

### 3.3 Competing business

In designing the proper group structure for an IPO, a listing applicant is recommended to take into account whether any businesses excluding those in the proposed listing group would constitute competitive businesses, and as a result adversely affect its chance of being considered as suitable for listing.

Under the Listing Rules, where a listing applicant has a controlling shareholder with an interest in a business apart from the listing applicant's business which competes or is likely to compete, the directors of the listing applicant shall, in the performance of their duties as directors, avoid actual and potential conflicts of interest and duty. Competing businesses of directors and controlling shareholders are allowable when and only when full disclosures have been made at the time of listing and on an on-going basis.

## 4. Financial Information

### 4.1 Determining track record period

In respect to an application for new listing on the Main Board of the HKEx, the financial information should cover each of the three financial years immediately preceding the issue of the prospectus. Under GEM Listing Rule 11.10, the financial information must cover at least the two preceding financial years.

The HKEx, in some circumstances, may consider accepting a shorter period. In any case, the latest financial period reported on by the reporting accountants must not have ended more than six months before the date of the prospectus. Due to this requirement, in some cases, an interim period is added to the financial information. Generally this additional interim period is referred to as the "stub period". The reporting accountants' true and fair opinion covers also the financial information of the stub period. In respect to comparatives in the stub period, the reporting accountants are required to perform a review on them.

Subject to certain conditions, HKEX accepts early filing of listing applications in which case the financial information would cover a shorter trading record period. (*Note: Financial information that covers only a part of the track record period is only permitted in an Application Proof that is filed early. Financial information for the complete track record period is still required for the final prospectus.*) For example, an applicant for new listing on the Main Board of the HKEx may present financial information covering two years and nine months in the Application Proof. Financial information of the nine-month stub period, including the comparatives, has to at least be reviewed by reporting accountants according to Hong Kong Standard on Review Engagements 2410 "Review of Interim financial information Performed by the Independent Auditor of the Entity". For the HKEx to accept an early filing, the HKEx requires a sponsor's confirmation that it is beyond reasonable doubt that the applicant will satisfy the Main Board Listing Rule 8.05/GEM Listing Rule 11.12A and other financial standard requirements.

The early filing application has to be filed after the trading record period of the listing applicant, and the listing applicant has to file the updated financial information covering the full trading record period as soon as practicable. Further, the reporting accountants would have to perform work on the updated financial information to support their opinion on the historical financial information of the trading record period as a whole.

### 4.2 Applicable accounting standards

The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the Main Board Listing Rules) and The Rules Governing the Listing of Securities on the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited (the GEM Listing Rules) generally have similar requirements on the form and contents of the financial information in an accountant's report. The financial information can be prepared

in accordance with either Hong Kong Financial Reporting Standards or International Financial Reporting Standards (or China Accounting Standards for Business Enterprises CASBE in the case of a PRC issuer that has adopted CASBE for the preparation of its annual financial statements).

In brief, the Listing Rules require, as a minimum, the following elements:

- statements of financial position as at the end of each of the periods reported on
- statements of comprehensive income, cash flows and changes in equity in respect to each of the periods reported on
- specific details concerning the financial information as set out in Main Board Listing Rule 4.04 & 4.05 and Appendix 16, or GEM Listing Rule 7.03 & 7.04

The Hong Kong Financial Reporting Standards (HKFRS), International Financial Reporting Standards (IFRS) must be prepared according to best practice, which is at least that required in the accounts of a company under the Hong Kong Companies Ordinance and the adopted financial reporting framework.

The HKEx also reserves the right to require a new applicant to provide more information, or vary the requirements for information to be disclosed according to what the HKEx considers necessary.

Directors of a listing applicant are responsible for ensuring the financial information is prepared in conformity with the above requirements. The reporting accountants are responsible to obtain sufficient relevant and reliable evidence to enable them to form an opinion on the financial information.

### 4.3 Practical issues when converting the current accounting standard into applicable accounting standards

For many of the listing applicants, for example, enterprises incorporated in the PRC, those entities in their listing group may not have been reporting under HKFRS or IFRS before the listing application. Making the transition to these financial reporting frameworks may be a hurdle to these listing applicants. Set out below are some common issues relating to financial reporting encountered by listing applicants.

- *Fair value assessment*  
Under various standards under HKFRS/IFRS, certain accounting items, such as financial instruments (including both assets and liabilities), investment properties, share based payments, etc., are subject to a fair value assessment. For those entities that have not been reporting under HKFRS or IFRS before the listing application, applying HKFRS or IFRS may have a substantial impact to their results and financial positions when transforming the recognition of certain accounting items into fair values. For group structuring during the IPO process that constitutes a business combination under HKFRS 3, the acquirer shall also measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.
- *Related party transactions*  
Under Hong Kong Accounting Standards/International Accounting Standards ("HKAS/IAS") 24, if the reporting entity has related party transactions during the reporting period, it is required to disclose the nature of this related party relationship, information about those transactions and outstanding balances. In PRC enterprises, the controlling shareholders are frequently individuals who also own other businesses not included in the listing groups. It should be noted that transactions between entities controlled by the same shareholders that are included in and outside of the listing group during the trading record period (which is three years before listing on the Main Board, and two years for the GEM) will fall within HKAS/IAS 24.

# The Role of an Independent Industry Research Company

(By Paul Schulte of Schulte Research)

### Independent Research in Asia is New and Fast Growing

While there are thousands of independent analysts in the United States, independent research in Asia is fairly new. There are now a few dozen independent research companies operating in Hong Kong as one of two basic kinds of firms. The first type typically focuses on macro funds, and covers strategy, economics, foreign exchange, interest rates and commodity research. The second type specialises in specific industry research, which currently covers many sectors in Asia including banking, telecommunications, IT, utilities, real estate and credit research.

There are several independent research companies which specifically cover China, and are based in both Hong Kong and China. These independent analysts have a cache, since they have gone out on their own and seek direct payment from the client for research provided. The largest among these are firms such as GaveKal and Asianomics. Others include companies like Trusted Sources, which covers several sectors.

### 4 Areas of Research

Independent industry research can be separated into four general areas:

1. **Stock coverage.** This represents a wide coverage of stocks in metals, internet, energy, telecommunications, banking, consumer business and gaming.
2. **Macro.** This encompasses macro-economics, strategy, technical and thematic.
3. **Special Situations.** This includes custom products, bespoke research, statistics, and also looks at ethical issues like the environment, 'sin' stocks, etc.
4. **Intelligence.** A rapidly growing industry in Asia is compliance, which embraces both investigatory and due diligence. This type of research can be especially helpful for a company seeking an IPO to help gain further credibility in the process.

Analysts have influence in their particular areas of expertise, and tend to be well compensated for their views. However, investment banks are affected by a number of factors including regulations, compliance requirements and capital constraints, and consequently are seeing falling margins. As a further result there have been significant cuts in this area of research, impacting the quality of analysts. In more dire cases, at a time when firms who are considering an IPO should include independent analysts in the process, the budget for research has been cut altogether.

### The Value Add of Independent Research

In addition to a reduction in budget by investment banks, analysts are also experiencing a decline in business because investors may not understand the value that an analyst can add to the IPO process. There is a misconception by many investors that analysts produce research reports that are nothing more than a regurgitation of information already provided to them by the company, lacking any further insight.

In truth, an independent analyst can offer differentiated research, which can help generate information that can be used to engender added investor excitement. As a further benefit, a seasoned analyst who has the ear of a senior portfolio manager, usually the decision maker, can lend her credible reputation to help sway a deal. This is particularly true of the CIOs of hedge funds and sovereign wealth funds. The analyst, using her influence with a CIO, may also serve to assist in the process of soft-sounding for pricing an IPO.

### Independent Analysts are Licensed and Seasoned

An independent analyst who discusses stock recommendations must be registered with the Securities and Futures Commission ("SFC"). Accordingly, an analyst is held accountable for his conduct, as well as for using responsible language. Consequently, he is bound by applicable regulations and ethical considerations in his analysis, criticism and commentary on any company during the IPO process.

### The Upside and the Added Roles of the Analyst

There is nothing but upside for a company seeking an IPO to use independent research, especially in light of the rapid improvement of the quality of research and the increasing sophistication of ways in which people are able to confirm data points. There are three reasons why a company seeking an IPO should invite independent research into the process: 1) an added level of professionalism and the potential for very high quality coverage of the stock, which could aid liquidity; 2) an extra layer of comfort for fund managers in their decision to take up the IPO; and 3) a report with diverse research, which can help since the process tends to produce several reports from different consultants that tend to reach the same conclusions. There is another important phenomenon occurring which plays into the strengths of independent research. Many corporations are now choosing to take their investment banking needs in-house and are bypassing the bank. As this happens, more outside independent entities will become involved in the process of assessing a company in preparation for the IPO. Therefore, independent research will take on a unique role similar to other companies like Poseidon, Kroll, Muddy Waters and others who are paid by funds to investigate the efficacy of the claims of the company as it prepares to tell its story to the public.

In addition to providing the research, there is an added role to be played by the independent research analyst. Given that many analysts have many years of experience both on the buy side and sell side as well as maintain close relationships with many senior portfolio managers, they have much wisdom to offer to a company in a consultancy role with regard to pricing, story-telling, pitching of the corporate structure and other important considerations. This is simply not within the purview of the investment bank any longer.

Furthermore, licensed independent research analysts are ideal to attend the IPO research day along with the other analysts as often, their resources are superior, and their knowledge of the industry is well ahead that of

### 2.2.1 Convertible Instruments

A convertible instrument will be accounted with the following considerations:

- effects on Equity and Liability portions
- different treatments–
  - i. between an issuer and holder
  - ii. at the initial recognition and subsequent reporting periods.

For financial instrument issuer, the treatments are summarised as follows:

	Balance Sheet	Income Statement	Cash Flow Statement
Initial Recognition	<ul style="list-style-type: none"> <li>• Assess the Liability Component as fair value;</li> <li>• Equity Component is the difference of the Transaction Cost and the Liability Component</li> </ul>	<ul style="list-style-type: none"> <li>• No net profit and loss effect</li> </ul>	<ul style="list-style-type: none"> <li>• Increase cash flow from financing</li> </ul>
Revaluation	<ul style="list-style-type: none"> <li>• Assess the Liability Component as fair value;</li> <li>• Assess the Equity Component as fair value.</li> </ul>	<ul style="list-style-type: none"> <li>• Profit and loss effect</li> </ul>	<ul style="list-style-type: none"> <li>• No Effect</li> </ul>

For financial instrument holder, the treatments are summarised as follows:

	Balance Sheet	Income Statement	Cash Flow Statement
Initial Recognition	<ul style="list-style-type: none"> <li>• Transaction Costs</li> </ul>	<ul style="list-style-type: none"> <li>• No net profit and loss effect</li> </ul>	<ul style="list-style-type: none"> <li>• Net cash outflow</li> </ul>
Revaluation	<ul style="list-style-type: none"> <li>• Assess the Liability Component as fair value;</li> <li>• Assess the Equity Component as fair value.</li> </ul>	<ul style="list-style-type: none"> <li>• Profit and loss effect</li> </ul>	<ul style="list-style-type: none"> <li>• No Effect</li> </ul>

### 2.2.2 Stock Options

It is a common practice, as well as a useful vehicle, for a company to issue stock options to its directors, employees, or contractors to recognise their achievement and to encourage their further contributions. For a listed company, the terms of its share option scheme are governed by Chapter 17 of the Hong Kong Listing Rules.

Pursuant to Note (1) to Rule 17.03(9) of the Hong Kong Listing Rules, the basis of determination of the exercise price is as follows:

"The exercise price must be at least the higher of:

- (i) the closing price of the securities as stated in the Exchange's daily quotations sheet on the date of grant, which must be a business day; and
- (ii) the average closing price of the securities as stated in the Exchange's daily quotations sheets for the five business days immediately preceding the date of grant.

For the purpose of calculating the exercise price where an issuer has been listed for less than five business days, the new issue price shall be used as the closing price for any business day falling within the period before listing."

When share options are being issued, in addition to the consideration of the human capital aspect of providing incentives, a company should be aware of the impact of the terms of the share option scheme to its financial position. The valuation of the share option should be performed to assess and analyse the potential financial impacts and accounting treatments prior to issuance of share option. The following are items to be considered:

Term Item	Valuation/Impact Description
Exercise Price	The higher the exercise price relative to the stock spot price, the lower the option value
Maturity	The longer the maturity, the higher the option value
Vesting Period	The duration of the vesting period has two different impacts: <ol style="list-style-type: none"> <li>i. the longer the vesting period, the higher the overall option value; however,</li> <li>ii. instead of having the option cost to be recognized at the issuance date, the overall cost will be amortized over the vesting period, and hence, mitigating the financial burden all at once at the initial financial reporting year</li> </ol>

### 2.3 Property

As mentioned above, a company may possess properties and the associated property activities are determining factors on whether valuation is required.

The following is a summary to determine whether a property valuation is required by the company in the IPO exercise:

Company's property interests forms part of property activities	✓/x
Property interests forms part of property activities <1% carrying amount of its total assets	x
The total carrying amount of property interests not valued >10% of its total assets	✓

or

Company's property interest for non-property activities	✓/x
Carrying amount of a property interest ≥15% carrying amount of its total assets	✓
Single property interests has a carrying amount ≥15% carrying amount of its total assets	✓

Notes:

- ✓ Valuation required
- x Valuation not required

approval of the relevant PRC authorities. Pre-IPO shares may also be subject to non-disposal restrictions under PRC laws.

- **Prospectus disclosure** – Pre-IPO investments must be fully disclosed in a prospectus. Disclosure requirements include providing details of the investor, including the name, beneficial owner, background, relationship with the company and strategic benefits. The disclosure must also include the date of investment; consideration paid, including cost per share and the discount to the IPO price; use of proceeds; investor's shareholding upon listing and any special rights granted. Lastly, the prospectus must also disclose whether the shares are subject to lock-up arrangements and count as part of the public float. Given their complexity, additional disclosures are required for convertible instruments.

### Timing Restrictions on pre-IPO Investments

The Hong Kong Exchanges and Clearing Limited ("HKEx") has provided guidance as to its expectations on timing for pre-IPO investments. The guidance sets out dates by which pre-IPO investments must generally be completed. Completed, for these purposes, is defined as the date upon which the funds are irrevocably settled and received by a company. Pre-IPO investments must, except in very exceptional circumstances, be completed either:

- a) at least 28 clear days before the date of the first submission of the first listing application form; or
- b) 180 clear days before the first day of trading of a company's securities.

In calculating the clear days, the listing application filing date, the first trading day and the date of completion of investment must be excluded.

If a pre-IPO investment does not comply with the guidance, the company would be expected to delay the listing date or unwind the pre-IPO investment. It is, therefore, important when considering pre-IPO investments to ensure that the funding of the investment is completed sufficiently in advance of the expected date for filing the listing application.

### Restrictions on Special Rights that may be Offered to Pre-IPO Investors

Pre-IPO investors may seek special rights to protect their investment. The general principle of even treatment for shareholders mentioned above, however, restricts a company's ability to offer special rights or rights which do not extend to all other shareholders, unless such rights fall away on listing. The HKEx has issued guidance as to which special rights would be allowed to survive listing:

- **Price adjustment** – Price adjustment provisions, such as a guaranteed discount to the IPO share price or an adjustment linked to the market capitalisation, are not permitted.
- **Put or exit options** – Put or exit options, where the investor has the right to put back its shares to the company or to its controlling shareholder, are not permitted unless the exercise right is limited to circumstances where the listing does not take place.
- **Director nomination rights** – The right to nominate a director following listing is not permitted. However, directors appointed by an investor prior to listing may remain in office, subject to retirement by rotation and reappointment in accordance with the company's constitutional documents.
- **Veto rights and prior consent rights for certain corporate actions** – Veto rights over major corporate actions are not permitted to remain after listing. Prior consent rights should also be removed before listing

unless the terms are not egregious and do not contravene the principles of fairness in the Listing Rules to the disadvantage of other shareholders.

- **Anti-dilution rights** – Anti-dilution rights should fall away on listing. Before listing, anti-dilution rights exercisable at the time of listing are allowed provided the subscription is at the IPO price and full disclosure is included in the prospectus and allotment results announcement.
- **Profit guarantee** – Any profit guarantee where a pre-IPO investor is entitled to compensation if the company's profit does not meet a certain level is not permitted if it is settled by the company or the compensation is linked to the market price or market capitalisation. However, if the compensation is settled by a shareholder, this would be permitted, provided again that the consideration is not linked to the market price or market capitalisation of the shares.
- **Negative pledges** – Negative pledges are generally not permitted except if they are widely accepted provisions in loan agreements, are not egregious and do not contravene the principles of fairness in the Listing Rules.
- **Exclusivity rights and no more favourable terms** – Any terms which, for example, restrict the issue of shares to a competitor of the investor or on preferential terms to those granted to the investor are not permitted to survive listing. An exception exists where such terms are structured with a "fiduciary out", which would enable directors to ignore the right if appropriate in exercising their fiduciary duties.
- **Information rights** – A right granting an investor access to information concerning the company can only survive after listing if the information is made available to the public at the same time.
- **Representation rights in senior management** – The right of an investor to nominate senior management or committee representatives is permitted, provided that the right is subject to the agreement of the board, exercising its fiduciary duties.
- **Right of first refusal and tag-along rights** – Where these rights are granted by the controlling shareholder, they are permitted to survive after listing.

The HKEx has also issued specific guidance dealing with convertible instruments, including convertible or exchangeable bonds. The guidance covers the following:

- **Conversion price and conversion price reset** – This should be either a fixed dollar amount or the IPO price, rather than any guaranteed discount to the IPO price or any linkage to the market capitalisation of the shares.
- **Partial conversions** – Partial conversions will only be permitted if all atypical rights are terminated after listing.
- **Redemptions and early repayments** – These are permitted at a price where the holder would receive a fixed internal rate of return on the principal amount being redeemed with the same rate applying at maturity.

### General Principles Applying to Cornerstone Investments

Placings to cornerstone investors are carried out on a preferential basis, providing a guaranteed allocation of shares to these investors, irrespective of the final offer price. They are generally permitted provided the general principles set out below are complied with.

## 5.5 Due Diligence

Sponsor(s) are required to conduct reasonable due diligence on the listing applicant, in order to enable them to carry out their duties and make the relevant declarations prescribed by the Code of Conduct for Persons Licensed by or Registered with the SFC ("Code of Conduct") and the Listing Rules. Paragraph 17 of the revised Code of Conduct consolidates and centralises key obligations of sponsor(s) under the new regime, some of which are fleshed out in the Listing Rules.

Under the new regime, sponsor(s) have the duty to take reasonable due diligence steps in respect of a listing application and to complete all reasonable due diligence on a listing applicant by the time of submitting the Form A1. Sponsor(s), after performing all reasonable due diligence, should ensure that all material information as a result of this due diligence has been included in the draft prospectus and that the draft prospectus is substantially complete save for matters that by their nature can only be dealt with at a later date.

Sponsor(s) must confirm, having made reasonable due diligence, it has no reasonable grounds to believe and do not believe that contents of the entire prospectus (expert and non-expert sections) is untrue, misleading or contain material omission. Sponsor(s) must examine all information with professional skepticism, instead of relying on management representations or experts' reports.

In response to the new requirements, the sponsor community, with the assistance of a number of law firms, assembled a detailed set of sponsor due diligence guidelines for Hong Kong IPOs, which are intended to assist sponsors and their advisers to meet what the SFC and HKSE expect of a sponsor. The guidelines, available online at [www.duediligenceguidelines.com](http://www.duediligenceguidelines.com), are not formally acknowledged by the regulators, but they do provide a useful reference to sponsor(s) conducting due diligence under the new regime.

The HKSE expects sponsor(s) to document its due diligence planning and significant deviations from their plan. Under the new regime, sponsor(s) are required to keep complete records including transaction team information, due diligence plans and related materials for at least 7 years after completion or termination of assignment.

## 5.6 The Prospectus

### 5.6.1 Drafting of the Prospectus

A prospectus is the principal marketing document in a Hong Kong IPO. It is ordinarily prepared by the listing applicant and its sponsor(s), with the assistance of their legal counsel, in accordance with the requirements of the Listing Rules, the Companies Ordinance and the Companies (Winding Up and Miscellaneous Provisions) Ordinance (collectively the "CO") and the Securities and Futures Ordinance ("SFO"). Other professional parties and experts will also contribute to the contents of the prospectus, for instance, reporting accountants and property valuers. The prospectus must contain all information necessary to enable investors to make an informed assessment of the listing applicant's assets and liabilities, business, financial position, management and prospects. A large number of amendments introduced by the new regime for IPO sponsors are, in effect, enhanced prospectus disclosure requirements.<sup>3</sup> Failure to comply may render the Application Proof substantially incomplete, which may result in the listing application being returned (see below).

### 5.6.2 Verification and Prospectus Liability

The sponsor(s) should carry out verification of the draft prospectus in order to ensure that all statements are true and accurate. This process is designed to protect all relevant parties, inter alia, issuers, their directors and arguably the sponsor(s) (see below) from potential liability for the prospectus contents.

<sup>3</sup> New guidance letter GL56-13 prescribed a list of information to be disclosed in the Application Proof for the document to be considered substantially complete.

Liability for the contents of a prospectus is governed under the CO, SFO, common law and other legislation. Both the CO and SFO provide for civil and criminal liabilities for false or misleading statements in the prospectuses.

The SFC is of the view that prospectus liability already extends to sponsor(s) under the existing legislation. In the initial consultation conclusions issued on December 12, 2012, the SFC concluded it was appropriate to state clearly that sponsor(s) have civil and criminal liability for prospectuses by amending legislation. However, in its supplemental conclusions issued on August 22, 2014, the SFC reaffirmed its view that sponsor(s) were already liable under existing legislation and hence the proposed legislative amendments need not be pursued as they would serve no purpose.

Although there were diverging views and a lack of case-law on the issue of whether the existing statutory provisions apply to sponsor(s), it should be noted that the SFC has made clear in its supplemental conclusions that it will have no hesitation in relying on the existing criminal provisions when considering whether to pursue criminal action against sponsor(s) in appropriate cases.

## 6 Listing Application and Vetting Process

### 6.1 Submission of Form A1 and publication of draft prospectus

The listing application (also known as Form A1 for Main Board listing application and Form 5A for GEM listing application) is to be submitted with, among other things, a substantially complete draft prospectus (including an Application Proof for vetting in English, and an Application Proof for publication in English and Chinese), sponsor(s)' undertaking and statement of independence. The new requirements are imposed with a view to shorten the listing timetable by encouraging the submission of a quality first draft prospectus. The Application Proof for publication will be made publicly available on the HKSE website at the time of submission. The Application Proof for publication and the Application Proof for vetting are basically the same except redactions and warnings are required or allowed to prevent the document constituting a prospectus under Hong Kong law. If the Application Proof is returned by the HKSE as not being substantially complete, the HKSE will disclose the applicant's name, the sponsor(s)' name(s) and the return date on the HKSE news website when all related review procedures on the decision to return the application have been completed or the time for invoking them has lapsed. There is an eight-week cooling-off period before a returned listing application can be resubmitted.

### 6.2 Vetting Process

The HKSE's purpose in reviewing the draft prospectus is to assess and consider the eligibility and suitability of the applicants for listing and to ensure adequate disclosure has been made in the prospectus, not to determine merits of the offering.

The SFC has committed to work with the HKSE to streamline the commenting process. They plan to focus on high-level issues only, such as public interest. Both the HKSE and SFC have pledged to steer way from making verbal and drafting comments and will work together to avoid duplication of comments.

### Why buy directors' and officers' liability insurance?

Claims from employees, clients, stockholders, creditors or liquidators may be made against any company and against the directors and officers of a company. Since a director or officer can be held responsible for acts of the company, most directors and officers will want to be covered rather than risk their personal assets. A major benefit of having a D&O liability insurance policy is to protect directors and officers from litigation and provide a legal defence should such litigation that may arise in the conduct of their duties. Protection of directors and officers by purchasing appropriate insurance coverage is also in compliance (but not mandatory) with the Hong Kong Stock Exchange's Listing Rules. What is appropriate insurance cover depends heavily upon the nature of the issuer's business.

Board of directors should not risk their personal assets to serve as a corporate director or officer without D&O liability insurance coverage.

### What does directors' and officers' liability insurance cover?

Defence costs, damages, judgments, settlements, civil fines and penalties resulting from a claim arising out of actual or alleged acts, errors, omissions, misstatements, neglect, or breaches of duty committed or allegedly committed by a director or officer are covered with D&O liability insurance.

Key Protection provided by a D&O policy includes the following key extensions:

- i) *Worldwide Coverage* – covers wrongful acts committed, claims made and investigations commenced anywhere in the world.
- ii) *Advancement of Defence Costs* – extends to provide coverage for defence costs prior to the final settlement of the claim. Allegations of wrongful acts or threats of litigation may lack merit or reasonable grounds for success. Whether or not the director or officer is ultimately held liable for allegations of wrongdoing, such actions require legal defence. By virtue of this extension, the policy advances defence costs subject to the policy terms and conditions. If, ultimately, defence costs are advanced for a matter not covered by the insurance, then such a need is to be repaid to the insurer.
- iii) *Investigation Costs* – can be incurred by a director or officer arising from a need to prepare for, attending or providing documents, with respect to an investigation by a regulatory body. An investigation generally is defined to mean an official investigation, examination or inquiry in relation to the affairs of the company at which the attendance of its director or officer is required.

A D&O policy is also designed to provide automatic coverage to directors and officers for liabilities which may arise out of the following:

- a) *Acquisition of a New Subsidiary* – a D&O liability insurance can automatically cover directors and officers of new subsidiaries subject to certain parameters.
- b) *Offering of Securities* – provides coverage to directors and officers of a company for claims arising out of an offering or placement of its securities subject to certain parameters.
- c) *Merger or Acquisition* – specific policy features provide discovery period or run-off coverage for directors and officers up to six years or the relevant statute of limitations, should the company be majority sold to, or merged with another entity..

### What are the Roles of Brokers?

Because D&O liability insurance is a sophisticated and somewhat complex insurance product, only certain insurance brokers have an expertise and comfort level in providing advice to clients and placing the business.

### How do you select an insurer?

There are several factors to consider such as:

- Evaluate the policy form, including the declarations, all endorsements, and the proposal form.
- Evaluate the financial strength and integrity of the insurer. Your insurance broker should have objective data on these.
- Evaluate the insurer's underwriting and claims-handling abilities in the D&O area. You can get this information from your insurance broker.
- Evaluate the premium level in relation to the limits of liability offered and applicable deductions or retentions. Price should not be a key factor in the purchasing decision in the D&O area when one considers the potential exposures to the management of a corporation.

Some additional tips on purchasing **directors' and officers' liability** insurance:

- Allow sufficient time before the IPO for an underwriting review by insurers.
- Select an insurance broker/advisor with this specialised knowledge and experience working with IPO risk and cover.
- Be aware of claim scenario involving an IPO or listed companies. An experienced insurance broker can advise you on these areas.
- Work with your insurance broker to determine an appropriate level of cover (policy limit). An experienced broker can provide benchmarking data and advice on this.
- Coverage and pricing terms are negotiable. Work with your insurance broker to arrange a suitable policy for your company.
- Respond to the underwriter's questions (through your insurance broker) promptly.
- Complete insurer proposal form and provide all requested information. Do not view the application process as a burdensome paperwork requirement, but as an important process for this protection. Be accurate and truthful in answering questions on the application (including any prior claim or circumstance). Misstatements may cause the policy to be void.
- Make certain that any prior incidents that might potentially give rise to a claim are reported on your application to a new carrier as well as to your existing carrier. Claims stemming from known incidents will be excluded under your new policy.

### 1. Operational Risks

Operational risks can be characterised as stemming from breakdowns in a company's internal procedures and those overseeing them. The first step should be to closely examine the company's management and shareholders. Several questions should be asked, including:

- Are there a high proportion of related family members amongst the owners?
- Are personal and professional connections between shareholders clearly disclosed?
- Is the senior management appropriately qualified to hold the roles they have in the company? Have they demonstrated integrity and business acumen?
- Do the key principals hold potentially conflicting business interests?
- Is there a co-location of multiple related businesses or an unclear separation of entities that are not part of the IPO?

Operational issues may extend beyond the confines of the company's immediate management or ownership, and involve related parties, nominees, purported customers, local government officials and regulatory authorities. It is therefore crucial for comprehensive due diligence efforts to locate any other business interests connected to the shareholders or senior management of the company. In addition, it is helpful to include reviews of a target company's major suppliers and customers, as issues found with these can often be a key indication of fraud or financial misrepresentation. In the case of customers and suppliers, this would ideally include confirmation that they actually exist.

### 2. Reputational Risks

Public domain research is the first step to obtaining a comprehensive understanding of any reputational risks relating to a target company and its key principals. This includes a search and analysis of the local language press reports, trade journals, industry association notices, local government bureau announcements and even social media posts. Such research should focus on determining:

- If the company has been involved in any civil litigation, either currently or historically (note that information on criminal records is not available in the public domain in most countries in Asia, though it is unlikely key principals of a substantial company will have a criminal record);
- If the company has been involved in any publicized disputes with its industry peers, clients, joint venture partners, own workforce, local neighbouring enterprises, etc.;
- If the company has been accused of fraudulent activities; and
- If the key principals at the company have notable political connections, which have the potential to damage the company in the future.

### 3. Regulatory & Sanctions Risks

Due diligence efforts, should include attempts to uncover whether the target company (and/or its key principals) are currently under investigation, or likely to be in the future; by the relevant State authorities (for example the increasingly active Central Commission for Discipline Inspection in China) or by local regulatory offices. Related to this, efforts should be made to establish if any key licenses or assets (for example in the case of former State Owned Enterprises), were obtained via non-compliant means. Environmental issues such as pollution should also be examined to identify issues that may potentially lead to regulatory risk in the future.

Consideration also needs to be given for the potential for key principals being drawn into regulatory investigations in relation to previous business activities or relationships with government officials. Furthermore, attempts should be made to identify if the company is dealing with any sanctioned entities or

jurisdictions. Whilst not an obvious issue for some Hong Kong IPO's, these will have reputational issues for the investment bank concerned if they are regulated by US or other authorities with strict sanctions policies in place.

### The Due Diligence Process

Addressing the issues outlined involves a combination of investigative research, public records retrieval and discreet interviews with knowledgeable sources. The service provider will typically begin by collecting, collating, and analysing information from a wide variety of sources, such as:

#### 1. Research and Public Records

Local corporate records, which are an essential cornerstone of any due diligence effort, once obtained, such records allow cross checking of information originally provided by a target company, such as confirming business addresses and scopes of work. For instance, does the company purport to have a factory in a commercial building? Do apparently independent entities share a common address or point of contact?

A search and analysis of social media and forum postings can be extremely useful. If the company is providing a service or supplies a well-known product, which is likely given its application for an IPO, it is probable that people will have commented on it online.

Sometimes, a lack of information can be a red-flag in itself. Do the companies have little to no exposure in the public domain? Is there little evidence of the company operating in its particular geographical location or industry sector?

#### 2. Inquiries

Discreet inquiries seek to gather human intelligence from a variety of people, including industry, government, and regulatory sources, who are well-placed to provide insight into the company and its principals.

This is often where the most valuable information is obtained, and it is a delicate exercise in asking the right questions to the right people. It is from such inquiries that it is possible to uncover information that would not be available from financial data or in the public domain, such as additional colour on previous partnerships, related entities or subsidiaries, connections with government officials or agencies, and corruption or bribery related issues.

In addition, discreet site visits are invaluable to get an accurate picture of a target company's genuine locations, and the size, and operational activity of these facilities. As multiple short seller reports have shown, creation of fake facilities and falsely reported levels of operational activity (including staff numbers) is still commonplace.

### The advantages of third party providers over in-house teams

For most of these sponsors, it is not financially viable to retain a substantial team of due diligence researchers and field investigators on a full-time basis. When conducting pre-IPO due diligence, it may be necessary to investigate a large number of individuals and associated entities, which requires significant manpower and expertise over a short period of time. However, the sponsor may only work on a small number of such deals in any given year, making it difficult to maintain an in-house team.

The third party provider also has the crucial advantage of objectivity. Regardless of the operational precautions put in place, an in-house due diligence team will inevitably have subtly different incentives for reporting information to the deal team. This may not entail direct pressure, but it is likely that the level

contribution of investor education – often played a critical role in generating investor interest in an upcoming issue and had a substantial impact on the offering's success.

More recently, efforts to cultivate an investor base for an offering now begin even further in advance. This lengthening of the investor engagement process and outreach is partly due to the listing process becoming ever more visible. As competition for investor interest intensifies, the market has developed higher IPO expectations, and regulatory scrutiny is accelerating at the same pace. In the past when listing candidates and sponsors submitted an initial IPO application to the Stock Exchange of Hong Kong (SEHK), the application was kept confidential. Nowadays the applications for listings are posted on the exchange's website for all to see, making it vital for banks to act quickly to measure and build investor interest in a potential IPO.

Typically, syndicate banks will begin engaging potential cornerstone and anchor investors once the Application Proof has been filed with the SEHK. Investors will also begin engaging with the banks and the company's management through a series of management meetings and site visits, and will conduct operational and financial due diligence as required to formulate a decision on a cornerstone or anchor investment. The lengthened investor engagement process is also a result of the market placing more emphasis on cornerstone and anchor investors – high-profile players who essentially agree to participate in the offering at the early stages of the deal, prior to the actual listing.

In the Hong Kong context, cornerstone investors typically include business or strategic partners of the listing candidate, major Chinese corporations, select institutional investors and sovereign wealth funds. These cornerstone investors can typically take anywhere from 30 to 40 percent of an offering. They are guaranteed allocations of shares from the IPO in return for agreeing to participate up to the top end of the price range and to hold the shares for a designated 'lockup' period during which they cannot be sold – in the Hong Kong context, usually six months. What is more, the identities of cornerstone investors are also disclosed in the IPO prospectus and vetted closely by the SEHK. Around the same time or shortly after cornerstone investors are secured by the lead underwriters, the management roadshow for a broader range of global institutional investors begins.

#### HK IPOs with Cornerstone Participation > US\$200mm since 2013

Date	Issuer	Cornerstones			
		Tranche #	% of Base (US\$mm)	Deal Cornerstone (US\$mm)	
2-Dec-14	CGN Power	18	1,331	42%	CSG International (100), CYPC International (100), CLP Nuclear(51), CDB International (110), GIC (100), OZ (100), Value Partners (100), Hillhouse (100), China Reinsurance (75), China Life (75), Cinda Sinorock (50), China Alpha (50), Minmetals (50), North Industries (50), Beijing Jingneng (50), Chow Tai Fook (30), E Fund (100), Guangzhou Fund (40)
3-Jul-14	Luye Pharma Group	6	280	37%	Dragon Billion China Master Fund (50), MQ Funds Mgmt HK Ltd (25), Minmetals (25), OribMed Advisors (50), TAL China Focus Master Fund (30), Value Partners (100)
25-Mar-14	Harbin Bank	7	513	45%	Fubon Life Insurance (289), CITIC Capital HB Investment (150), China Fortune Finance Holdings(20), Wah Tao International Fund Limited (20), Chongqing Tian Tai Real Estate Development (13.8), Boom Win Holdings Limited (10), Introwell Limited(10)
22-Jan-14	HK Electric Investments	2	1,150	37%	State Grid (1100), Oman Investment(50)

Date	Issuer	Cornerstones			
		Tranche #	% of Base (US\$mm)	Deal Cornerstone (US\$mm)	
13-Dec-13	China Everbright Bank	19	1,744	58%	China Shipping Group(800), Chinese Estates(100), The Prudential Insurance (50), Sun Life Assurance Company of Canada (50), Zhongrong International (200), TEDA (80), Wenze (70), China Oceanwide Int'l (67), Sinochem (66), Shanghai Electric Group (30), Sany Int'l (30), C.N. Team Ltd (Ms Wu Xiuli) (30), Mr. Huo Qing Hua (30), Mr. Chen Hua Wei(30), China Chengton (ABCI QDII) (30), Hongkong Energy Group (Mr. Sun Pei Hua) (30), Lina Wang(30), Sun Hung Kai Strategic Cap (10), First Asian (wholly owned by United Asia Finance) (10)
12-Dec-13	China Conch Venture	5	233	50%	CNBM (96), TCC(49), Asia Cement (38), Hillhouse (38), Linda Cheung (13)
5-Dec-13	China Cinda Asset Management	10	1,082	44%	China Life Insurance (200), OZ (200), Norges (150), Farallon (100), Haixia Fund (100), Shen Zhen Rongtong (100), Ping An (75), Shandong State owned Assets Investments (60), Oaktree (53), Yuedean (50)
5-Dec-13	Qinhuangdao Port	7	240	43%	Zhongrong Trust (50), China Coal (40), China Communications Construction (30), China Datang (30), Guodian Fuel (30), Zhejiang Energy (30), China Taiping Insurance (30)
6-Nov-13	Huishang Bank	6	585	49%	Vanke Property (401), Chow Tai Fook (25.7), Jiangsu Huijin (62.2), Genertec Capital (30), Peaceland / Mr. Xu Ping (56.2), Kan Hung Chih (10)
19-Sep-13	China Huishan Dairy Holdings	3	214	16%	Norges (124), Yili (50), COFCO(39.5)
16-May-13	Sinopec Engineering	7	350	19%	China Shipping (100), China Aerospace (60), Aerospace Science & Technology Finance (50), China Export & Credit Insurance (50), Zhongrong International Trust (50), Albertson Capital (30), CAMCE(10)
15-May-13	China Galaxy Securities	7	360	34%	Khazanah (100), Sinopec (80), AIA (50), Sino Life Insurance (50), China Life Insurance (30), Genertec (30), China Cinda (HK) Asset Management (20)
24-Jan-13	Chinalco Mining Corp International	5	240	60%	Trafigura Beheer (Urion) (100), Hongfan Group (30), Tongling Nonferrous Metals Group (50), Louis Drefus Commodities Metals Suisse(30), Rio Tinto(30)

Source: Company prospectus as of December 15, 2014

In a highly developed and regulated market home to firms with strong growth potential such as Hong Kong's, investors have learned to expect the participation of cornerstone investors in IPOs, as they feature in most of the city's major listings – CGN Power Co. and Dalian Wanda Commercial Properties' IPOs being just two recent examples. Investors find the presence of cornerstone investors reassuring; they not only represent high-profile votes of confidence in the listing candidate but are also seen as stabilizing forces that can mitigate the risks of volatility associated with a deal ahead of its launch.

A strong cornerstone investor base is often perceived by the retail investment community as a 'stamp of approval' from the largest, savviest market players, who tend to invest with a longer-term perspective. An IPO arriving to market with a solid list of cornerstone participants is akin to a new movie boasting a roster of previous Oscar winners – and sends a message to the market that the IPO is likely to be successful and that the company's shares are set to perform well after their debut. Conversely, a sponsor's failure to secure commitments from cornerstone investors can sometimes sink an IPO, as the issue is perceived by the public as lacking momentum and investor interest. Given the increasingly high stakes and evolving demands of the market, banks underwriting the offering will typically begin to sound out potential cornerstone or anchor investors two to three months before pricing.



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## CHAPTER 4

# 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 the 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. This chapter discusses some of the specific listing issues that may be encountered by potential issuers. In particular, as mainland enterprises form a substantial portion of Hong Kong's stock market, this chapter highlights some common issues those businesses experience when listing in Hong Kong.

### 1. Listing of a PRC business – red chip or H-share?

#### 1.1 What is meant by "red chip" and "H-share"?

People's Republic of China ("PRC") businesses listed on The Stock Exchange of Hong Kong Limited ("HKEx") 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 business in the PRC, and which are usually controlled by PRC entities. Listing a PRC business is generally more complicated than other listings in Hong Kong as relevant PRC approvals may be required for the reorganisation and listing process.

#### 1.2 Circular 10 – A hurdle to overcome for red chip listings

Historically, the PRC regulatory process for the reorganisation and 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 ("SAFE") on August 8, 2006. It came into effect on September 8, 2006 and was amended by MOFCOM on June 22, 2009. By virtue of Circular 10, MOFCOM's approval is required at various stages of a red chip listing, including:

<b>Specified Penalties for Violations</b>	In contrast with Circular 75, Circular 37 sets out specific penalties for various violations. In particular, Circular 37 expressly provides that prior to the implementation of Circular 37, if a PRC resident has already contributed capital to a SPV without a proper foreign exchange registration, the PRC resident should explain the reasons for failing to register and make remedial registration. SAFE will determine whether to accept the remedial registration and impose administrative penalties on any violation of foreign exchange regulations. <sup>13</sup>
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#### 1.4 Relaxation of the “4-5-6 requirements” – a new era for H-share listing

Pursuant to the CSRC’s rule issued in July 1999, enterprises must have RMB400 million of net assets, raise US\$50 million of funds, and have an after-tax profit of not less than RMB60 million before they can apply for listing on overseas main boards, including Hong Kong’s.<sup>14</sup> These are commonly referred to as the “4-5-6 requirements”. During the IPO boom year of 2007, it was widely reported that CSRC had adopted an unofficial policy of approving an H-share listing only if the amount to be raised exceeded US\$1 billion or if the company was willing to do a dual-listing in the mainland.<sup>15</sup> As a result, the trend over the past few years has been for mega-PRC enterprises to conduct “A + H dual listings” on the Shanghai and Hong Kong stock exchanges. For less sizable PRC businesses, they are more commonly listed in Hong Kong by way of red chip listings.

Further to Supplement IX to the Closer Economic Partnership Arrangement (CEPA) which was signed on June 29, 2012, the CSRC promulgated the Guidelines for Supervising the Application Documents and Examination Procedures for the Overseas Stock Issuance and Listing of Joint Stock Companies (No. 45 [2012] of the CSRC) to lift the “4-5-6 requirements” and simplify the approval procedures for overseas listings. The relaxation took effect on January 1, 2013. As CSRC is loosening its grip on overseas IPO applications, H-share listings are opening up to smaller issuers. From January 2013 to October 2014, there have been 23 new H-share issuers on the Main Board of the Stock Exchange, one of which has a market capitalisation of only around HK\$160 million.<sup>16</sup>

#### 1.5 Red chip or H-share?

With the abolition of the “4-5-6 requirements”, the distinction between H-share and red chip listing is diminishing. Here is a summary of the comparison between red chip and H-share listing on the HKEx:

<sup>13</sup> Article 12 of Circular 37

<sup>14</sup> The Notice on Relevant Issues Concerning Enterprises’ Application for Overseas Listing (No.83 [1999] of the CSRC) issued on July 14, 1999.

<sup>15</sup> “China ups the ante against HK listing” (2007) Financial Times, 16 April.

<sup>16</sup> List of H Share Companies (Main Board), available at [www.hkex.com.hk/eng/stat/smstat/chidimen/cd\\_hmb.htm](http://www.hkex.com.hk/eng/stat/smstat/chidimen/cd_hmb.htm)

	Red chip	H-share
<b>Listing vehicle</b>	No specific requirements. Any recognised/acceptable jurisdiction can serve as the listing vehicle. The most common listing vehicles are Cayman Islands and Bermuda companies.	Must be a PRC joint stock company.
<b>Key legal obstacle</b>	The listing group needs to undergo restructuring to inject domestic assets/business into an offshore structure, which may be restricted by Circular 10 and Circular 37.	Approval from the CSRC is required.
<b>Financial tests</b>	Same. Previous 4-5-6 requirements applicable to H-share listing have been abolished.	
<b>Restriction on circulation</b>	Subject to lock-up requirements, all securities can be freely circulated.	Domestic shares held by founders cannot be circulated outside PRC without CSRC approval. The regulatory authorities are exploring full circulation of H-shares. <sup>17</sup>
<b>Lock-up period</b>	Pursuant to the Listing Rules, controlling shareholders cannot sell any of their shares 6 months from the date of listing; and within the 6 months thereafter, controlling shareholders cannot sell their shares to the extent of losing the controlling status.	Apart from the requirements under the Listing Rules, according to PRC Company Law, shares issued before listing cannot be transferred within one year from the date of listing.
<b>Issue after listing</b>	Pursuant to the Listing Rules, a listed company cannot issue new shares within six months after listing. Generally speaking, approval from PRC authorities is not required for issue of shares after listing. Future financing is more flexible.	Apart from the requirements under the Listing Rules, an H-share listed company requires approval from the CSRC every time when it issues new shares.
<b>Ease of Future Financing</b>	Subject to the lock-up restrictions, controlling shareholders generally can charge their shares for their own borrowings.	The shares held by controlling shareholders are domestic shares, which are not freely tradeable on the stock exchange. Lenders are less likely to accept domestic shares as security for lending.

<sup>17</sup> “Charles Li: Full Circulation of H Shares Undergoing the Final Decision-Making Stage” (李小加：內地就 H 股全流通方式上市已進入後期決策階段), infocast, 4 March 2014