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Our ref VKL/BD/SFC

31 March 2005

Attn: Corporate Finance Division

Dear Sirs

Comments on draft amendments to the Securities and Futures (Stock Market Listing) Rules

Overseas and
associated offices

We refer to your invitation to comment on the draft amendment to the Securities and Futures (Stock Market Listing) Rules ("SMLR").

Athens

Bucharest

We appreciate the current initiative to further strengthen the listing regulatory structure, and in particular to bring the regulatory framework for listings and listed companies in Hong Kong in line with regulatory regimes in other developed markets.

Guangzhou

Johannesburg

In general, we are in agreement with the proposal to codify the more important requirements of the Listing Rules. We do, however, have concerns as to the proposal to reproduce sections of the current Listing Rules as statutes without, at least, reviewing whether the current rules need improvements.

Kuwait

London

Paris

Piraeus

As the SFC is aware, the Listing Rules was substantially amended effective 31 March 2004. In many areas, particularly areas relating to notifiable transactions and connected transactions, the new Listing Rules was a substantial re-write from the previous Listing Rules.

Shanghai

Singapore

Zagreb

Over the course of the past 12 months working with the new Listing Rules, we found many aspects of the new Listing Rules to be vague and imprecise. At the same time, clients often complained about some of the quirks resulting from the application of the rules. While the Listing Rules remained as "rules" rather than law, the system works (albeit imperfectly) because the Exchange becomes the final arbiter of the rules. In the event of doubt, the Exchange can be consulted¹.

¹This often works imperfectly because the Exchange would not entertain non-names enquiries and many listed issuers do not wish to reveal their names at the enquiry stage. Also, as the Exchange does not comment on individual cases, it is often difficult to tell why certain listed issuers were allowed dispensations while others were not.

PARTNERS John Gale, Mark Reed, Ian Devereux, Malcolm Kemp, Twiggy Liu, Roderick White, Voon Keat Lai, Hilda Chiu, Andrew Cotterell, Allen Wong, Jeremy Sargent, Owen Chan

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We note from the consultation paper that the SFC intends to publish guidelines and issue for "safe harbour" waivers. We believe these steps are important to assist practitioners and listed issuers to navigate the SMLR. We note that these steps are consistent with practices elsewhere. However, even though a code or a guideline in relation to interpretation issues could be produced, and such codes/guidelines being useful, we believe it would be wrong to use such codes/guidelines to change, or even replace, what might be a set of poorly drafted law in the first place. It would be preferable for the SFC to iron out as much of the issue as possible prior to enacting the SMLR as law.

We also note from the SFC consultation paper that the SFC has made changes in the SMLR to deal with aspects which caused interpretative difficulties. However, as the effects of the new Listing Rules have never been subjected to formal consultation (as far as we are aware) and there were never been a formal channel set up by either the SFC or the Exchange for directing general interpretative/substantive issues, we wonder whether the Exchange or the SFC has a complete feel as to where the new Listing Rules caused interpretative/substantive difficulties. As a case in point, we attach, for the SFC's information, a copy of a letter which we sent to the Exchange in June 2004 regarding the confusions caused by the definitions of "connected persons" and FAQ 56 issued by the Exchange. We have received no reply from either the Exchange or the SFC with regard to our enquiry. The issue raised in the letter caused practitioners and listed issuers difficulties till today. We wonder how many such letters go unnoticed.

In our view, before SMLR becomes law, the SFC should undertake a further consultation and ask practitioners and listed issuers for comments on the interpretative/substantive aspects of the SMLR (which, in most cases, merely reproduced the rules under the Listing Rules). We believe, only then, we can start on a footing that the SMLR is a piece of legislation which we know (at the relevant time) to be as best as we can have.

Separately, we believe, with all the best intentions, it will be most improbable that the SMLR will be "perfect" when enacted. There will continue to be interpretative and substantive difficulties². At the moment, we do not see any suggestions in the consultation paper that the SFC will set up any system to assist practitioners and listed issuers to seek interpretative guidance on an individual basis. In the "Consultation Conclusion on Proposals To Enhance The Regulation of Listing" (Para 4.7), the Exchange reported that they were contemplating, *inter alia*, the following measure to enhance transparency:-

- "(a) with immediate effect to increase the number of listing decisions to be published;
- (b) in the short term to establish a practice of publishing, on a regular basis, interpretations made by the Listing Unit of provision in the Red Book; and

²In time, many of them may well be covered by the codes/guidelines and "safe harbour" waivers issued by the SFC.



- (c) In the longer term to explore the possibility of:-
- (i) establishing a "help-desk" facility to answer general enquiries on interpretation and application of the provisions in the Red Book; and
 - (ii) communicating more clearly the standards and behaviour that the Exchange expects of listed issuers and their directors by, for instance, reviewing the form and structure of the provisions in the Red Book."

Since the publication of the "Consultation Conclusion on Proposals To Enhance The Regulation of Listing", we do not believe the Exchange has achieved these objectives. In view of the increased involvement of the SFC in the regulation of listings, we wonder whether the SFC will pick these objectives up from where the Exchange left off.

In addition, we think the SFC should further consider a system, in relation to any statutory listing regulation, similar to that used by the Inland Revenue in relation to advance tax rulings, by which a person may apply to the commissioner, subject to payments and certain regulations, for a ruling on how any provision of the Inland Revenue Ordinance applies to him or the arrangement specified in the application.

Summary of Recommendations

In summary, our recommendations are as follows:-

1. Establish a consultation to seek the market's views on the interpretative and substantive issues relating to the SMLR as currently drafted.
2. Consider enhancing transparencies by taking up the objectives proposed by the Exchange in the "Consultation Conclusion on Proposals To Enhance The Regulation of Listing" (Para 4.7).
3. Consider setting up a system of advance rulings by which listed issuers may apply to the SFC for a ruling on how any provision of the SMLR applies to that issuer.

For the SFC's information, we set out in the attached schedule, four examples of interpretative difficulties which the writer of this letter has come across. These examples are by no means exhaustive. They are merely provided to provide an indication of the issues involved.

Given that substantive difficulties in applying the rules are more likely to be particular to individual cases, we have not provided any examples at this stage beyond the facts set out in our attached letter to the Exchange of June 2004.

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Date 31 March 2005



羅夏信律師樓
STEPHENSON HARWOOD & LO

If you wish to discuss any aspects of this submission, please feel free to contact Voon Keat Lai of this office.

Yours faithfully

Stephenson Harwood & Lo

Enc.



SCHEDULE

NOTE: This is not exhaustive. We have merely set out a small sample of interpretative issues which we have encountered.

1 The meaning of "year":

- 1.1 According to Rule 14A.35(1), each agreement to enter into continuing connected transactions cannot be for a "duration longer than 3 years". This is reproduced in Schedule 7, section 15(a)(iii) of the SMLR
- 1.2 According to the Exchange, the phrase "3 years" should be read as meaning three financial years. From a practical perspective, the interpretation of the Exchange is understandable because, under Rule 14A.38(4) (reproduced in Schedule 7, section 15(e)(4) of the SMLR), the auditors must confirm that the annual cap has not been exceeded. It would be difficult for the auditors to confirm caps that straddle two financial years. However, from an interpretative perspective, it is not obvious that "3 years" should mean three financial years.
- 1.3 Indeed, if we were to read the new Listing Rules as we would construe a statute, section 3 of the Interpretation and General Clauses Ordinance (Cap.1) states that "year" means a year according to the Gregorian calendar. Hence, the Exchange's interpretation should be wrong. However, if we do interpret this according to the statutory interpretation, how will the auditors give their confirmation in Schedule 7, section 15(e)(4)?

2 The definition of "continuing connected transaction":

- 2.1 Rule 14A.14 provides a definition of "continuing connected transactions" and says that:-

"14A.14 Continuing connected transactions are connected transactions involving the provision of goods and services, which are carried out on a continuing or recurring basis and are expected to extend over a period of time. They are usually transactions in the ordinary and usual course of business of the issuer."

This definition is reproduced in Schedule 7, section 1(1).

- 2.2 On more than one occasions, we have been told by the Exchange (which we disagree) that the definition set out in Rule 14A.14 is non-exhaustive and that the meaning of "continuing connected transactions" can be extended to apply to financial assistance given by a listed issuer to its non-wholly owned



subsidiaries³. Hence, on that basis:-

- 2.2.1 if a listed issuer provides a non-revolving financial assistance to one of its non-wholly owned subsidiary (which is treated as a connected person), the financial assistance is merely treated as a "connected transaction" and is subject to the usual connected transaction rules; but
 - 2.2.2 where the listed issuer provides a revolving financial assistance (for example, providing an agreed amount of funds that the subsidiary can drawdown/repaid as needed), it would be treated as a continuing connected transaction.
- 2.3 From a substantive perspective, treating revolving financial assistance as continuing connected transactions is neither logical nor commercially feasible because in many cases, listed issuers cannot subject the funding requirements of their non-wholly owned subsidiaries for reconsideration every three years. Legally, the only easy way to avoid this treatment is to ensure that the subsidiary does not repay the financial assistance. Commercially, this prevents the listed issuer from maximising the use of its funds.
- 2.4 Whether the SFC will want to treat revolving financial assistance as continuing connected transaction is one of merit to be determined by the SFC. Whichever way the SFC decides to proceed, from an interpretative perspective, we believe that the definition should clarify whether financial assistance is deemed to be provision of "goods and services".

3 Continuing connected transactions and "revenue ratio":

- 3.1 Also in respect of continuing connected transactions, as the SFC is aware, the compliance requirements (whether announcement and/or shareholders approval are required) depends on whether the size of the relevant transaction exceeds the prescribed ratios. The only ratio to be ignored is the "profit ratio" (see Rules 14A.32 and 14A.33 and equivalent in Schedule 7, sections 31 and 32).
- 3.2 As the Exchange is aware, one of the relevant ratios is the "revenue ratio" which is defined as "the revenue attributable to the assets which are the subject of the transaction divided by the revenue of the listed issuer" (see Rule 14.07(3)).
- 3.3 In the context of a continuing connected transaction, if the listed issuer is the provider of "goods and services" and hence earn revenue from the transaction, the revenue ratio would clearly apply. However, in cases where the listed issuer

³This issue is only relevant where the non-wholly owned subsidiary is also a connected person.



is the recipient of services (and hence the amount expended is an expense for the listed issuer and not "revenue"), it is not obvious that the "revenue ratio" is applicable. However, we believe the Exchange has, nevertheless, taken the view that the "revenue ratio" applies even when the listed issuer is receiving the goods/services (and hence paying out expenses rather than earning "revenue").

- 3.4 We note that in Schedule 1, section 1, the SMLR tries to express "revenue ratio" differently by defining that revenue ratio means "the revenue attributable to the transaction or event divided by the revenue of the group". However, the SMLR then goes on to say that as follows:-

"(ii) "revenue" means revenue arising from the principal activities of the group and does not include those items of revenue and gains that arise incidentally."

Given that the word "group" should probably mean only the listed issuer and its subsidiary, how do we reconcile this with the application of the "revenue ratio" in relation to transactions where the listed issuer is expending money (as opposed to earning money)?

4 The treatment of operating leases:

- 4.1 According to Rule 14.04(1)(d), a "transaction" includes:

"(d) entering into or terminating operating leases which, by virtue of their size, nature or number, have a significant impact on the operations of the listed issuer. The Exchange will normally consider an operating lease or a transaction involving multiple operating leases to have a "significant impact" if such lease(s), by virtue of its/their total monetary value or the number of leases involved, represent(s) a 200% or more increase in the scale of the listed issuer's existing operations conducted through lease arrangements of such kinds."

- 4.2 Schedule 6, section 2(d) defined this slightly different and provides that a "transaction" includes:-

"(d) entering into or terminating an operating lease or sub-lease, including an operating lease or sub-lease of property, which, by virtue of their size, nature or number, have a significant impact on the operations of the group"

- 4.3 The problem with the definition used in the new Listing Rules and also in the SMLR are as follows:-

4.3.1 Even if we accept that operating leases are transactions, how do we



apply this to the “relevant percentage ratios” given that, from an accounting perspective, operating leases are not treated as “assets” and do not usually have values ascribed to them?

4.3.2 Even if you treat the payments under the operating leases as the nominator for the purposes of the “relevant percentage ratios”, do you look at them on a yearly basis or do you look at them for the entirety of the operating lease bearing in mind that, for the purposes of notifiable transactions, there is no equivalent of continuing connected transactions?

4.4 The new definition used in the SMLR introduces a new problem. Given that there is now no explanation what is meant by “significant impact”, it will be even harder for the listed issuer to know whether an operating lease is a transaction.



The Stock Exchange of Hong Kong Limited
Listing Division
11th Floor, One International Finance Centre
1 Harbour View Street
Central
Hong Kong

Email
Direct line
Direct fax
Our ref

Attention:

Dear Madam,

Connected Transactions:

Enquiry relating to apparent inconsistency between FAQ 56 and the Listing Rules

Overseas and
associated offices

I am a partner of Stephenson Harwood & Lo, a firm of solicitors.

Athens

I have been informed that you might be the correct person to answer this enquiry. If this is not the case, I would be grateful if you would pass this enquiry to your colleague who might be more appropriate to deal with this issue.

Bucharest

Guangzhou

Johannesburg

This enquiry relates to the Frequently Asked Questions on Rule Amendments relating to Corporate Governance and Listing Criteria Issues (31 March 2004)" published by the Exchange. According to the cover page of the FAQ, practitioners are urged to contact the Listing Unit at the earliest opportunity with any queries they may have on the Listing Rules. Unfortunately, there is no mention anywhere (or in the Exchange's website) who in the "Listing Unit" I should contact.

Kuwait

London

Paris

Piraeus

Shanghai

The issue revolves around an apparent discrepancy between the Exchange's response, as set out in FAQ 56 and the Listing Rules.

Singapore

Zagreb

The issue is important because the scenario set out in FAQ 56 is a very common joint venture scenario and practitioners have been advising clients as to whether or not a non wholly-owned subsidiary is a connected person based the Exchange's response in FAQ 56.

1. Background

1.1 In FAQ 56, the Exchange was asked the following question:-

"Under the existing connected transaction rules a transaction between an issuer and a non wholly owned subsidiary where a person holds 30% shareholding interest in such a non wholly owned subsidiary is exempt where the transaction is on normal commercial terms and in the ordinary course of business and such person is a connected person by virtue only of his substantial shareholding in the non wholly owned subsidiary concerned



(Existing Main Board rule 14.24(4)).

If the transaction concerned relates to the grant of financial assistance, it is only required to disclose details of transaction in annual report (Existing Main Board rule 14.25(a)). Under the new connected transaction rules, is there any exemption for such transactions such that there is no requirement to disclose by way of announcement or obtain shareholders' approval if the amount concerned does not exceed the *de minimis* threshold (New Main Board rule 14A.31(1) / GEM rule 20.31(1))?"

1.2 The Exchange's response to the enquiry was as follows:-

"Provided the 30% shareholder is not a connected person at the issuer level, and also does not have any other relationship at the subsidiaries level (e.g. a director of a subsidiary), then the non-wholly owned subsidiary is not a connected person. Therefore, if the substantial shareholder has no other relationship, e.g. he is not a director of a subsidiary, the non wholly-owned subsidiary will not be treated as a connected person."

In this case, the transaction will not be subject to the notifiable transaction requirements as intra-group financial assistance is exempt. Also, financial assistance will not be treated as a connected transaction as the non-wholly owned subsidiary is not a connected person."

2 The Issue

2.1 In a nutshell, FAQ 56 appears to say that a non wholly-owned subsidiary is not a connected person notwithstanding the fact that, in the example given in FAQ 56, the non wholly-owned subsidiary would have been treated as an associate of the 30% shareholder under rule 1.01.

2.2 This appears to be at odd with the Listing Rules and, in particular, the Exchange's views other information disseminated by the Exchange.

2.3 For example, in FAQ 58, the Exchange was asked the following question¹:-

"Financial assistance to an issuer by a connected person is a connected transaction. Does this "connected person" include an associate of a substantial shareholder of a subsidiary (i.e. a non wholly-owned subsidiary) of the listed company?"

The Exchange's response to FAQ 58 was as follows:-

¹ A similar scenario was set out in Chart 8 of the charts prepared by the Exchange during the seminar on Enhancing Corporate Governance and Market Quality,

"Yes. A substantial shareholder of a subsidiary (whether or not wholly-owned) is a connected person. Therefore, its associate is also a connected person."

While FAQ 58 is about a non wholly-owned subsidiary granting financial assistance to a listed issuer, it is submitted that the analysis would have been the same in relation to the financial assistance granted by the listed issuer to the non wholly-owned subsidiary. In the scenario set out in FAQ 58, the non wholly-owned subsidiary is a connected person because it is an associate of a connected person.

- 2.4 Reading FAQ 56 and FAQ 58 together, why is it that, in the scenario set out in FAQ 56, the non wholly-owned subsidiary not treated as an associate of the 30% shareholder (and hence become a connected person of the listed issuer)?

3 The Analysis

- 3.1 It would appear to us that, as the non wholly-owned subsidiary is 30% owned by the 30% shareholder, under rule 1.01, the non wholly-owned subsidiary should be treated as an "associate" of the 30% shareholder.

- 3.2 According to Note 1 of rule 14A.11(5), a non wholly-owned subsidiary will not be treated as a connected person only if:-

- (a) no connected person(s) of the listed issuer (other than at the level of its subsidiaries) is/are (individually or together) entitled to exercise, or control the exercise of, 10% or more of the voting power at any general meeting of such non wholly-owned subsidiary; and
- (b) the non wholly-owned subsidiary is not an associate of a person referred to in rules 14A.11(1), (2) or (3).

- 3.3 It is quite clearly, in the scenario set out in FAQ 56, the condition in para 3.2(a) is satisfied. However, it is not clear why the condition set out in para 3.2(b) is also satisfied (which it will have to be if FAQ 56 is correct).

- 3.4 In order to reconcile FAQ 56 with Note 1(b) of rule 14A.11(5), we will have to interpret the meaning of "listed issuer", as set out in rule 14A.11(1), to have different meanings for "directors and chief executives" and "substantial shareholders":-

- (a) in the context of "directors and chief executives", it would have to mean the directors and chief executives of the listed company and its subsidiaries while,
- (b) in the context of "substantial shareholders" it would have to mean substantial shareholders of the listed company only.



- 3.5 This is not impossible because, under rule 14A.10(7), the definition of a "listed issuer" has the same meaning as set out in rule 14.04(6) which basically means the listed company and "unless the context otherwise requires" its subsidiaries.
- 3.6 While it is not immediately obvious why this should be so, it may be that the Exchange does consciously intends that the context requires directors to be treated differently to substantial shareholders in the context of non wholly-owned subsidiary.
- 3.7 We note that, in all the examples used by the Exchange where "other circumstances" is quoted so that the non wholly-owned subsidiary becomes a connected person, it is always by reference to "directors" (see FAQ 56, FAQ 57, Charts 7 and Charts 8).
- 3.8 Is this a deliberate attempt to make a distinction between directors and substantial shareholders in the context of non wholly-owned subsidiaries.
- 3.9 From a commercial perspective, it would appear that the conclusion in FAQ 56 is commercially sensible because it is difficult to see why it would have matter whether the substantial shareholder owns 29.9% or 30.1%. However, we do not know whether this is truly intended.

4 **Our Request**

- 4.1 As mentioned previously, the scenario contemplated by FAQ 56 is very common. Particularly with the change in the new rule relating to pro-rata financial assistance - where the exemption set out in rule 14A.65(3)(b)(i) does not apply where the non wholly-owned subsidiary is itself a connected person - it is very important to determine whether a non wholly-owned subsidiary is a connected person or not.
- 4.2 For the benefits of listed issuers and practitioners alike:-
- (a) if FAQ 56 correctly states the position with regards to non wholly-owned subsidiaries who are also associates of minority shareholders, we wonder whether the Exchange would be able to make a note on FAQ 56 to this effect; and
 - (b) if FAQ 56 does not correctly state the position, we would be grateful if the Exchange would consider amended FAQ 56.
- 4.3 For our own information, we would be helpful if the Exchange could give us a written response in due course on this enquiry.

If possible, I should like to have a chat with you further on this issue. With your permission, I should like to give you a call some time later once you have had the opportunity to digest the content of this letter.

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Date 10th June 2004



羅夏信律師樓

STEPHENSON HARWOOD & LO

In the meantime, if you would like to contact me, my contact details are D/L: 2533 2790, Fax: 3150 3790 and email: vk1@shl.com.hk.

I look forward to hearing from you in due course.

Yours faithfully

A handwritten signature in black ink, appearing to be 'Lai Voon Keat', written over a horizontal line.

Lai Voon Keat