

# The Hong Kong Stock Exchange Consults on Reforming the Connected Transaction Rules

On 26 April 2013, The Stock Exchange of Hong Kong Limited (the Exchange) published two sets of consultation papers on reforming the connected transaction rules.

**The issuer-friendly proposals include (amongst others):**

1. plain language reform - replacing the whole Chapter 14A with the "[Guide on Connected Transaction Rules](#)" published by the Exchange in April 2012
2. relaxation of the regulation of connected persons at the subsidiary level:
  - (a) the "insignificant subsidiary exemption" introduced in June 2010 exempts transactions between the issuer group and any person who is connected only by virtue of his/its relationship with an "insignificant" subsidiary of the issuer, subject to a number of qualifying conditions. The Exchange now proposes to expand this exemption at the definition level, so that all persons connected only because of his/its relationship with the issuer's insignificant subsidiaries will categorically be excluded from the "connected person" definition in the first place. In determining what constitute "insignificant subsidiaries", the existing formula used shall continue to apply
  - (b) introducing any one or all of the following proposed exemptions so that most transactions between the issuer and the connected persons at the subsidiary level will be out of the radar screen:
    - (i) exempting from the circular and independent shareholder approval requirements any transactions (on normal commercial terms) between the issuer group and persons connected only at the subsidiary level
    - (ii) exempting from all requirements any transactions (on normal commercial terms) between the issuer group and persons connected at the subsidiary level, other than transactions between a subsidiary (or any subsidiary below it) and the person connected with that subsidiary
  - (c) at present, transactions which involves any acquisition or disposal of interests in a target company where each of the issuer and its "controller" is, or will be, a shareholder of the target

company are classified as "connected transactions". "Controller" is a director, chief executive or the controlling ( $\geq 30\%$ ) shareholder of the issuer or any of its subsidiaries. The Exchange now proposes to exclude from the radar screen "controller(s)" at the subsidiary level. On top of that, the Exchange also proposes to categorically exclude from the rule disposals of interests in target companies as the risk of abuse is low

3. broadened or new exemptions in areas where the risk of abuse is limited:
  - (a) removing the 1% cap (based on the total consideration or value of the goods or services) from the qualifying conditions to the exemption for the provision of consumer goods or services. This means, going forward, an issuer providing or receiving consumer goods or services to or from a connected person will be fully exempt from the connected transaction rules regardless of the transaction size, provided that the transaction complies with the (remaining) principle-based exemption conditions which relate to the transaction nature (i.e. the goods or services must be of a type ordinarily supplied for private use or consumption, they must be for the buyer's own consumption or use, and they must be consumed or used by the buyer in the same state as when they were bought)
  - (b) introducing full exemption for the provision of indemnities to directors and the purchase and maintenance of directors' insurance against liabilities incurred in the course of performing their duties, provided that it is lawful in the law of the place of incorporation of the company providing the indemnity / purchasing the insurance
4. relaxation of the compliance framework for continuing connected transactions (CCTs):
  - (a) if compliance can be proven unduly onerous, the fixed-term (usually 3 years) framework agreement requirement can be replaced by a shareholders' mandate. It is now stated in the proposed amendments that the mandate must not exceed 3 years. In our view, the proposed change would not be particularly helpful to the issuers unless more flexibility could be built in allowing a mandate to last for more than 3 years
  - (b) for CCTs of a revenue nature in the issuer's ordinary and usual course of business, issuers are allowed to express the annual cap as a percentage of the issuer's annual revenue or other financial items in its published accounts

**The Exchange has also put forward the following proposals to enhance regulation:**

5. broadening the Exchange's specific power to deem the following persons as an issuer's connected persons
  - (a) a shadow director or de facto controlling shareholder of the issuer
  - (b) a person who is accustomed to act according to a connected person's directions or instructions

6. in respect of the definition of "associate" of a connected person, qualifying the current exemption in respect of a connected person holding an interest in an associate through the issuer with a 10% cap. In other words, a company will be regarded as an associate of a connected person if the latter (and his/its associate(s) together) has / have an interest in the company (*other than those held through the issuer group*) of 10% or more
7. aligning the requirements applicable to the transfer, non-exercise or termination of options such that all of them should be classified as if the option is exercised (although an alternative value-based classification test has been proposed)
8. renaming the definitions of "connected person" and "associate" in Chapter 1 to "restricted connected person" and "close associate" respectively, so that Chapter 14A would have self-contained definitions of "connected person" and "associate"
9. applying the definitions of "connected person" and "associate" used in Chapter 14A to a number of Listing Rules, where their purposes are also to protect independent or minority shareholders e.g. the notifiable transaction rules, and the rules concerning voting at general / board meetings, share repurchase, INED, IFA and sponsors

**Although no definitive proposals have been made, the Exchange also seeks market's views on the following issues:**

10. whether current definition of "connected person" at the issuer level should be extended to cover directors of the controlling shareholder or holding company (to align with the related party transaction regime in comparable overseas jurisdictions such as the UK, Australia and Shanghai)
11. whether the connected transaction requirements for financial arrangements with a commonly held entity (i.e. a company whose shareholders include: (a) the issuer group; and (b) any connected person(s) at the issuer level who can control the exercise of 10% or more of the voting power at the company's general meeting) should be retained
12. whether the monetary limits of the de minimis exemptions (i.e. HK\$1 million for fully exempt transactions and HK\$10 million for connected transactions exempt from the independent shareholders' approval requirement) should be retained or increased for the benefit of smaller issuers

**Deadline for submitting comments is 26 June 2013.**

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