

The Hong Kong Stock Exchange publishes Listing Rule changes to reform the connected transaction regime

The Stock Exchange of Hong Kong Limited (**the Exchange**) has published Listing Rule amendments to reform the connected transaction regime. These changes will take effect from 1 July 2014.

Last year the Exchange consulted the market on a series of issuer-friendly proposals which targeted to simplify the connected transaction rules, but a few of them have now been withdrawn primarily because of the concerns raised by the disagreeing respondents. Withdrawn proposals include those originally intended to relax the compliance framework for continuing connected transactions.

On the other hand, the Exchange has slashed a number of the proposals on enhancing regulation so as to strike a balance between the needs to safeguard shareholders' interests and imposing compliance burden on issuers. This briefing provides a high-level overview of the impending changes.

The issuer-friendly amendments 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 enhances this exemption to work 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) one further exemption has been introduced to alleviate any transactions (on normal commercial terms or better) between the issuer group and persons connected only at the subsidiary level from the circular and independent shareholder approval requirements. However, announcements will still have to be published in respect of these connected transactions;
 - (c) under the existing rules, transactions involving 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. Starting from 1 July, "controller(s)" at the subsidiary level will be excluded from the radar screen. On top of that, disposals of interests in target companies will also be categorically excluded from the rule 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. That 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 Hong Kong and in the law of the place of incorporation of the company providing the indemnity / purchasing the insurance;
 - (c) increasing the monetary limit of the de minimis exemption for fully exempt transactions from HK\$1 million to HK\$3 million (however, the threshold for exempting connected transactions from the independent shareholders' approval requirement will be retained at HK\$10 million).

The following amendments will be introduced to enhance regulation:

4. applying the definitions of "connected person" and "associate" used in Chapter 14A to the following areas of the Listing Rules:
- (a) the scope of the reverse takeover rules will be extended to include significant acquisitions from the incoming controlling shareholders' extended family members and companies controlled by them;
 - (b) significant corporate actions (e.g. large scale rights issue / open offer or transaction that would result in a fundamental change in the issuer's principal business activities within 12 months after listing), spin-offs, refreshment of general mandate, director's service contracts exceeding 3 years and grant of share options to connected persons etc. – relevant connected persons' extended family members and companies controlled by them must abstain from voting in the general meeting approving these matters;

- (c) sponsor in a new listing application must confirm that it is not a connected person (as defined in Chapter 14A) of the new applicant;
 - (d) in the case of a connected transaction which requires independent shareholder's approval, the independent financial adviser (IFA) must confirm that it is not, and does not hold more than 5 per cent interest in, an associate (as defined in Chapter 14A) of the counterparty of the transaction; and
 - (e) other rules where the use of the Chapter 14A definitions of "connected person" and "associate" are corollary to the connected transaction requirements;
5. re-naming the definitions of "connected person" and "associate" in Chapter 1 to "core connected person" and "close associate" respectively, so that Chapter 14A would have self-contained definitions of "connected person" and "associate";
 6. qualifying the current exemption in respect of a 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 adopted).

Apart from the Listing Rule amendments, the Exchange has also published a new series of frequently asked questions (FAQs) relating to the connected transaction regime and a guidance letter on the pricing policies in agreements for continuing connected transactions and their disclosure.

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