SULLIVAN & CROMWELL

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Listing VIE Structures on the Hong Kong Stock Exchange

A Brief Guide for Listing Applicants Using VIE Structures

INTRODUCTION

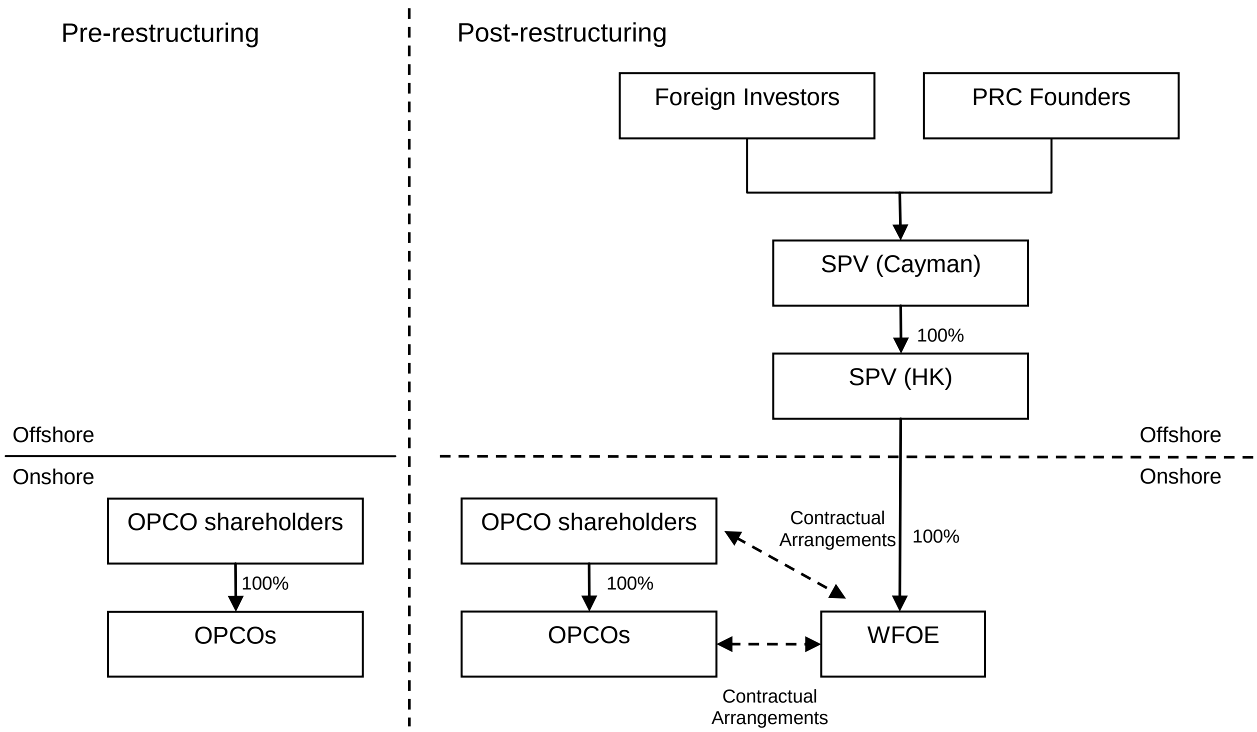
A variable interest entity ("***VIE***") structure is commonly used by listing applicants in industry sectors that are subject to certain PRC legal and regulatory restrictions (for example, foreign ownership limitations). A VIE structure generally involves PRC founders establishing a foreign holding company (which will normally become the listing vehicle) which holds a subsidiary in the PRC (the "***WFOE***"). The WFOE will enter into certain contractual arrangements (the "***Contractual Arrangements***") with operating companies established in the PRC (the "***OPCOs***") and wholly owned by PRC domestic entities or natural persons (the "***OPCO shareholders***"). The Contractual Arrangements allow the WFOE to obtain control over and consolidate into its financial results, substantially all of the economic benefits from, the OPCOs.

The Stock Exchange of Hong Kong Limited (the "***SEHK***") generally allows listing applicants using VIE structures to list in Hong Kong but adopts a heightened standard of review as set out in its Listing Decision HKEx-LD43-3[1]. The SEHK has recently revised its decision[2] to impose additional requirements on listing applicants using VIE structures.

VIE STRUCTURE

The following diagram shows a typical VIE structure.

A typical VIE structure



The Contractual Arrangements are normally structured to achieve the following:

- To confer to the WFOE and its subsidiaries all the economic benefits, management control, control over voting, operation and management of the OPCOs.
- The WFOE will normally own the rights to intellectual property or licences which it will assign to the OPCOs.
- The WFOE will be granted rights to acquire, as and when permitted by the relevant laws and regulations, the equity interests in and/or assets of the OPCOs for a nominal price or a pre-paid amount.
- The WFOE will be granted a first priority security interest in the OPCO shares owned by the OPCO shareholders, as security for proper performance of the Contractual Arrangements.

FACTORS TO CONSIDER WHEN LISTING A VIE STRUCTURE IN HONG KONG

General Principles

Generally, a company will not be unsuitable for listing in Hong Kong simply because its operations are in the form of a VIE structure. However, in considering the suitability for listing of a VIE structure, the SEHK will consider and scrutinize the listing applicant's rationale for adopting the Contractual Arrangements. In cases where VIE structures are adopted for unrestricted businesses, the Listing Division will normally refer the case to the Listing Committee.

Suitability for Listing

When determining the suitability for listing of a company with VIE structure, the SEHK has provided the following guidance:

(i) Disclosure-based approach

The sponsor and the listing applicant must demonstrate that the listing applicant had complied in fact and in good faith with all relevant PRC laws and regulations. Full disclosure of the Contractual Arrangements is expected to be provided in the prospectus. In practice, the listing applicant's PRC legal adviser will often be required to opine on, among other things:

- the validity of the Contractual Arrangements (as individual contracts and as a whole) under PRC laws and regulations and that no further approval or confirmation is required for the Contractual Arrangements under PRC laws and regulations; and
- the WFOE and the OPCOs have obtained all necessary approvals and completed all registrations and have the capacity to carry out business operations.

(ii) Standard of review

- As a matter of general principle, the SEHK expects that the Contractual Arrangements are narrowly tailored to achieve the listing applicant's business purposes and minimize the potential for conflict with relevant PRC laws and regulations (and the opinion of the PRC legal adviser is expected to reflect this).
- A broad review of all relevant facts and circumstances concerning the listing applicant would be undertaken by the SEHK, including a review of its legal and compliance history, its management systems and corporate governance practices, its records in protecting shareholder interests and its financial resources to ensure compliance with the applicable laws and regulations.
- Appropriate regulatory assurance should be obtained from the relevant regulatory authorities or there must be an appropriate statement in the PRC legal opinion to the effect that all possible actions or steps to be taken to enable it to reach its legal conclusions had been taken.
- The Listing Rules and Listing Division policies would be strictly construed.

(iii) Other requirements

The listing applicant is also expected to:

- provide reasons for the use of the Contractual Arrangements;
- have in place mechanisms to unwind the Contractual Arrangements as soon as the law allows the business to operate without them;
- ensure that the Contractual Arrangements include a power of attorney by which the OPCO shareholders grant to the listing applicant's directors and their successors the power to exercise all the rights of the OPCO shareholders;
- ensure that the Contractual Arrangements contain dispute resolution clauses that provide for arbitration and that arbitrators may award remedies over the shares or land assets of the OPCOs, injunctive relief or order the winding up of the OPCOs, and provide the courts of competent jurisdictions with the power to grant interim remedies in support of the arbitration pending formation of the arbitral tribunal or in appropriate cases;
- be able to deal with the OPCO assets under the Contractual Arrangements; and
- ensure that a liquidator, acting on the Contractual Arrangements, can seize the OPCO assets in a winding up situation for the benefit of the listing applicant's shareholders or creditors.

DISCLOSURE REQUIREMENTS

Disclosure in Prospectus

In addition to meeting the above requirements, the listing applicant is now also expected to disclose the following in its prospectus.

(i) Arrangements with OPCO shareholders

- A detailed description of the OPCO shareholders is expected to be included in the prospectus. In particular, the listing applicant must demonstrate how its interests are protected in the event of the death, bankruptcy or divorce of the OPCO shareholders to avoid any practical difficulties in enforcing the Contractual Arrangements.
- The prospectus must also disclose the extent to which the listing applicant has arrangements in place to address the potential conflict of interest between the listing applicant and the OPCO shareholders, particularly in cases where these shareholders are officers and directors of the listing applicant.
- The Contractual Arrangements are also expected to be illustrated by a corporate structure chart in the prospectus to facilitate investors' review and understanding of the arrangements.

(ii) Legality and enforceability of the Contractual Arrangements

- The directors of the listing applicant must state in the prospectus the bases why they believe that each of the agreements conferring significant control and economic benefits from the OPCOs to the listing applicant is enforceable under the PRC and local law.
- The prospectus should include a discussion on whether the listing applicant has, to date, encountered any interference or encumbrance from any PRC governing bodies in operating its business through the OPCOs under the Contractual Arrangements.

(iii) Risk factors to be included

- The prospectus should disclose the following risks:
  - the economic risks the listing applicant bears as the primary beneficiary of the OPCOs
  - in what way the listing applicant shares the losses of the OPCOs
  - the circumstances that could require the listing applicant to provide financial support to the OPCOs or other events or circumstances that could expose the listing applicant to losses
  - the limitations in exercising the option to acquire ownership in the OPCOs and clarifying that ownership transfer may be subject to substantial costs
- Other risks to be disclosed regarding the nature of the VIE structure include: the risks of the PRC government determining that the Contractual Arrangements do not comply with applicable regulations; the absence of direct ownership control over the OPCOs; potential conflict of interest between the listing applicant and the OPCO shareholders; and additional scrutiny from PRC tax authorities over the Contractual Arrangements.

(iv) Material contracts

- The SEHK considers the underlying agreements of the Contractual Arrangements to be "material contracts" which must be summarized in the prospectus and copies of the underlying agreements are to be made available for public inspection on the website of the listing applicant.

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ENDNOTE(S)

[1] HKEx-LD43-3 (First Quarter of 2005, updated in November 2011).

[2] HKEx-LD43-3 (First Quarter of 2005, updated in November 2011 and August 2012).

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