



HAN KUN LAW OFFICES

# Legal Commentary



CHINA PRACTICE • GLOBAL VISION

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## HKEx Updates Listing Decision on Contractual Arrangements

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In 2005, the Hong Kong Exchanges and Clearing Limited (the “**HKEx**”) issued a listing decision (cited as HKEx-LD43-3, the “**Listing Decision**”) regarding a listing applicant incorporated outside Hong Kong (the “**Applicant**”), which controls an entity that is incorporated inside China (the “**OPCO**”) to run business via contractual arrangements. HKEx should determine whether the Applicant has demonstrated the legality of contractual arrangements and whether it has the ability to ensure the sound and proper operation of the contractual arrangements based on the material facts and the PRC legal opinion. If the decision were positive, HKEx should adopt a disclosure-based approach to deal with the application, and so long as appropriate disclosures in terms of contractual arrangements and the risks associated therewith were included, the Applicant as well as its business should be suitable for listing.

In November 2011, HKEx adopted an amendment to the Listing Decision, pursuant to which, in principle, HKEx should accept contractual arrangements on a case-by-case basis when assessing a listing application. If the business covered by the contractual arrangements is not restricted to or prohibited from foreign investment in accordance with applicable PRC laws and regulations, the Listing Division of HKEx should normally refer the case to the Listing Committee of HKEx. Meanwhile, HKEx further requests that (1) the Applicant should disclose the rationale for adopting the contractual arrangements; (2) the Applicant should unwind the contractual arrangements as soon as the law allows the business to be operated without contractual arrangements; and (3) the Applicant should follow a series of provisions to ensure the proper implementation of contractual arrangements.

In August 2012, HKEx adopted another amendment (the “**Amendment**”) to the Listing Decision, clarifying the disclosure requirements of the contractual arrangements in prospectus. We will interpret the provisions of the Amendment with reference to certain arrangements of Flying Financial Service Holdings Limited (Stock code: 8030) (“**Flying Financial**”), a newly listed company in HKEx adopting the contractual arrangements.

S/N in the Listing Decision	Mandatory Disclosures regarding the Contractual Arrangements in the Prospectus	Note/Interpretation/Solution
19a	Detailed discussion about the OPCO's registered shareholders and a confirmation that appropriate arrangements have been made to protect the Applicant's interests in the event of death, bankruptcy or divorce of the OPCO's registered shareholders to avoid any practical difficulties in enforcing the contractual arrangements.	<p>Given the nature of "personal cooperation" of a limited liability company, it can be provided in the OPCO's articles of association that in the event of death of a registered individual shareholder, his/her lawful heir(s) shall not have the right to inherit the shareholder's right; or otherwise, relevant inheritance issues can be demonstrated in prospectus and a confirmation from the heir(s) of the registered individual shareholder of OPCO consenting to execution of the structured contracts can be included in the structured contracts. Please refer to relevant disclosures on page 67 of Flying Financial's prospectus.</p> <p>PRC laws and regulations have yet to regulate individual bankruptcy.</p> <p>A letter from spouse of a registered shareholder of OPCO waiving his/her claim to OPCO's respective equity interest as jointly owned property can be included in the structured contracts; or otherwise, a commitment from the spouse covenanting to cooperate with OPCO to execute the structured contracts in case he/she acquires respective equity interest of OPCO due to divorce with a registered shareholder of OPCO.</p>
19b	The extent to which the Applicant has arrangements in place to address the potential conflicts of interest between the Applicant and the OPCO's registered shareholders, particularly in cases where these shareholders are officers and directors of the Applicant.	<p>The Applicant can designate any third party to become or serve as registered shareholder, legal representative and/or director of OPCO to avoid abusing of shareholder rights by founders of OPCO.</p> <p>The business license, official seal and other important documents and seals can be kept by a wholly foreign-owned enterprise (the "WFOE") established by the</p>

S/N in the Listing Decision	Mandatory Disclosures regarding the Contractual Arrangements in the Prospectus	Note/Interpretation/Solution
		<p>Applicant or any third party designated by the Applicant.</p> <p>Fully exercise of shareholder rights authorized by OPCO's registered shareholder to the WFOE in accordance with a power of attorney. Please refer to relevant descriptions on page 67 of Flying Financial's prospectus.</p> <p>The articles of association or other corporation governance documents of the Applicant can provide the withdrawal system for directors/senior management.</p>
19c	Bases why the directors believe that each of the agreements conferring significant control and economic benefits from the OPCO to the Applicant is enforceable under the PRC and local law.	PRC counsel to issue PRC legal opinion. Please refer to relevant descriptions from page 68 to 69 of Flying Financial's prospectus.
19d	The economic risks the Applicant bears as the primary beneficiary of the OPCO, in what way the Applicant shares the losses of the OPCO, the circumstances that could require the Applicant to provide financial support to the OPCO, or other events or circumstances that could expose the Applicant to losses.	It can be provided in the structured contracts that the Applicant promises to provide (or via WFOE) unlimited financial support to OPCO.
19e	A discussion on whether the Applicant has, to date, encountered any interference or encumbrance from any PRC governing bodies in operating their business through the OPCO under the contractual arrangements.	Disclosure requirement

<b>S/N in the Listing Decision</b>	<b>Mandatory Disclosures regarding the Contractual Arrangements in the Prospectus</b>	<b>Note/Interpretation/Solution</b>
19f	The limitations in exercising the option to acquire ownership in the OPCO, include a separate risk factor explaining these limitations, and clarifying that ownership transfer may still subject to substantial costs.	To include an independent risk factor, disclosing relevant risks and limitations in connection with exercise of exclusive call option by WFOE to acquire OPCO's equity interest from registered shareholder of OPCO. Please refer to relevant descriptions from page 65 to 66 of Flying Financial's prospectus.
19g	The contractual arrangements as material contracts in the "Statutory and General Information" section and make them available on the Applicant's website, or to justify and disclose the basis of not doing so.	Disclosure requirement
19h	Corporate structure table in the "Summary" section for the purpose of illustrating the contractual arrangements and facilitating investors' review and understanding of the arrangements.	Disclosure requirement

HKEx further regulates the disclosure requirement in the risk factor section of the prospectus regarding the contractual arrangements, requiring that all risks in relation to the contractual arrangements should be disclosed under one risk factor, and at least include the followings:

1. The PRC government may determine that the contractual arrangements do not comply with applicable regulations;
2. The contractual arrangements may not provide control as effective as direct ownership;
3. The domestic shareholders may have potential conflicts of interest with the applicant; and
4. Contractual arrangements may be subject to scrutiny of the PRC tax authorities and additional tax may be imposed.

A full text of the Amendment and the Listing Decision are attached hereto for your reference.

Flying Financial's prospectus can be obtained from

<http://gem.ednews.hk/listedco/listconews/GEM/2012/0420/GLN20120420014.pdf>.

In consideration of the recent incidents with respect to the contractual arrangements and the risks involved, obviously the Amendment is aimed at regulating such risks, and the Amendment also emphasizes the disclosure requirements at the same time. We think HKEx should also believe that fundamental risk of the contractual arrangements cannot be eliminated for now and thus, a full disclosure approach would probably be the best option to protect investors at this stage. While U.S. Securities and Exchange Commission is now conducting an investigation on New Oriental's change to its contractual arrangements, the issuance of Amendment at this moment evidences attention to contractual arrangements from both U.S. and Hong Kong two major capital markets. Thus, it is advisable that PRC companies that have listed or are considering to be listed overseas, shall seek advice from their PRC counsels prior to creation of or effect of any change to the contractual arrangements in order to avoid any unnecessary trouble.

## HKEx LISTING DECISION

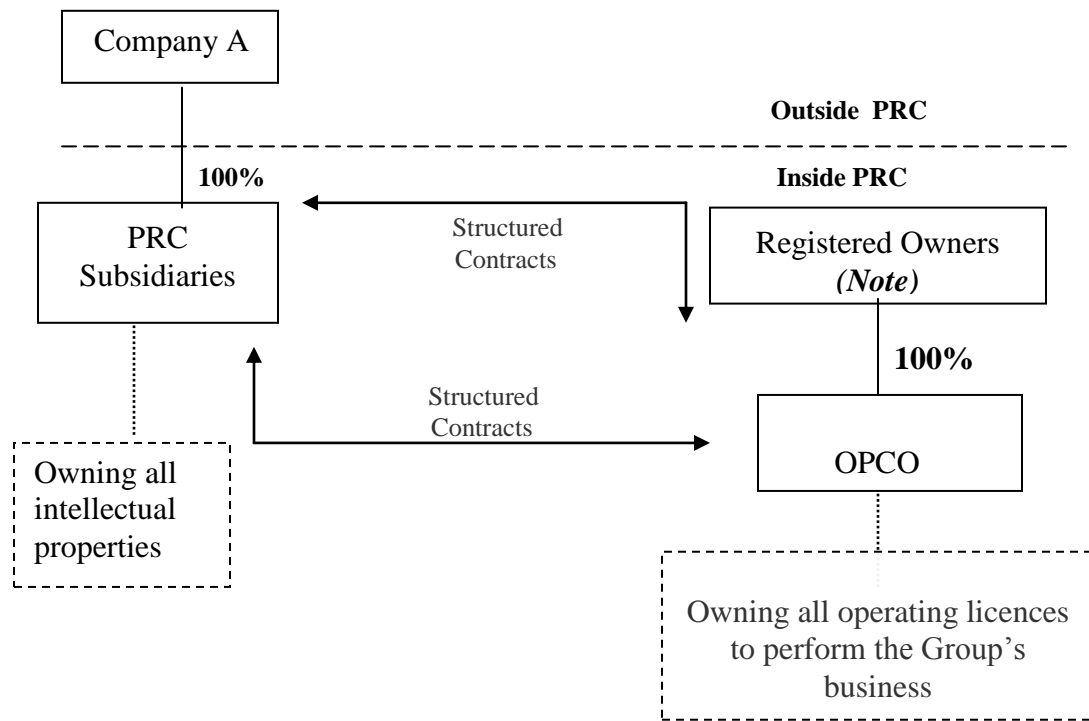
Cite as HKEx-LD43-3 (First Quarter of 2005, updated in November 2011 and August 2012)

Summary	
<b>Name of Parties</b>	<p><b>Company A</b> - a Main Board listing applicant</p> <p><b>Group</b> - Company A together with its subsidiaries</p> <p><b>PRC Subsidiaries</b> - subsidiaries of Company A with substantially all operations in the PRC</p> <p><b>OPCOs</b> - companies incorporated in the PRC and owned by the Registered Owners</p> <p><b>Registered Owners</b> - shareholders of the OPCOs who were PRC nationals and controlling shareholders of Company A</p>
<b>Subject</b>	Whether, in view of the fact that, in the conduct of its business in the PRC, Company A was a party to a number of contract-based structures (“Contractual Arrangements”) between or among Company A, the PRC Subsidiaries, the OPCOs and the Registered Owners, Company A was unsuitable for listing due to legal questions associated with the Contractual Arrangements?
<b>Listing Rules</b>	Rules 1.01; and 8.04
<b>Decision</b>	The Exchange determined that the Contractual Arrangements would not render Company A unsuitable for listing.

### SUMMARY OF FACTS

1. Company A was incorporated outside Hong Kong. The Group operated a business in the PRC, and PRC regulations applicable to its industry sector limited foreign investment.
2. Therefore, the Group did not possess the licences required to operate its business in the PRC. However, the Group adopted Contractual Arrangements designed to give the various rights listed in paragraph 4. The Contractual Arrangements were binding on Company A, the PRC Subsidiaries, the OPCOs and the Registered Owners.

3. A brief diagram illustrating the Contractual Arrangements is set out below:-



**Note:** The Registered Owners were controlling shareholders of Company A

4. The Sponsor submitted that the Contractual Arrangements were designed specifically to confer upon the Group :-

- a. the right to enjoy all the economic benefit of the OPCOs, to exercise management control over the operations of the OPCOs, and to prevent leakages of assets and values to shareholders of the OPCOs;
- b. the right to all intellectual properties through assignments from the OPCOs;
- c. the right to consolidate the financial results of the OPCOs as if they were wholly-owned subsidiaries of the Group under prevailing accounting principles;
- d. the right to acquire, if and when permitted by PRC law, the equity interests in and/or assets of the OPCOs for a nominal price or a pre-paid amount; and
- e. a first priority security interest in the OPCO shares owned by the Registered Owners, as security for the proper performance of the Contractual Arrangements.

5. The Sponsor confirmed that Company A had satisfied all conditions for listing under the Listing Rules (save for waivers sought) and no alteration of the confirmation was necessary by reason of the existence of the Contractual Arrangements. The Sponsor intended to disclose full details of the Contractual Arrangements in the prospectus.
6. The PRC legal adviser of Company A issued an opinion that the Contractual Arrangements complied with PRC laws, rules and regulations, including those applicable to the business of Company A, the PRC Subsidiaries and the OPCOs, and complied with the articles of association of the PRC Subsidiaries.
7. The reporting accountants of Company A confirmed that it had the right to consolidate the financial results of the OPCOs as if they were wholly-owned subsidiaries of the Group under prevailing accounting principles.

#### **THE ISSUE RAISED FOR CONSIDERATION**

8. Whether, in view of the fact that, in the conduct of its business in the PRC, Company A was a party to the Contractual Arrangements between or among Company A, the PRC Subsidiaries, the OPCOs and the Registered Owners, Company A was unsuitable for listing due to legal questions associated with the Contractual Arrangements?

#### **APPLICABLE LISTING RULES OR PRINCIPLE**

9. Rule 1.01 states that ‘subsidiary’ includes ‘any entity which is accounted for and consolidated in the audited consolidated accounts of another entity as a subsidiary pursuant to applicable Hong Kong Financial Reporting Standards or International Financial Reporting Standards.
10. Rule 8.04 provides that in the opinion of the Exchange both the issuer and its business must be suitable for listing.

#### **THE ANALYSIS**

11. When considering Company A’s suitability for listing under Rule 8.04, the Exchange reviewed whether the Group’s business operations, including the use of the Contractual Arrangements, complied with all applicable laws and regulations.
12. In the review, the Exchange continued its established practice of utilizing a principally disclosure-based approach. Under this approach, the sponsor and the directors of Company A had to demonstrate, by a clear preponderance of the



materials submitted for review, that it had complied in fact and in good faith with all relevant PRC laws and regulations. If Company A could meet this burden it would not be considered unsuitable for listing on the Exchange by reason of the Contractual Arrangements.

13. In this case, the Exchange adopted the following standard of review:-
  - a. the Listing Rules and Listing Division policies would be strictly construed;
  - b. the Contractual Arrangements should be narrowly tailored to achieve the applicant's business purposes and minimize the potential for conflict with relevant PRC laws and regulations. Wherever possible, the listing applicant would be required to demonstrate genuine efforts to comply with applicable laws and regulations. Evidence to the contrary would tend to indicate a higher risk of the contractual arrangements being considered non-compliant with relevant laws and regulations;
  - c. a broad review of all relevant facts and circumstances concerning the listing applicant would be undertaken by the Exchange, including a review of its legal and compliance history (if any), its management systems and corporate governance practices, its records in protecting shareholder interests and its financial resources to ensure compliance with the applicable laws and regulations. If material uncertainties were identified in the areas of the applicant's business, a higher level of assurance with respect to the arrangements would be required; and
  - d. subject to availability and practicability, appropriate regulatory assurance should be obtained from the relevant regulatory authorities. In the absence of such regulatory assurance, the applicant's legal counsel would be required to make a statement to the effect that in its legal opinion all possible actions or steps taken to enable it to reach its legal conclusions had been taken. In consultation with the applicant and the sponsor, other relevant forms of assurance could be considered.
14. Based on the submissions of the Sponsor which were supported by professional opinions from the PRC legal advisers and the reporting accountants, Company A had demonstrated that it had satisfied the above requirements. Consequently, the Exchange determined that the Contractual Arrangements were legal and binding and that Company A had the ability to ensure the sound and proper operation of the Contractual Arrangements. Given that there would be full disclosure of the Contractual Arrangements in the prospectus, the Exchange determined that Company A or its business would not be rendered unsuitable for listing by reason of the use of the Contractual Arrangements.

## THE DECISION

15. The Exchange continued to adopt a disclosure-based approach in considering Company A's listing application. Based on the material facts and the PRC legal opinion as submitted, the Exchange determined that Company A had demonstrated the legality of the Contractual Arrangements and its ability to ensure the sound and proper operation of the Contractual Arrangements. Subject to appropriate disclosures in the prospectus of the Contractual Arrangements and the risks associated therewith, the Exchange determined that Company A was suitable for listing.

## **SUBSEQUENT DEVELOPMENT** *(Paragraphs 16 to 18 added in November 2011; paragraphs 19 to 20 added in August 2012)*

16. In a review in 2011, the Listing Committee confirmed the practice of allowing Contractual Arrangements (also commonly known as Structured Contracts) on a case-by-case basis after full consideration of the reasons for adopting such arrangements and subject to the conditions in this listing decision.
17. If non-restricted businesses are involved, the Listing Division will normally refer the case to the Listing Committee.
18. In addition to the matters in paragraph 13, the Exchange requires any applicant using Structured Contracts and its sponsor to:
  - a. provide reasons for the use of Structured Contracts in its business operation;
  - b. unwind the Structured Contracts as soon as the law allows the business to be operated without them;
  - c. ensure that the Structured Contracts:
    - (i) include a power of attorney by which the OPCO's shareholders grant to the applicant's directors and their successors (including a liquidator replacing the applicant's directors) the power to exercise all rights of the OPCO's shareholders, including the rights to vote in a shareholders' meeting, sign minutes, file documents with the relevant companies registry;
    - (ii) contain dispute resolution clauses that:
      - provide for arbitration and that arbitrators may award remedies over the shares or land assets of OPCO, injunctive relief (e.g. for the conduct of business or to

compel the transfer of assets) or order the winding up of OPCO;

- provide the courts of competent jurisdictions with the power to grant interim remedies in support of the arbitration pending formation of the arbitral tribunal or in appropriate cases. The courts of Hong Kong, the applicant's place of incorporation, the OPCO's place of incorporation, and the place where the applicant or the OPCO's principal assets are located should be specified as having jurisdiction for this purpose; and

(iii) encompass dealing with the OPCO's assets, and not only the right to manage its business and the right to revenue. This is to ensure that the liquidator, acting on the Structured Contracts, can seize the OPCO's assets in a winding up situation for the benefit of the applicant's shareholders or creditors.

19. An applicant using Structured Contracts for the entire or part of its business should disclose the following information concerning the Structured Contracts in its prospectus:

- a. Detailed discussion about the OPCO's registered shareholders and a confirmation that appropriate arrangements have been made to protect the applicant's interests in the event of death, bankruptcy or divorce of the OPCO's registered shareholders to avoid any practical difficulties in enforcing Structured Contracts.
- b. The extent to which the applicant has arrangements in place to address the potential conflicts of interest between the applicant and the OPCO's registered shareholders, particularly in cases where these shareholders are officers and directors of the applicant.
- c. Bases why the directors believe that each of the agreements conferring significant control and economic benefits from the OPCO to the applicant is enforceable under the PRC and local law.
- d. The economic risks the applicant bears as the primary beneficiary of the OPCO, in what way the applicant shares the losses of the OPCO, the circumstances that could require the applicant to provide financial support to the OPCO, or other events or circumstances that could expose the applicant to losses.
- e. A discussion on whether the applicant has, to date, encountered any interference or encumbrance from any PRC governing bodies in operating their business through the OPCO under the Structured Contracts.

- f. The limitations in exercising the option to acquire ownership in the OPCO, include a separate risk factor explaining these limitations, and clarifying that ownership transfer may still subject to substantial costs.
  - g. The Structured Contracts as material contracts in the “Statutory and General Information” section and make them available on the applicant’s website, or to justify and disclose the basis of not doing so.
  - h. Corporate structure table in the “Summary” section for the purpose of illustrating the Structured Contracts and facilitating investors’ review and understanding of the arrangements.
20. The relevant disclosure on Structured Contracts in prospectus should follow the following guiding principles:
- a. **Various sections** - To avoid repeated disclosure in various sections, such as those relating to connected transactions arising from the Structured Contracts, the basis of consolidation of the OPCO, and the terms of the Structured Contracts. Appropriate cross references should be sufficient.
  - b. **Risk Factors** –To disclose all related risk factors in a cluster under an appropriate heading, such as “Risks relating to Corporate Structure”. In addition, the prospectus should include at least the following Structured Contracts-related risk factors:
    - (i) The PRC government may determine that the Structured Contracts do not comply with applicable regulations;
    - (ii) The Structured Contracts may not provide control as effective as direct ownership;
    - (iii) The domestic shareholders may have potential conflicts of interest with the applicant; and
    - (iv) Structured Contracts may be subject to scrutiny of the PRC tax authorities and additional tax may be imposed.

## **Important Announcement**

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