Private investment in public equity (PIPE):

what you need to know to invest in **Hong Kong** and **US PIPE** transactions

Favourable market conditions have led to a recent rise in PIPE deals. In this article, Paul Chow and Miranda So of *Davis Polk* answer your burning questions and give their thoughts as to why investors and companies may favour PIPE transactions over those through the public market, as well as discussing the variables.

Public companies can access the capital markets and raise capital through a variety of means. One such avenue is commonly referred to as 'PIPE' (private investment in public equity), where one investor or a small group of investors subscribes for shares or convertible instruments of a public company in a privately negotiated transaction. From the listed company's perspective, a PIPE transaction can usually be done much more quickly than a registered offering. From the investor's perspective, a PIPE transaction offers it the opportunity to negotiate for contractual rights, such as board and observer seats, which it likely would not be able to obtain in a public offering by the listed company. While the terms of PIPE transactions may vary depending on the size of the investment, the identity of the investor and the strategic rationale of the issuance, there are various key legal considerations that one should know when evaluating a PIPE transaction. This article explores such key legal considerations relevant to two principal markets in which Chinese companies are listed: Hong Kong and the United States.

Hong Kong PIPE transactions[1]

General mandate

PIPE transactions are common in Hong Kong in part because many Hong Kong-listed companies have a general mandate from their shareholders that allows them to issue up to 20 percent of their issued share capital during the relevant year. Under the Hong Kong listing rules (HKLRs) governing the listing of securities on the stock exchange of Hong Kong Limited (the Hong Kong Stock Exchange (HKSE)), such a general mandate can be given to the directors of a Hong Kong-listed company by its shareholders at an annual general meeting. If the listed company in question has a general mandate available and the mandate can be utilised for the proposed transaction, a PIPE transaction can be completed very quickly, sometimes in weeks or even days. On the other hand, if a general mandate is not available, or if the mandate cannot be utilised for the proposed transaction, the listed company will need to convene an extraordinary general meeting and obtain a specific mandate from its shareholders to proceed with the transaction.

A general mandate could be unavailable at the time of the proposed transaction even if it was obtained at an annual general meeting. For example: if the listed company had already fully utilised such mandate earlier in the year and such mandate had not been refreshed by its shareholders. There are also other situations where a general mandate cannot be used for a particular issue of securities by the listed company. For instance, a Hong Kong-listed company generally cannot use its general mandate to issue securities to its connected persons as defined in the HKLRs (predominantly the directors, chief executives and substantial shareholders of the listed company or any of its subsidiaries and any of their respective associates). Where convertible bonds are contemplated and the terms of such convertible bonds contain certain conversion price adjustment provisions other than the customary provisions which are designed to prevent dilution of the interests of the convertible bondholders in the listed company, such as a price-reset provision, the HKSE should be consulted early to determine whether the listed company can rely on its general mandate to issue the convertible bonds in question.

It should be noted that HKLRs provide that a listed company may not issue any securities pursuant to a general mandate at a price which represents a discount of 20 percent or more to the benchmarked price of the relevant securities (calculated by reference to recent closing prices). This restriction, however, does not apply to the price at which convertible bonds may be converted into shares of the relevant listed company.

Public float

Another important consideration to keep in mind when structuring a PIPE transaction in Hong Kong is ensuring that upon completion of the transaction (or if convertible securities are contem-

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plated, upon conversion of such convertible securities), the public float of the listed company can be maintained. Unless a waiver has been obtained from the HKSE, at least 25 percent of a Hong Kong-listed company's total issued share capital must at all times be held by the public shareholders. Importantly, the definition of public shareholders excludes any core connected person of the listed company (as defined in the HKLRs) and anyone whose acquisition of shares was financed by a core connected person or who is otherwise accustomed to take instructions from a core connected person with respect to the shares in question. In our experience, the HKSE may not be satisfied simply with an undertaking from the listed company to restore public float at any time when it is not maintained, but it may go further to require a positive undertaking from the listed company that any conversion of the convertible securities will be subject to the listed company being able to comply with the public float requirements immediately after such conversion.

Takeovers code mandatory general offer

Investors should also carefully analyse the terms of their proposed investment at an early stage to determine whether a mandatory general offer obligation will be triggered as a result of the proposed investment.

Pursuant to the codes on takeovers and mergers, if any person or group of persons either holds less than 30 percent of the voting rights of a Hong Kong-listed company and they acquire voting rights, thereby increasing their collective holding to 30 percent or more; or holids between 30 and 50 percent of the voting rights of a Hong Kong-listed company and acquires additional voting rights thereby increasing their voting rights by more than 2 percent from the lowest percentage holding in the 12-month period ending on the date of the relevant acquisition, then such person shall make a mandatory general offer to all holders of share capital of such listed company.

If such obligation will be triggered, a whitewash waiver should be sought from the Securities and Futures Commission (SFC), subject to a number of minimum conditions, mainly including obtaining approval from the independent shareholders of the listed company, appointing an independent financial adviser to advise the independent board committee of the listed company and that the person seeking the waiver must not have conducted any disqualifying transactions in the six-month period prior to the announcement of the proposed acquisition up to and including the date of the shareholders' meeting.

When investing by way of convertible securities, the mandatory general obligation would only be triggered at the time of conversion of the convertible securities into voting shares of the listed company. In this situation, the investors should consider obtaining a whitewash waiver from the SFC in advance at the time of investing in the convertible securities, and not wait until the time of their proposed conversion.

Investors' special rights

Investors in PIPE transactions often ask for special rights, such as director nomination rights, pre-emption rights and veto rights on significant corporate transactions. There is no per se prohibition on Hong Kong-listed companies granting such rights to investors in PIPE transactions. However, directors of listed companies should always be mindful of their fiduciary duties to act for proper purposes and in good faith in the interests of the listed company as a whole when agreeing on the terms of the proposed investment.

US PIPE transactions

Shareholder approval requirement

Similar to Hong Kong, PIPE transactions involving issuances below 20 percent of the listed company's outstanding common stock are common in the United States. While there is no concept of a general mandate in the US, the relevant rules of the New York Stock Exchange (NYSE) and the NASDAQ Stock Market (NASDAQ) set the threshold for seeking prior shareholder approval of a proposed issuance at 20 percent or more of all outstanding common stock of the relevant listed company. When determining whether the 20 percent threshold is met, the numerator should include the maximum amount of securities theoretically issuable upon conversion (including shares issuable as a result of, for example, warrants, payment-in-kind dividends or anti-dilution protections), and the denominator should only include voting securities outstanding prior to the proposed issuance.

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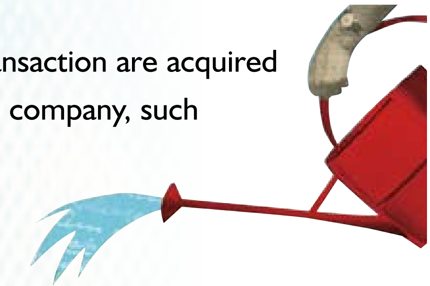
> "Because the securities acquired in a PIPE transaction are acquired in an unregistered private sale from the listed company, such securities are 'restricted securities' within the meaning of Rule 144 under the US Securities Act of 1933, and cannot be resold publicly, except pursuant to a valid registration statement or an exemption from such registration requirements"

Miranda So



In addition, if the proposed issuance would result in a change of control or would involve issuance to certain related parties, prior shareholder approval may also be required.

If one of the shareholder approval triggers is met, the listed company will need to hold a shareholders' meeting before it can proceed with the issuance, unless an exemption applies. For example, the 'financial hardship exemption' allows an issuance to proceed without shareholder approval upon application to the exchange. When the delay in securing such approval would "seriously jeopardise the financial viability of the enterprise", audit committee approval is obtained and notice is given to shareholders. The 'at market exemption', which only applies to the 20 percent threshold trigger, allows an issuance to proceed without shareholder approval, as long as the shares are issued at or above the greater of the current market price and book value per share. Finally, the 'home country exemption' allows a 'foreign private issuer' (as defined under the Securities Exchange Act of 1934, the Exchange Act) to proceed with an issuance without shareholder approval, as long as such approval is not required under its jurisdiction of incorporation.

A Chinese company listed in the United States will qualify as a 'foreign private issue' if it is incorporated in a jurisdiction other than the United States and 50 percent or less of its outstanding voting securities are held by US residents; or if more than 50 percent of its outstanding voting securities are held by US residents, and none of the following three circumstances applies: the majority of its executive officers or directors are US citizens or residents; more than 50 percent of the issuer's assets are located in the United States; the issuer's business is administered principally in the United States. In order for a foreign private issuer to avail itself of the 'home country exemption', the issuer should disclose in its annual report on Form 20-F filed with the Securities and Exchange Commission (the SEC) any exchange requirements that it does not follow and its home country practice followed in lieu of such requirement. If the 'home country exemption' is available, the listed company in question can issue shares exceeding 20 percent of its outstanding common stock, subject only to its available authorised share capital set forth in its charter.

Securities filings and exchange notifications

Investors who will acquire five percent or more beneficial ownership of the voting securities of a US-listed company should be aware of its reporting obligations under US federal securities laws.

Generally speaking, Section 13 of the Exchange Act requires a beneficial owner of five percent or more of a registered class of voting securities to make a Schedule 13D filing with the SEC within 10 days of the acquisition of such voting securities, and thereafter requires the filer to promptly file amendments to Schedule 13D to disclose any material changes to the information set forth therein (including, for example, a change in investment intent and/or a one percent or greater increase or decrease in beneficial ownership). A passive investor may be able to utilise the shorter Schedule 13G which also has less onerous amendment filing obligations.

In addition, if the investor will become an insider of a US-listed company as a result of the transaction (i.e. a director, officer or beneficial owner of 10 percent or more of a registered class of voting securities), it will be subject to Section 16's reporting requirements and its 'short swing profit rule', which requires disgorgement of any profits made on sales and purchases of the subject securities within any six-month period. Note, however, if the relevant listed company is a foreign private issuer, then Section 16 does not apply.

Registration rights

From the investor's perspective, liquidity is a key benefit to acquiring shares of a listed company in a PIPE transaction as compared to an investment in a private company.

Because the securities acquired in a PIPE transaction are acquired in an unregistered private sale from the listed company, such securities are 'restricted securities' within the meaning of Rule 144 under the US Securities Act of 1933, and cannot be resold publicly, except pursuant to a valid registration statement or an exemption from such registration requirements.

Investors in PIPE transactions, therefore, often ask for registration rights from the listed company. Registration rights typically include the right to demand that the listed company file and maintain a resale registration statement within a specified period of time after closing, such that the investors can be assured of its ability to publicly resell the acquired securities pursuant to the registration statement when it desires to exit.

In most circumstances, the registration rights will fall away when the investor is able to freely resell the acquired securities pursuant to an exemption available under Rule 144 once the six month minimum holding period has passed, provided that the listed company is current on its public information requirements. However, this exemption is available only to non-affiliates of the listed company. Investors who become affiliates of the listed company will continue to be subject to other applicable restrictions under Rule 144, and in those circumstances, investors should make sure that they will continue to benefit from the registration rights granted by the listed company, so that they are able to resell the acquired securities using the resale registration statement.

Investors' special rights

Investors in US PIPE transactions often ask for special rights to protect their interest in the listed company, just as investors in Hong Kong PIPE transactions would, as described above. The NYSE and NASDAQ rules generally require director appointment rights to not be greater than the investor's economic interest in the relevant company, and for any veto rights given to an investor to be reasonable in light of the investor's economic interest in the relevant company. Subject to these guidelines, what governance rights and other protections a PIPE investor can expect to obtain often depend on the size of the investment and the relative bargaining power of the parties; an investor that is offering a strategic alliance beyond the equity investment may be able to obtain greater rights. At the same time, the listed company may ask the investor to agree to not transfer the acquired shares within a certain period of time or to agree to a standstill restriction to not increase its stake in the company without the prior approval from the listed company's board of directors. While the parties will be guided by market precedents when negotiating special rights, these rights are often tailored to the specific situation and can vary greatly.

Endnote

1. This article considers PIPE transactions involving companies listed on the Main Board of Hong Kong Stock Exchange only. We do not consider herein considerations applicable to companies listed on the Growth Enterprise Market of Hong Kong Stock Exchange.

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