

HKEX Issued Modified Guidelines on Controlling Shareholders and Ownership Continuity

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Introduction

On October 13, 2017, the Hong Kong Stock Exchange (“HKEX”) issued an updated guidance letter to assist listed applicants, listed issuers and their advisers in understanding the HKEX’s interpretation of ownership continuity and control by “controlling shareholders”.

What is a “controlling shareholder” and what does “ownership continuity” mean?

Rule 1.01 of the Main Board Rules defines a “controlling shareholder”, in respect of an issuer, as any person who is or group of persons who are together entitled to exercise or control the exercise of 30% (or such other amount as may from time to time be specified in the Code on Takeovers and Mergers as being the level for triggering a mandatory general offer) or more of the voting power at the general meetings of the issuer, or a person or group of persons capable of controlling a majority of the board of directors of the issuer.

The identification of the controlling shareholder will be different in each listing case. Identification of the controlling shareholder and ownership continuity of the listing applicant involves issues that the sponsor and the lawyer will focus on in the process of the pre-IPO reorganization. If the listing applicant does not meet the requirements of ownership continuity, it will face the risk of not meeting the listing requirements. Therefore, it is necessary for each listing applicant to identify the controlling shareholder and ensure ownership continuity in the listing process.

The purpose of ownership continuity and control

Rule 8.05 of the Main Board Rules and GEM Board Rule 11.12A(2) states that the ownership continuity and control requirement is one necessary condition under the profit or cash flow test for a listing applicant’s

trading record to be counted towards the minimum required profit or cash flow for listing. The main purpose of this provision is to avoid the risk of instability in the control and management of the listing applicant in the running up to listing. Therefore, it enables the HKEX to ensure that the listing applicant’s financial performance resulted from the controlling shareholder and the management for at least the last financial year of the track record, meaning that the listing applicant is capable of operating as an integrated unit under the influence of the controlling shareholder.

Criteria for determining ownership continuity

In determining ownership continuity, two different aspects are generally being considered by the HKEX:

1. A group of controlling shareholders holding their interests directly in the listing applicant

Such listing applicants must comply with the following requirements at least during the Relevant Period (i.e. for at least the most recent financial year up until the time immediately before the offering and/or placing becomes unconditional) in order to comply with the requirement of ownership continuity and control:

- (1) The shareholders constituting the group of controlling shareholders must not change (i.e. in the recent financial year, no shareholder has joined and no shareholder has left).
- (2) There must be no material changes in the voting interests in the listing applicant held by each shareholder constituting the group of controlling shareholders.
- (3) The group of controlling shareholders together remains a group of controlling shareholders of the listing applicant and there are no new controlling shareholders.

2. A group of controlling shareholders holding their interests indirectly in the listing applicant

Such listed applicants must comply with the following requirements at least during the Relevant Period in order to comply with the requirement of ownership continuity and control:

- (1) The shareholders constituting the group of controlling shareholders must not change (i.e. in the recent financial year, no shareholder has joined and no shareholder has left).
- (2) There must be no material changes in the voting interests in the investment vehicle held by each shareholder of the vehicle.
- (3) The investment vehicle remains a controlling shareholder of the listing applicant and there are no new controlling shareholders.

The applicant should consult the HKEX beforehand if the voting interests held by each shareholder constituting the group of controlling shareholders changes. The HKEX will assess whether the change is material on a case-by-case basis.

Modifications introduced by the guidance letter

The most important modification in this updated guidance letter is that the listing applicant may be exempted from the ownership continuity requirement in certain circumstances. The HKEX has clarified that

the listing applicant may be exempt from complying with the strict ownership continuity requirement aforesaid by proving that, despite a change in controlling shareholder(s), the influence on the management of the company will not be materially affected and that there have been no material changes to the management of the company. This would enable the listing applicant to be eligible for the listing.

This change transforms the ownership continuity requirement from an apparently mandatory provision to a provision that can be exempted. In practice, this change may have a significant impact.

At present, many private enterprises need to undergo reorganization before applying for listing on the HKEX. In the process of reorganization, it is necessary to ensure that the company operates under the same controlling shareholder or group, its trading record can be classified as under the controlling shareholder or group, and that the financial requirements of the Listing Rules are met. Under the provisions of the original guidance letter, the controlling shareholder structure and the relevant financial data of entities under its control are subject to rigid requirements during the Relevant Period. Under the provisions of the updated guidance letter, if the applicant can convince the HKEX that there has been no material change in “influence on the management” of the listing applicant despite a change of controlling shareholder, the change of controller shareholder in the last financial year maybe accepted by the HKEX. However, in view of the lack of precedent cases applying the updated guidelines to date, it is necessary to examine the HKEX’s grasp of this issue in the context of specific listing applications.

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