HKEX GUIDANCE LETTER
HKEX-GL44-12 (October 2012) (Updated in March 2017)

Subject	**Guidance on Pre-IPO investments in convertible instruments**
Listing Rules	**Main Board Rules 2.03(2) and (4) GEM Rules 2.06(2) and (4)**
Related Publications	**HKEX News Release (updated: 13/10/2010) and Guidance Letter HKEX-GL29-12 (Updated in March 2017)** **HKEX-GL43-12 (October 2012) (Updated in March 2017)**
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Important note: *This letter does not override the Listing Rules and is not a substitute for advice from qualified professional advisers. If there is any conflict or inconsistency between this letter and the Listing Rules, the Listing Rules prevail. You may consult the Listing Department on a confidential basis for an interpretation of the Listing Rules, or this letter.*

1. Purpose

1.1 This guidance sets out our current practice in dealing with convertible instruments issued to pre-IPO investors. The guidance relating to special rights attached to pre-IPO share investments set out in Guidance Letter HKEX-GL43-12 shall apply to all special rights attached to convertible instruments. Any reference to shares therein shall refer to convertible instruments as applicable. *(Updated in March 2017)*

2. Applicable rules, regulations and principles

2.1 Main Board Listing Rules 2.03(2) and (4) (GEM Rules 2.06(2) and (4)) (the "**Rules**") require the issue and marketing of securities to be conducted in a fair and orderly manner and that all holders of listed securities be treated fairly and equally.

3. Convertible or exchangeable bonds, notes or loans and convertible preference shares (collectively "CBs") *(Updated in March 2017)*

3.1 CBs issued to pre-IPO investors may be structured in such a way that they are not shares in form, but the investors would enjoy a risk-return profile similar to or even better than that of a shareholder. We have in the past requested the removal of conversion price reset mechanism of CBs and the termination of all special rights for bondholders. The rationale is to ensure that all shareholders are treated fairly and equally under the Rules.

3.2 We set out in paragraphs 3.3 to 3.5 our current practices in dealing with convertible instruments with conversion price reset mechanism issued to pre-

IPO investors.

(a) Conversion price linked to IPO price or market capitalisation

3.3 The conversion price for the CBs should be at a fixed dollar amount or at the IPO price. A guaranteed discount to the applicant's IPO price or market capitalization of shares may give rise to concerns that the pre-IPO investor does not bear the same investment risk as public investors and is not permitted.

(b) Conversion price reset

3.4 We consider that any conversion price reset mechanism of the CBs should be removed as they are considered to be contrary to the principle of the Rules.

3.5 An example is where the conversion price reset mechanism is based on the lower of a fixed price and a floating market price. Such a price reset mechanism allows conversion at a discount to the fixed price. As the share price declines, the market price based conversion formulae would lead to more shares to be issued, hence greater dilution and greater potential for share price reduction which can work in a spiral.

(c) Mandatory or partial conversions

3.6 Partial conversion of CBs is only 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 bondholder by converting a significant portion of their CBs into shares and yet still be entitled to special rights by holding a small portion of the CBs.

(d) Early redemptions

3.7 Certain CBs provide bondholders the option to redeem early the outstanding CBs at a price which would enable the bondholders to receive a fixed internal rate of return (IRR)[1] on the principal amount of the CBs being redeemed. Upon maturity, all outstanding CBs shall become immediately payable at a price which would enable the bondholders to receive the same fixed IRR.

3.8 We consider that the IRR on the principal amount of the CBs to be redeemed is compensation for the investment and risk undertaken by the bondholders and is allowed.

(e) Negative Pledges

3.9 Negative pledges restrict an applicant from certain corporate actions such as

[1] IRR is the interest rate needed in the discounting of cash flows to their present value so the investment's net present value is equal to zero. For example, if the cost of investment of a financial instrument is HK$100 and it is expected to pay its holder $110 in one year's time, the investment's internal rate of return is 10%.

creating any additional lien, encumbrance or security interest on its assets and revenues, or paying dividends without prior consent of the pre-IPO investor. They are common in debt instruments, such as convertible bonds.

3.10 Negative pledges should be removed upon listing unless the sponsor confirms that the negative pledges are not egregious, and do not contravene the fairness principle in the Rules.

(f) Disclosure requirements

3.11 Given the complexity of CBs and their terms, additional information should be disclosed in the “Financial Information” and “Risk Factors” sections of the prospectus to explain the impact of the CBs on the applicant, including if the applicant was required to redeem the CBs before the maturity date:

(i) a qualitative analysis on the cash flow and cash position in the event of CBs redemption;

(ii) the various terms and impact of early redemption, including the monetary amount that the applicant is required to pay to the bondholders on the assumption of redemption upon maturity or early redemption, so as to enable the bondholders to receive the required percentage of IRR;

(iii) the maximum number of shares that would be converted and the corresponding change in shareholding; and

(iv) the expected source of cash inflows upon listing, in particular the applicant’s existing cash position of the Group, the additional positive operating cashflow the applicant expects to generate and estimated net proceeds from the IPO.

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