



STRATEGIC INVESTORS AND PRE-IPO INVESTMENT DURING PRE-IPO PREPARATION STAGE

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An important role during pre-IPO preparation stage as they can provide capital to the company on its way to listing and/or to enhance the confidence of further institutional and public investors in investing in the company at listing.

Pre-IPO investments are investments in companies made prior to the listing (pre-IPO) which can be in various forms, such as ordinary shares, preference shares or convertible notes. This kind of investments play an important role during pre-IPO preparation stage as they can provide capital to the company on its way to listing and/or to enhance the confidence of further institutional and public investors in investing in the company at listing.

In particular, pre-IPO investments have vital importance for companies with a weighted voting rights structure and biotech companies seeking for listing under Chapter 8A and Chapter 18A of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (Listing Rules), respectively, as it is one of the listing requirements that such companies must have previously received meaningful third party investment from at least one “sophisticated investor” at least six months before the date of the proposed listing (which must remain at listing).

Regulatory Requirements

There are no specific provisions under the Listing Rules which deal with pre-IPO investments. The underlying principles governing the requirements relating to pre-IPO investments are the ones under Rule 2.03 of the Listing Rules that “the issue and marketing of securities must be conducted in a fair and orderly manner and all holders of securities must be treated fairly and equally” (Rule 2.03 Principles). The Stock Exchange of Hong Kong Limited (Stock Exchange) has issued three guidance letters (Guidance Letters): HKEx-GL29-12 (Interim Guidance on Pre-IPO Investments), HKEx-GL43-12 (Guidance on Pre-IPO Investments) and HKEx-GL44-12 (Guidance on Pre-IPO Investments in Convertible Instruments), which have consolidated the listing decisions on pre-IPO investments issued by the Stock Exchange in the past and set out the requirements for pre-IPO investments.

All acquisitions of shares from a company (Listing Applicant) or its shareholder(s) by a new or existing shareholder prior to the Listing Applicant’s listing will be treated as “pre-IPO investments” and subject to the Guidance Letters, unless (i) the shares are acquired in an exchange of shares of a predecessor in interest company or an

operating subsidiary of the Listing Applicant or otherwise as part of a corporate restructuring of the Listing Applicant in connection with the listing; or (ii) the shares are awarded to directors or employees of the Listing Applicant as part of a defined share award scheme.

Timing of pre-IPO investments

It will contravene the Rule 2.03 Principles if pre-IPO investments, with prices at a deep discount to the IPO price and much more favorable terms than investors at the IPO stage, are to be completed at a time close to the hearing of the listing application. Thus, according to the Stock Exchange guidance letter HKEx-GL29-12, pre-IPO investments must be “completed” at least 28 clear days before the date of the first submission of the first listing application form (First Filing). If the pre-IPO investment was completed (i) within 28 clear days before the date of the First Filing or (ii) on or after the date of First Filing, the Stock Exchange will delay the listing day of the Listing Applicant until 120 clear days after completion of the pre-IPO investment.

“Clear days” exclude the day of the pre-IPO investment completion, the day of the submission of the listing application form and the first day of trading of securities on the Stock Exchange. Pre-IPO investments are considered “completed” when the funds for the underlying shares are irrevocably settled and received by the Listing Applicant.

Divestment rights of pre-IPO investors

The only divestment right of pre-IPO investors which may exist on or after the First Filing is the one which is only exercisable if the listing does not take place and will terminate upon listing.

Any other divestment right (e.g., put options, redemption or repurchase rights) granted by the Listing Applicant or the controlling shareholder to the pre-IPO investor or right (e.g., call options) permitting the Listing

Applicant or the controlling shareholder to repurchase shares of the pre-IPO investor must be terminated before the First Filing. Divestments on or after the First Filing will lead to a 120-day delay of the listing process regardless of when the pre-IPO investment was made or whether the divestment is pursuant to a contractual right.

For pre-IPO investors who divest prior to the First Filing, as they neither disrupt the listing process nor affect the equal treatment of shareholders post listing, regardless of when the pre-IPO investment was made or whether the divestment is pursuant to a contractual right, the Stock Exchange will not impose any delay to the listing timetable of the Listing Applicant.

Terms of pre-IPO investments

To attract investors to invest in a company prior to listing, special rights are usually offered by the company or its shareholders to pre-IPO investors. The range of these special rights varies and in general, special rights which do not extend to all other shareholders are not permitted to survive after listing to comply with the Rule 2.03 Principles.

Set out below are examples of some commonly seen special rights granted to pre-IPO investors:

- i. **Price adjustments** - terms that provide a fixed rate of return to the pre-IPO investor and settled by a shareholder provided that they are not based on (a) a discount to the IPO price; or (b) a discount to market capitalisation of the shares at IPO, shall be allowed and can survive after listing.
- ii. **Director nomination rights** - any right granted by the Listing Applicant to pre-IPO investor to nominate or appoint a director must terminate upon listing. Any director nominated or appointed by a pre-IPO investor need not resign at listing unless

- required under the Listing Applicant's articles of association. However, any agreement among the shareholders to nominate and/or vote for certain candidates as directors are generally not subject to the Guidance Letters and shall be allowed to survive after listing.
- iii. **Veto rights** - any contractual right to veto the Listing Applicant's major corporate actions must be terminated upon listing.
 - iv. **Profit guarantee** - any financial compensation settled by a shareholder (and not by the Listing Applicant) which is not linked to the market price or capitalisation of the shares may survive after listing.
 - v. **Right of first refusal and tag-along rights** - (a) any right of first refusal granted by the controlling shareholder to the pre-IPO investor; and (b) any right granted by the controlling shareholder to include the shares of a pre-IPO investor for sale together (i.e., tag-along) with the shares of the controlling shareholder, may survive after listing.
- ii. **Conversion price reset** - any conversion price reset mechanism of the convertible securities should be removed as it is considered to be contrary to the principle of the Listing Rules.
 - iii. **Partial conversion of the convertible securities** - it will only be allowed if all special rights are terminated after listing. This prevents the situation where a pre-IPO investor enjoys the special rights it held as holder of convertible securities by converting a significant portion of their convertible securities into shares and yet still be entitled to special rights by holding a small portion of the convertible securities.
 - iv. **Early redemptions** - the option enabling a holder to redeem early the outstanding convertible securities at a price which would enable it to receive a fixed internal rate of return (IRR) on the principal amount of the convertible securities being redeemed is allowed as such IRR is compensation for the investment and risk undertaken.

Convertible Securities

In some cases, pre-IPO investments will be made in the form of convertible securities as the investors will be able to enjoy a risk-return profile better than that of a shareholder. In view of the features of convertible securities, there are certain additional requirements as set out in the Stock Exchange guidance letter HKEx-GL44-12, some examples are set out below:

- i. **Conversion price** - the conversion price for the convertible securities should be at a fixed dollar amount or at the IPO price. A guaranteed discount to the Listing Applicant's IPO price or market capitalisation of shares is not permitted.

Lock-up and Public Float

Lock-up on the shares held by pre-IPO investors is not a mandatory regulatory requirement. However, the Listing Applicant or the underwriters will usually request the pre-IPO investors to be subject to a lock-up period of six months or more in order to avoid a significant drop in share price shortly after listing as a result of the disposal of a considerable amount of shares by the pre-IPO investors. These shares are counted as part of the public float so long as such shares are not financed directly or indirectly by a connected person of the Listing Applicant.

Disclosure requirements

Details of the pre-IPO investments have to be disclosed in the prospectus in accordance

with the requirements set out in the Guidance Letters, which include but not limited to the date, amount and use of proceeds of the pre-IPO investments, the beneficial owners and background of the pre-IPO investors, the basis of determining the consideration and the material special rights granted to the pre-IPO investors. For convertible securities, given their complexity, certain additional information should also be disclosed in the “Financial Information” and “Risk Factors” sections of the prospectus to explain the impact of the convertible securities on the Listing Applicant.

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