can survive after listing.</p> <p>Similarly, any right granted by the controlling shareholder to include the shares of a pre-IPO investor for sale together (i.e. tag-along) with the shares of the controlling shareholder if the controlling shareholder sells any of its shares to another investor is also permitted.</p>	-

**Appendix 1 - Special Rights commonly attached to the pre-IPO investments (Continued)**

*Specific examples in Pre-IPO Investment Guidance on special rights attached to convertible instruments such as convertible or exchangeable bonds, notes or loans and convertible preference shares (collectively, “CBs”):*

Special Rights	Permitted	Must terminate upon listing
<b>Conversion price linked to IPO price or market capitalisation</b>	The conversion price for CBs should be at a fixed dollar amount or at the IPO price.	Any guaranteed discount to the listing applicant's IPO price or market capitalization of shares is not permitted as this may give rise to concerns that the pre-IPO investor does not bear the same investment risk as public investors.
<b>Conversion price reset</b>	-	<p>Any conversion price reset mechanism of the CBs should be removed as they are considered to be contrary to the general principle of even treatment of shareholders.</p> <p>An example is where the conversion price reset mechanism is based on the lower of a fixed price and a floating market price. Such a price reset mechanism effectively allows conversion at a discount to the fixed price.</p>
<b>Mandatory or partial conversions</b>	<p>Partial conversion of CBs is only allowed if all Special Rights are terminated after listing.</p> <p>This prevents the situation where a pre-IPO investor enjoys the Special Rights it held as bondholder by converting a significant portion of their CBs into shares but is still enjoying the Special Rights by holding a small portion of the CBs.</p>	-
<b>Early redemptions</b>	Seen as a compensation for the investment and risk undertaken by the bondholders, an option to early redeem the outstanding CBs at a price commensurate with the fixed internal rate of return (IRR) on the principal amount of the CBs to be redeemed is permitted.	-
<b>Negative Pledges</b>	Negative pledges should be removed upon listing unless the sponsor confirms that the negative pledges are not egregious, and do not contravene the general principle of even treatment of shareholders.	Negative pledges that restrict a listing applicant from certain corporate actions such as creating any additional lien, encumbrance or security interest on its assets and revenues, or paying dividends without prior consent of the pre-IPO investor must be terminated upon listing.