Pre-IPO Investments: The Dos and Don’ts

Quick Read
We wrote in October 2010 about the approach taken to Pre-IPO investments by Hong Kong Exchanges and Clearing Limited (HKEx).

Certain terms and pricing arrangements of Pre-IPO investments are considered acceptable by HKEx, while others are not. The determining factor is the “fair and equal” principle under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (Listing Rules). Pre-IPO investments should not be used as a means to create a preference tranche of shares for early investors, because doing so would be unjust and unfair to those who invest at IPO. All this seemed fine, except that when structuring a Pre-IPO investment, there remained some uncertainty for market practitioners, who had to figure out exactly what terms could or could not go into the arrangement and what terms would survive IPO. Going back and forth, between Listing Decisions and published precedents, became unavoidable rituals before the conclusion was inevitably reached that each case had to be decided based on its own facts.

On 25 October 2012, HKEx published two guidance letters, “HKEx-GL43-12” and “HKEx-GL44-12” (Guidance Letters), to help remove some of the uncertainty surrounding this area by cataloguing which Pre-IPO investment terms and which Pre-IPO convertible instruments pricing arrangements are allowed, and which ones are not.

This is another attempt to bring clarity to the market since HKEx first issued the Interim Guidance on Pre-IPO Investments on 13 October 2010 (Interim Guidance). The Interim Guidance requires pre-IPO investments to be completed (subject to very exceptional circumstances): (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 the listing applicant’s securities (28 Day/180 Day Requirement). Pre-IPO investments are considered completed when the funds are irrevocably settled and received by the listing applicant. For details, please see our earlier legal update entitled “Hong Kong Stock Exchange Issues Guidance on Pre-IPO Investments” published on 14 October 2010.
The “Dos and Don’ts”

The following table summarizes those terms that are likely to be acceptable to HKEx to survive an IPO (‘Dos’) and those terms which are not likely to be acceptable (‘Don’ts’):

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<th>DOS</th>
<th>DON’TS</th>
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<td>Fixed conversion price for convertible securities (e.g., convertible or exchangeable bonds, notes or loans and convertible preference shares) (collectively CBs). That is, the conversion price can be stipulated as a fixed dollar amount or the “IPO price”</td>
<td>Price adjustment provisions, e.g., guaranteed discount on the IPO price or share price or an adjustment linked to the market capitalization of the IPO company, or any price reset mechanism for CBs</td>
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<td>Nomination rights (management) for the Pre-IPO investor to nominate senior management and committee representative if: • the appointment is subject to the decision of the board of the IPO company; and • the board is not contractually obligated to approve the nominations without exercising its own judgment in view of the fiduciary duties it owes to all the shareholders</td>
<td>Nomination rights (directors) conferring special rights to the Pre-IPO investor to appoint or nominate directors</td>
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<td>&quot;Reserved Matters&quot; only if the relevant terms: • are not egregious; and • do not violate the fundamental principles of the Listing Rules to the disadvantage of other shareholders Presumably, rights extended to shareholders generally (e.g., right to approve a substantial disposal, declaration of dividend, sale of substantial assets, amendments to articles or change in directors) by virtue of a percentage shareholding in the IPO company (as opposed to a specific investor) could qualify. But what exactly the above contemplates remain to be seen</td>
<td>“Reserved Matters” on major corporate actions (such as winding-up petition/resolution, change of business or mergers, etc.)</td>
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<td>Anti-dilution right triggered at IPO if: • it was pre-agreed; • full disclosures are made in the prospectus; and • it is exercisable at the IPO price</td>
<td>On-going anti-dilution rights conferring preferential rights to the Pre-IPO investor by the IPO company to maintain its percentage shareholdings</td>
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<tr>
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| **“Widely accepted” negative pledges** (e.g., covenants to create no further encumbrances and/or shareholders’ lock-up) may be permitted if they:  
  • are not egregious; and  
  • do not violate the fairness principle in the Listing Rules  
For this purpose, sponsors are required to confirm that these negative pledges are consistent with the normal terms of debt issues | **Negative pledges** that amount to “reserved matters”-type restrictions will not be permitted |
| **Right of first refusal and tag-along rights** between the controlling shareholders and the Pre-IPO investor, if they are purely contractual arrangements between two shareholders | **Put or exit options** to revert the investments (or risks) back to the IPO company or its controlling shareholder (e.g., if the IPO price does not achieve a certain amount) |
| **Redemption or early redemption of CBs**, if it compensates the Pre-IPO investor for the investment and risk undertaken (e.g., on a pre-agreed, fixed internal rate of return basis) | **Partial conversion of CBs** to retain special rights post-IPO will not be permitted. Full conversion will be expected prior to IPO if there are residual special rights for holders |
| **Pre-agreed Qualified-IPO compensation**, i.e., exit provisions whereby the Pre-IPO investor is promised a qualified IPO exit by a certain time or compensation pursuant to pre-agreed provisions | **Qualified-IPO compensation**, i.e., exit provisions whereby the Pre-IPO investor is promised a qualified IPO exit by a certain time WITHOUT pre-agreed compensation. Any compensation not set out in the investment agreement (or otherwise cannot be derived from such agreement) would be viewed as an alteration to the original investment terms and the 28 Day/180 Day Requirement would therefore apply |
| **Exclusivity rights and no more favourable terms** in favour of the Pre-IPO investor (e.g., the IPO company is not to issue or offer any securities to any direct competitors of the Pre-IPO investors or to other investors on more favourable terms than those terms offered to the Pre-IPO investors), ONLY if there is an explicit “fiduciary out” clause for the IPO company directors to decide not to enforce such provision | **Information rights** which do not extend to other shareholders and the public |
| **Profit guarantee** provided by a shareholder (instead of by the IPO company itself) which is not linked to the market price or market capitalization of the IPO company | **Profit guarantee** linking to the market price or market capitalization of the IPO company or given by the IPO company |
A Few Points To Note

Pre-IPO investors should also note that:

- **Guiding principle remains unchanged**: The guiding principle underlying these “Dos and Don'ts” remains the same in that investors at IPO should be treated fairly and equally. We expect that Pre-IPO investment terms will in most cases continue to be scrutinised or re-opened if they seek to off-load the investment risks (or more specifically IPO risk) to others. Further guidance on this may be required as the present guidance seems to be inconsistent in that some terms having an off-loading effect will be disallowed (e.g., “Put or exit option”), while others (e.g., “Profit guarantee”, “Pre-agreed qualified-IPO compensation”) will be allowed.

- **Rights before listing remain largely unaffected**: While all the “Don'ts” will be disallowed to survive an IPO and be removed, most of these rights are allowed to stand in favour of Pre-IPO investors before a listing.

- **Public float**: Shares held by Pre-IPO investors may not be counted as public float, if their stake post-IPO will be more than 10% or if they are “influenced” by connected persons (e.g., taking directions or financial subsidies from connected persons).

- **Arrangements with controlling shareholders**: HKEx appears to be concerned about terms seeking to off-load investment risks to other shareholders and about exchangeable bonds issued by other shareholders. Yet, the present guidance seems to suggest that in other circumstances Pre-IPO investors are allowed to look to controlling shareholders (as opposed to the IPO company) for protection of investment because these are “private arrangements”. However, Pre-IPO investors should be reminded that arrangements with other shareholders (especially if they seek to regulate how the parties should vote on matters of the IPO company) could make them “acting in concert”, meaning their respective shareholdings could be viewed as one “block” for the purpose of the Takeovers Code.

- **Additional disclosure**: Additional disclosure (including analysis on redemption and dilution impact) on CBs will be required in the “Financial Information” and “Risk Factors” sections of the prospectus and in the interim and annual reports after the IPO.

**Conclusion**

We believe that the Guidance Letters will be updated from time to time to reflect the changes in market practices. We will keep you posted as and when appropriate.
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