

Characteristics of HKEx and its attractiveness to international business

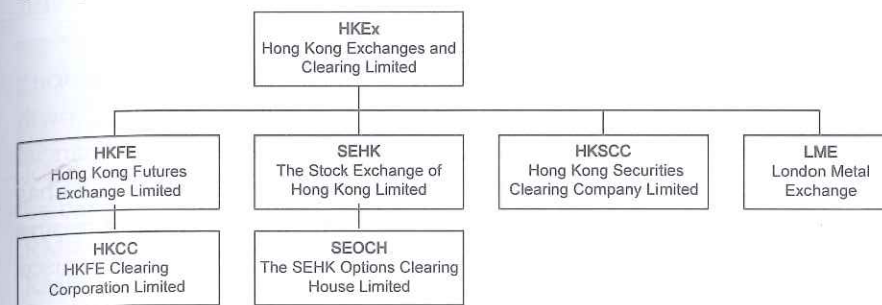
¶2-030 Introduction

Authorised under the SFO to be the sole authorised exchange, HKEx operates a stock exchange and futures exchange in Hong Kong and the associated clearing houses, namely Hong Kong Securities Clearing Company Limited ("HKSCC"), HKFE Clearing Corporation Limited ("HKCC") and the SEHK Options Clearing House Limited ("SEOCH").

HKEx offers two separate boards for issuers, being the Main Board and GEM. The Main Board is a market for more established businesses that fulfill financial requirements stated under Main Board Listing Rule 8.05 which require issuers to meet minimum requirements on profits, market capitalisation, revenue and/or cash flow.

GEM is a second board in HKEx. There was a change of direction from HKEx when GEM was launched. The board was intended to be a stepping stone to the Main Board for companies with growth potential and less stringent process was involved for the companies to be transferred from GEM to the Main Board. GEM is now a new market with lower listing eligibility criteria but similar continuing obligations compared to that of the Main Board, serving the needs of small and mid-sized issuers.

Group structure of HKEx



Note 1: HKEx acquired 100% of the ordinary share capital of the London Metal Exchange Holdings in June 2012.

Note 2: HKEx, Shanghai Stock Exchange and Shenzhen Stock Exchange established a joint venture, China Exchanges Services Company, in September 2012.

Source: HKEx – Listing in Hong Kong and HKEx Annual Report 2017

The Stock Exchange of Hong Kong Limited, a wholly-owned subsidiary of HKEx, is a recognised exchange company under the *Securities and Futures Ordinance* ("SFO"). It operates and maintains a stock market in Hong Kong and is the primary regulator of stock exchange participants with respect to trading matters and of companies listed on the Main Board and GEM.

Hong Kong Futures and Exchange Limited, a wholly-owned subsidiary of HKEx, is a recognised exchange company under the SFO. It operates and maintains a futures market in Hong Kong and is the primary regulator of future exchange participants with respect to trading matters.

The Hong Kong Securities Clearing Company Limited ("HKSCC"), SEHK Options Clearing House Limited ("SEOCH"), HKFE Clearing Corporation Limited ("HKCC") and OTC Clearing Hong Kong ("OTC Clear"), subsidiaries of HKEx, are recognised clearing houses for the purposes of the SFO. HKSCC and SEOCH provide services for the clearing and settlement of securities and stock option transactions respectively. HKCC provides services for the clearing and settlement of futures transactions. OTC Clear provides clearing and settlement services for interest rate and foreign exchange derivatives traded over-the-counter to its members.

¶2-040 Geographical advantages and close linkage to Mainland China

With close trading and business links to Mainland China, the world's second-largest economy, HKEx is strategically located in a high growth region. Located in Hong Kong, an internationally recognised financial centre with expertise and a well-established legal framework, HKEx has provided many Chinese and international companies with fund raising opportunities and ranked the third and first in terms of funds raised through IPOs in 2017 and 2018.

Hong Kong has served as the gateway to Mainland China in the past decade and a growing number of companies have chosen to list on HKEx in order to establish a presence or foothold in the Greater China market. The acceleration of RMB's internationalisation and the expansion of the Renminbi Qualified Foreign Institutional Investor scheme presented great opportunities for Hong Kong in playing its role as the gateway to Mainland China and a channel for capital destined for and originating from China.

Hong Kong is the key platform for Mainland China's trading with the rest of the world. It is widely recognised as a gateway for companies to access the China market and the springboard for Chinese enterprises to gain exposure to international markets. In 2014, around 25% of Mainland China's trade volume¹ was intermediated by Hong Kong in the form of offshore trade or re-exports. Hong Kong is also the largest source of foreign direct investment for Mainland China, accounting for 60% of the total amount in 2013. At the same time, Hong Kong is the largest recipient of outward direct investment from Mainland China, being either the beneficiary or intermediary of about 60% of outward direct investment.

¶2-050 The largest RMB offshore centre in the world

In the 12th Five Year Plan of the People's Republic of China announced in March 2011, Hong Kong has been designated as a major offshore RMB centre and the testing ground for broadening RMB's role in the world.

¹ Source: "The Global Offshore Renminbi Business Hub" issued by the Hong Kong Monetary Authority ("HKMA") dated January 2016.

The following table illustrates the RMB transactions statistics between 2017 and 2018:

	2017 RMB billion	2018 RMB billion	Growth/ (Decline)
RMB trade settlement handled by banks in Hong Kong	3,913.90	4,206.20	7%
RMB deposits and outstanding RMB certificates of deposits in Hong Kong (at year-end)	618.4	657.7	6%
Outstanding RMB loans (at year-end)	144.5	105.6	-27%

Source: Half Yearly Monetary & Financial Stability Report issued by Hong Kong Monetary Authority dated March 2019

At the beginning of 2011, the People's Bank of China announced a pilot scheme to allow PRC enterprises to use RMB in conducting overseas direct investment ("ODI"). Banks in Hong Kong can obtain ODI-related RMB funds from the Mainland China enterprises to facilitate and finance ODI transactions through the Hong Kong platform. In the same year, the People's Bank of China gave the green light for RMB foreign direct investment and this provided more ways for offshore RMB to flow back into Mainland China.

In August 2011, the RMB trade settlement scheme was expanded from 20 provinces and cities in Mainland China to all provinces and cities. Outside Mainland China, the program was extended to all countries and regions after being piloted in Hong Kong, Macau, and the Association of Southeast Asian Nations ("ASEAN"). All of these new RMB currency policies boosted the growth of the RMB business in Hong Kong and further enhanced Hong Kong's prime role as an offshore RMB business centre in the world.

RMB trade settlements conducted through banks in Hong Kong increased in 2018. RMB trade settlements handled by Hong Kong banks soared 7% year on year to RMB4,206 billion. RMB deposits and outstanding RMB certificates of deposit grew to RMB658 billion, representing a 6% growth

from 2017. With the largest pool of RMB in the world outside China, Hong Kong is now the prime platform for offshore RMB trading.

Hong Kong has a well-established RMB payment and settlement network covering more than 30 countries in six continents². At the year-end of 2019, there were 207 banks participating in Hong Kong's RMB clearing platform.

The offshore RMB business in Hong Kong, particularly RMB financing activities and RMB financial products, will grow substantially as channels for cross-border circulation of funds continue to broaden. The Renminbi Qualified Foreign Institutional Investor ("RQFII") scheme was first introduced in December 2011 with an initial quota of RMB20 billion. At the end of 2018, the total RQFII quota has reached RMB1.94 trillion, while the aggregated quota of RMB646.7 billion has been granted to 233 RQFIIs. The RQFII quota will allow more foreign institutional investors to take part in the mainland stock market by using their RMB funds raised or held in Hong Kong. Moreover, in September 2011, HKEx launched the Dual Tranche Dual Counter model which allows listed companies to issue RMB-denominated shares and raise RMB funds. This dual-currency model will fulfill listed issuers' growing demand for RMB funds. In November 2014, HKEx introduced the Shanghai and Hong Kong Stock Connect which allows non-Mainland China investors to invest in eligible shares listed on the Shanghai Stock Exchange and Mainland China investors can also invest in eligible shares listed on HKEx. This scheme helps to open up Mainland China's capital markets and to promote the internationalisation of Renminbi. In the long run, the scheme will enhance the use and circulation of RMB.

With strong liquidity support, HKEx's profile of RMB-denominated products, including RMB-denominated shares, RMB bonds and other RMB denominated financial derivatives, will be expanded in terms of number of issues and size. These products will be traded much more actively, producing a strong multiplier effect and generating even more RMB liquidity.

HKEx's growth of RMB business is expected to be strong, particularly when China accelerates the opening of its capital account and further

² Briefing to the Legislative Council Panel on Financial Affairs (3 March 2012) by HKMA.

internationalises RMB. There is a strategic opportunity for HKEx to build an offshore market for Mainland China investors who are seeking to diversify their investments beyond their home market.

¶2-060 China's offshore capital formation centre

HKEx provides a platform for Mainland issuers to raise funds from international investors. In 2018, 218 companies were newly listed in Hong Kong, of which 101 companies were from Mainland China. At the end of 2018, Mainland enterprises accounted for 68% of the total market capitalisation and 80% of the average daily turnover of HKEx.³

Qualified RQFII holders can now channel RMB funds raised in Hong Kong to invest in the Mainland China securities markets. This marked a significant step in the reinforcement of Hong Kong's position as the preferred offshore RMB centre. In response to these opportunities, HKEx has upgraded its trading systems, including the cash market trading system's processing capacity, and has constructed a new data centre to support the growing offshore RMB business in Hong Kong.

In April 2011, the successful listing of Hui Xian REIT (HKEx: 87001) on HKEx, raising RMB10.5 billion, set an important milestone as it was the first RMB-denominated REIT IPO in Hong Kong. Apart from RMB-denominated debt securities and REITs, HKEx is prepared for the introduction of other products such as RMB-denominated shares, futures and options. The Dual Tranche Dual Counter model and RMB Equity Trading Support Facility are available to facilitate listings and trading in RMB-denominated securities. The Dual Tranche Dual Counter model allows listed companies to issue both RMB-denominated shares and HKD-denominated shares. The RMB Equity Trading Support Facility enables investors to buy RMB-traded shares using HKD.

In October 2012, Hopewell Highway Infrastructure Limited (HKEx: 80737) became the first listed company to issue RMB-denominated shares and raised RMB386.4 million through a share placing.

In November 2014, the launch of the Shanghai and Hong Kong Stock Connect program allowed Mainland Chinese investors to trade shares listed in Hong Kong.

³ Source: HKEx Market Statistics 2018.

In December 2016, the launch of the Shenzhen and Hong Kong Stock Connect Program provide an additional channel for Mainland Chinese Investors to trade shares listed in Hong Kong.

In March 2017, HKEx introduced RMB Currency Option. The US dollar-Offshore RMS(USD/CNH) Option contract became the first currency options traded at HKEx.

In July 2017, Bond connect was launched. Mainland Chinese investors are allowed to trade bonds through this mutual bond market access programme.

Given the strong market interest in RMB stocks in Hong Kong, more RMB-denominated IPOs are expected in the near future.

¶2-070 Global listing venue

In 2017 and 2018, HKEx was ranked third and first in terms of IPO funds raised. Since 2002, HKEx was among the world's top five in IPO fundraising. HKEx performed remarkably well in terms of IPOs from 2009 to 2011 and was named the number one stock exchange in fundraising through IPO.

HKEx has a strong track record of IPO funds raising therefore. In 2018, HKEx even stepped up to be the top IPO funds raised market in the world.

HKEx accounted for the top three IPOs in the world history. The IPO of Agricultural Bank of China Limited (HKEx: 1288), which was dually listed on HKEx and as well as SSE with IPO proceeds in an aggregate of US\$22.1 billion in 2010, remains the largest IPO in world history. The second largest IPO was that of the Industrial and Commercial Bank of China (HKEx: 1398), which was dually listed on HKEx and the SSE with total funds raised in the amount of US\$22 billion in 2006. AIA Group Limited (HKEx: 1299) listed on HKEx in 2010 with total funds raised being US\$20.5 billion and this IPO was ranked as the third largest in world history.

Apart from being the top IPO centre, a number of overseas companies have been attracted to list in Hong Kong because of wishing to benefit from the market's liquidity, appealing valuation and access to Asian investors. For example, the Swiss-based commodity trader Glencore

International plc completed its dual IPO in HKEx and the London Stock Exchange in May 2011. Kazakhmys, a London-listed Kazakh copper miner, completed its secondary listing on HKEx in June 2011. At the end of 2010, Vale S.A., a Brazilian mining company, was the first company listed on HKEx in the form of depositary receipts.

International luxury brands also seek a Hong Kong listing in order to tap the growth of Mainland China's consumers. L'Occitane International Limited, a French cosmetic manufacturer and retailer, was listed in May 2010. Prada, the luxury fashion brand, was listed in June 2011. Coach also completed its secondary listing in the form of depositary receipts in December 2011. In December 2014, Fast Railing Co. Ltd., a Japanese apparel retailer of UNIQLO, was listed in Hong Kong in the form of depositary receipts.

In order to facilitate the listing of international companies, the acceptable jurisdictions by HKEx as an issuer's place of incorporation have been increased to 30 in January 2020. Details of the acceptable jurisdictions by HKEx are covered in Chapter 3.

HKEx will continue to be attractive to international companies as Hong Kong remains a major hub for foreign investors to access the China market and is recognised as an alternative to the US and UK capital markets.

¶2-080 Integrated exchange with equities and commodities

In June 2012, HKEx successfully bid for the acquisition of the London Metal Exchange ("LME") for a consideration of HK\$16,673 million. LME is the world's leading exchange for the trading of base metal futures and options contracts, with a global market share estimated to be approximately 80%⁴. It achieved record volumes during 2011, with 146.6 million lots traded, which are equivalent to US\$15.4 trillion (approximately HK\$120 trillion) in notional contract value.

LME is also the world's price formation venue with prices discovered on LME used as the global benchmark and basis for physical trading. Between 2007 and 2011, trading volumes have grown by 12.1% per

⁴ Source: HKEx's Announcement published on 15 June 2012.

annum despite the difficult global economic environment, demonstrating the resilience of LME's business model and the elasticity of its client base. All the contracts traded on LME are currently cleared through an external clearing house. LME has announced a plan to establish its own clearing house which is expected to be operated by its subsidiary, LME Clear. Currently, there are over 500 LME-approved warehouses across 35 locations in the USA, Europe and Asia.

The acquisition aligns with HKEx's strategic priority to become a horizontally and vertically integrated global exchange group, with its scope expanding beyond equities to additional asset classes including fixed income, currencies and commodities. In particular, HKEx recognises the significant and growing demand in Asia for an exchange which meets the needs of metals market participants in the region, especially China. China is the leading consumer and producer of base metal, representing 42% of global consumption of base metal and 32% of global production of base metal. The alliance allows LME to increase trading volumes through improved access to China. In the long term, LME can expand its business and operation in Asia and the Mainland China market by leveraging HKEx's resources, infrastructure and network in Asia. Under the ownership of HKEx, LME enjoys significant room for growth in China, including:

- (1) the enhancement of market data distribution and connectivity into China and other Asian regions;
- (2) expansion of the warehouse network in China and other Asian regions;
- (3) expansion of the number of Mainland Chinese participants and clients; and
- (4) the introduction of new products tailored for the Asian market.

LME provides HKEx with a platform to enter into other asset classes and synergies relating to the development of RMB products in fixed income and currencies that are attached to commodity flows and opportunities for further geographical expansion, especially in emerging markets like China and the BRICS⁵ countries.

⁵ BRICS refers to Brazil, Russia, India, China and South Africa.

¶ 2-090 Advanced clearing and settlement infrastructure

HKEx operates a securities market and a derivatives market in Hong Kong and clearing houses for those markets. Trading in all HKEx markets is fully electronic and transactions are guaranteed and cleared through linked electronic systems. To prepare for an anticipated increase in data traffic, HKEx has made substantial investments in its IT infrastructure to maintain a competitive edge regionally and position HKEx for the capture of longer-term growth opportunities.

One of HKEx's major recent achievements is the establishment of a state-of-the-art data centre in January 2013. The center was equipped with a comprehensive HK\$3 billion program designed to enhance HKEx's technological infrastructure. The new data centre will enable high capacity trading and provide ultra-low latency price information to support the continuing growth of HKEx into a multi-asset class exchange.

To support the Shanghai – Hong Kong Stock Connect and enhance connectivity with Mainland investors and international investors, HKEx has set up a Mainland Market Data Hub in Shanghai during 2014. The hub enables more efficient distribution of market data across cross-border markets.

¶ 2-100 Aligning trading hours with other Asian exchanges

Under the new trading hours implemented on 5 March 2012, the continuous trading session of HKEx's securities market runs from 9:30am to 12:00 noon and then from 1:00pm to 4:00pm. The lunch break was shortened from two hours to one hour. The new hours were intended to enhance the price discovery function in Hong Kong by opening the market earlier and increasing the overlap of HKEx's trading hours with the trading hours of Mainland China exchanges. In addition, the change strengthens HKEx's competitiveness by narrowing the trading hour gap between HKEx and the Asian exchanges.

If the listing applicant has delayed its proposed timetable and more than six months have lapsed since the date of the listing application form, the initial listing fee is considered as forfeited.

¶15-050 Listing document – Prospectus

The listing document serves as an invitation to the public to subscribe for shares in the listing applicant. It provides details of the historical and prospective information about the prospective issuer's operations and financial situation for potential investors to consider and decide on whether they will subscribe for the securities. It also contains the methods of subscribing for the securities.

The listing document for an IPO application should be in the form of a prospectus, a circular (applicable in certain circumstances such as a reverse takeover) or any equivalent document. A prospectus serves as the listing document for most IPOs.

The content requirements of the prospectus are set out in Appendix 1 of the Main Board/ GEM Listing Rules. The listing applicant must comply in full with the content guidelines therein before submitting its application. HKEx may refuse to review any documents if it considers that the prospectus is not in an advanced form.

The key items of content required for the preparation of the prospectus are explained in the following section.

¶15-060 General information about the listing applicant, experts and other parties involved in the IPO

- Name and address of the listing applicant, its directors, its experts including sponsors, auditors, reporting accountants, legal advisers, valuers, etc. and other parties involved in the IPO such as underwriters, bankers, registrars and trustees to the IPO;
- Corporate information such as the date and country of incorporation, the principal place of business in Hong Kong, and a summary of the articles of association of the prospective issuer; and

- A statement made by the directors of the prospective issuer regarding their responsibilities on the information contained in the prospectus.

¶15-070 Information on the securities for which listing is sought and the terms and conditions of their issue and distribution

- Nature and amount of the issue, such as the number of securities which have been created, and a full description of the terms attaching to such securities;
- Particulars of any expenses in relation to the issue and the application for listing that are incurred or to be incurred; and
- A statement of the net tangible asset backing for each class of securities for which listing is sought.

¶15-080 Information relating to the issuer's capital

- Particulars of the authorised share capital of the prospective issuer, including the amount issued or to be issued, the amount paid up, the nominal value and the voting rights of each class of shares;
- Particulars of any options granted or agreed to be granted including the price, terms, and the name and address of the grantee;
- Details of any controlling shareholders of the prospective issuer, including the names and the amount of their interests in the prospective issuer; and
- A statement explaining how the prospective issuer is capable of carrying its business independent of the controlling shareholder and its associates after listing.

¶15-090 General information on the group's activities

- General nature of the business supported by figures and explanation to demonstrate the importance of each activity and the main categories of products sold or services provided. A commentary covering changes in market conditions and

developments; introduction of new products or services and their impact on the prospective issuer's performance, market share, turnover and margins, and the geographic analysis of trading operations and assets;

- Statements of the percentage of turnover and purchases attributable to the group's largest and five largest combined customers and suppliers respectively. If the largest or five largest customers or suppliers are owned by a person connected to the prospective issuer, such facts should be disclosed;
- Commentary and information on other business risk factors such as changes in the number of people employed and related policies, research and development policies, particulars and importance of intellectual properties, etc.; and
- Particulars of any restrictions affecting the remittance of profits or repatriation of capital into Hong Kong.

¶15-100 Financial information on the group and its prospects

- Statements as at the most recent practical date of:
 - (a) the total amount of debt securities issued;
 - (b) total amount of borrowings or indebtedness;
 - (c) all mortgages and charges;
 - (d) total amount of any contingent liabilities or guarantees;
 - (e) sales turnover figures and gross trading profits during the three financial years immediately preceding the issue of prospectus; and
 - (f) information on the emoluments of directors and top five individuals and related pension schemes;
- A commentary on the listing applicant's liquidity and financial resources, and the prospective issuer's capital structure;

- Information on the business, financial and trading prospects, and, where appropriate, a profit forecast²; and
- Statements by the directors on their opinions regarding working capital sufficiency for at least 12 months from the date of the prospectus, and on any material adverse changes in the groups' financial or trading position since the end of the reporting period included in the reporting accountants' report.

¶15-110 Information on the issuer's management

- Particulars of every director and senior management including the full name; residential or business address;
- Brief biographical information, particularly their relevant management expertise and experience, current and past directorships in other listed companies;
- Interests and short positions in the listing applicant held by each director; and
- The directors' interests in contracts with the listing applicant.

¶15-120 Use of proceeds

- Details of the intended use of the proceeds should be provided in the prospectus. In case the IPO proceeds are intended to be used in acquiring properties, the full details of such proposed property transactions should be disclosed.

¶15-130 Other additional information

- Chapter 18 of the Main Board Listing Rules set out the additional content requirements for a mineral company, which are mainly the inclusion of professional reports on the mining rights and information on the mineral resources or reserves.

² The issuer must determine in advance with its sponsors whether to include a profit forecast in the listing document. The sponsors must report in addition that they have satisfied themselves that the forecast has been made by the directors after due and careful enquiry, and such report must be written out. Details of issues with profit forecasts are set out in the section "Forecasts" in Chapter 4.

- Chapter 18A of the Main Board Listing Rules set out the additional content requirements for biotech companies, including the conditions for listing of biotech companies and the contents of listing documents for biotech companies.

¶15-140 Information on property interests

- In case the listing applicant is holding or developing properties for investment purposes or for its own use, the full text of the valuation reports on the material property interests should be included in the prospectus.

¶15-150 Material contracts and documents for inspection

- Particulars of all material contracts entered into by any member of the group within the two years immediately preceding the issue of the prospectus; and
- Details of the time and location in Hong Kong where the material contracts and documents are available for public inspection³.

The prospectus must be in the English language and be accompanied by a Chinese translation copy. The English language version of the prospectus may be distributed separately from its Chinese translation copy (and vice versa) provided that both are available at each place of distribution. The prospectus, whether in the advanced proof or final proof, should be filed with HKEx together with two CD-Roms containing the same proof of the prospectus.

¶15-160 Accountants' report

A prospectus should include the financial information of the prospective issuer for the track record period. In order to assist potential investors in making investment decisions, the reporting accountant, who must

³ Within 14 days after the issue of the prospectus, the prospective issuer should deliver to a place, usually the office of a solicitor, a list of material contracts and documents for public inspection. Such contracts and documents include the memorandum and articles of association, material contracts entered within two years, all reports or letters referred to in the prospectus, statement of adjustments signed by the reporting accountants and audited financial statements of the prospective issuer or in the case of a group, the consolidated audited accounts of the prospective issuer and its subsidiaries.

be an independent certified public accountant, is required to give an independent opinion on whether the financial information of the prospective issuer is true and fair.

The reporting accountants' report should be prepared under the accounting standards acceptable to HKEx. In general, HKFRS or IFRS would be accepted for the purpose of the accountants' report. A PRC issuer may adopt China Accounting Standards for Business Enterprises. Other accounting standards may also be acceptable for other overseas incorporated issuers. Chapter 4 of the Main Board Listing Rules and Chapter 7 of the GEM Listing Rules govern the contents of an accountants' report to be included in the prospectus. The basic contents of an accountants' report should include the following items.

¶15-170 History of results

At least three years' consolidated results, and the results of any business or subsidiary acquired or to be acquired during these periods are required to be published in the accountants' report. The report on results shall be in the form of an income statement and must separately disclose, as a minimum, the following information:

- turnover;
- investment and other income;
- profit or loss on sale of investment properties;
- cost of goods sold;
- interest on borrowings;
- depreciation and amortisation;
- profit or loss before taxation including share of profit or loss of associated companies;
- taxation (both Hong Kong and overseas) on profits;
- profit or loss attributable to shareholders and non-controlling interests; and
- rates of dividends or special dividends paid or proposed.

¶15-180 Balance sheet

The balance sheets and, if applicable, the consolidated balance sheets as at the end of each of the three financial years in the track record period of:

- (1) the prospective issuer and its subsidiaries; and
- (2) any business or subsidiary acquired during the track record period or agreed/proposed to be acquired after the track record period should be provided.

The minimum balance sheet information includes:

- fixed assets;
- current assets such as stocks, cash at bank and in hand, debtors with credit policies and ageing analyses, etc.;
- current liabilities including borrowing and debts, accounts payable with ageing analyses;
- net current assets/liabilities;
- total assets less current liabilities;
- non-current liabilities such as borrowings and debts;
- capital and reserves; and
- non-controlling interests.

¶15-190 Cash flow statement

The cash flow statement or, if applicable, the consolidated cash flow statement of the prospective issuer and its subsidiaries for each of the three years in the track record period should be included.

¶15-200 Statement of changes in equity

The statement of changes in equity or, if applicable, the consolidated statement of changes in equity of the prospective issuer and its subsidiaries for each of the three years in the track record period should be provided.

¶15-210 Segmental information

The income statement and balance sheet shall include segmental information as required by the accounting standards adopted for the preparation of the accountants' report.

¶15-220 Other information required

- Earnings per share;
- Movements in reserves;
- Statement of indebtedness;
- Principal accounting policies;
- Statement of subsequent events; and
- Pre-acquisition financial information of subsidiaries acquired during the financial periods.

¶15-230 Statement of adjustments

The accountants' report is prepared based on the underlying audited accounts of the prospective issuer for the respective periods reported. As different accounting standards may be adopted in the underlying audited accounts of different entities forming the group for listing, the reporting accountants may make adjustments as appropriate to ensure that the financial information in the prospectus is presented on a consistent and comparable basis.

Depending on the circumstances, the reporting accountants must state in their report that adjustments have been made or that no adjustments were considered necessary. A written statement of adjustments, which must be signed by the reporting accountants, needs to be made available for public inspection.

The statement of adjustments should be made for each of the years reported on and for each adjustment made. Sufficient details of the adjustments must be provided so as to reconcile the figures in the accountants' report with the corresponding figures in the audited accounts.

PRC's disclosure requirements for related party transactions	¶18-450
Hong Kong's contemporaneous transfer pricing Documentation requirements	¶18-460

Tax considerations

¶18-000 Introduction

Major tax considerations in an IPO includes:

- tax compliance status;
- tax planning arrangements; and
- transfer pricing.

¶18-010 Tax compliance status

During an IPO, HKEx will focus on the listing applicant's tax compliance status in the following areas:

- major types of tax the listing applicant is subject to;
- related tax filing positions;
- amount and sufficiency of taxes provided by the listing applicant;
- whether the group's related party transactions are conducted on an arm's length basis;
- whether the group has observed and complied with the transfer pricing disclosure requirements in the relevant jurisdictions; and
- whether tax or transfer pricing audits are being conducted and the state of the final tax assessment.

To prepare for a listing, management should consider taking the following pre-IPO actions:

- arrange tax compliance health check for all group companies to be included in the listed group, in particular, the operating and active companies;

- ensure valid approval letters have been obtained for tax preferential treatments granted to the group companies;
- review the correspondence between the companies and the relevant tax authorities;
- review the transfer pricing documentation;
- identify related party transactions and assess the potential tax impact if there is a transfer pricing concern;
- calculate the amount of tax provision required for each company of the prospecting listing group; and
- identify actions to rectify any under-reporting tax issues.

For more details on tax compliance can refer to ¶18-040 to ¶18-170.

¶18-020 Tax planning arrangements

A listing applicant should have in place a global tax strategy that facilitates its business objectives. The starting point is the development of a solid understanding of the listing applicant's business and financial position, its operating strategy, and where and how it intends to operate. International tax planning can then be approached in a coherent manner to take into account the listing applicant's broader global tax and operating strategies. This will involve an examination of all aspects of the group, from the level of daily operations and transaction flows to the overall group organisational structure, which impacts on profit repatriations. Both domestic tax laws and double tax treaties should be taken into consideration.

Further details on tax planning arrangement are provided in ¶18-180 to ¶18-450.

¶18-030 Transfer pricing

Transfer pricing is an important tax area to look into where the businesses of the listing applicant is conducted in many tax jurisdictions and where there are intra-company transactions. It is an area in which HKEx would query during the IPO process.

Since the publication of *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ("OECD guidelines") and the *Base*

Erosion and Profit Shifting (“BEPS”) Action Plan (Actions 8 to 10) by the Organisation for Economic Cooperation and Development (“OECD”) in 1995 and 2013 respectively, the issue of transfer pricing has become increasingly important. Transfer prices, according to the definition in the OECD guidelines, refer to payments from one part of a multinational enterprise for goods or services provided by another. As commercial transactions between different parts of a multinational group may not be subject to the same market forces that shape relations between two independent firms, transfer prices may diverge from market prices for the purpose of minimising tax. The OECD guidelines attempt to ensure that the tax base of a multinational enterprise is divided fairly, so that transactions within a group approximate those which would be negotiated between independent firms. This “arm’s length principle”, set out in Art 9 of the OECD Model Tax Convention is the internationally accepted standard for transfer pricing between related parties.

Most OECD countries have moved to take a hard line on transfer pricing. Revenue authorities have become increasingly vigilant and sophisticated and transfer pricing audits have become more common. Although transfer pricing compliance/ documentation requirements may vary in different tax jurisdictions, most of the tax jurisdictions, including Hong Kong and China would follow the “arm’s length principle” as stipulated under the OECD Model Tax Convention.

We summarise below the potential questions that may be raised by different stakeholders during the IPO process, where the listing applicant has multiple and significant related party transactions:

Questions from HKEx

HKEx may question:

- whether the listing applicant has observed and complied with the relevant transfer pricing requirements of the jurisdictions in which it operates; and
- whether or not the related party transactions are conducted on an arm’s length basis.

¹ More details on “arm’s length principle” are discussed in ¶8-340.

It is important for management to conduct a transfer pricing analysis during the IPO planning stage.

Tax authorities

In view of the globalisation of trade, an increasing number of jurisdictions incorporate transfer pricing requirements or interpretations in their tax regulations. This provides grounds for tax authorities to raise queries or even conduct transfer pricing audits. Any uncertainty on the part of tax bureaus may delay the listing process.

Existing shareholders and public investors

During pre-IPO due diligence, transfer pricing issues should be properly identified and any potential risks arising from their financial information should be estimated and documented in the listing documents. If the risk and impact are over-stated, this may diminish the true value of the listing applicant and weaken its attractiveness to public investors. On the other hand, if the risk is under-stated, the listing applicant may have understated tax liabilities and may be subject to tax penalties.

More details on transfer pricing are given in ¶8-330.

Tax compliance

¶8-040 Introduction

As mentioned in the previous section, one of the major concerns of HKEx is the listing applicant’s tax compliance status. It is common for HKEx to raise queries to the listing applicant about the basis and sufficiency of the amount of tax paid. A well-maintained set of tax filing and compliance records, e.g. calculation of the relevant taxes, tax returns filed and tax payment receipts, should therefore be held by the group.

In the following sections, we provide a brief outline of the tax regimes in Hong Kong and the PRC.

¶8-050 Hong Kong profits tax

Hong Kong adopts a territorial basis of taxation, under which only profits arising in or derived from Hong Kong will be subject to Hong Kong profits tax. According to s14 of the Hong Kong *Inland Revenue Ordinance*,

a person is subject to Hong Kong profits tax if all of the following three conditions exist:

- (1) the person is carrying on a trade, profession or business in Hong Kong;
- (2) profits are derived from that trade, profession or business; and
- (3) the profits in question are sourced in Hong Kong.

¶18-060 Year of assessment

Hong Kong's tax assessment year runs from 1 April to 31 March of the following year. For example, the year of assessment 2019/20 runs from 1 April 2019 to 31 March 2020. Taxpayers may choose their own accounting year-end dates, and the profits of the taxpayer are assessed on the basis of the fiscal year in which the accounting year ends.

¶18-070 Profits tax rate

For the year of assessment 2018/19 onwards, the Hong Kong profits tax rates for corporation and unincorporated business are as follow: -

Tax Rates	2018/19 onwards
Corporations	
- first HK\$2 million	8.25%*
- beyond the first HK\$2 million	16.5%
Unincorporated businesses	
- first HK\$2 million	7.5%*
- beyond the first HK\$2 million	15%

* Each group can only nominate one entity in the group to enjoy the two-tiered profits tax rates.

¶18-080 Tax filing and payment

Hong Kong's annual profits tax returns are normally issued to taxpayers on the first working day in April each year. The returns must be submitted to the Hong Kong Inland Revenue Department ("IRD") within one month of issue subject to the following statutory extensions:

Accounting year end	Extended due date
1 April – 30 November (N code)	No extension (i.e. a month after issue)
1 – 31 December (D code)	15 August
1 January – 31 March (M code)	15 November

Notice of assessment will be issued after the tax return has been filed with the tax authority.

For tax collection purposes, provisional tax will be payable during the tax year based on the preceding year's tax liabilities. Normally, the demand for the provisional tax for the current tax year will be issued together with the notice of assessment for the tax year that just ended, and the provisional profits tax paid will be credited against the final profits tax assessed.

The due dates for the payments of final tax and the provisional tax are specified in the combined notice issued. In general, 75% of the tax payment will be due in January whilst the remaining 25% will be due in April.

¶18-090 PRC corporate taxes

Corporate taxation in the PRC is mainly comprised of the following:

- corporate income tax;
- turnover taxes, e.g. value added tax, consumption tax;
- customs duty; and
- miscellaneous tax and local levies.

We shall focus on PRC corporate income tax and turnover taxes (including value-added tax and consumption tax) in the subsequent sections of this Chapter.

¶18-100 PRC corporate income tax

Except for sole proprietorships and partnerships, corporate income tax ("CIT") shall be paid in accordance with the provisions of the PRC's Corporate Income Tax Law ("CIT Law") by all PRC enterprises and income receiving organisations – including PRC domestic enterprises,

We will focus on the IIT taxability of an individual's Comprehensive Income in the following section.

Comprehensive Income

For PRC tax residents, Comprehensive Income will be taxed on an annual basis (but IIT withholding should be performed by the withholding agent (i.e. the payer) on a monthly basis or when taxable income arises). IIT standard deduction is RMB 60,000 per annum (i.e. RMB 5,000 per month). Besides the current specific deductions (e.g. basic pension insurance, basic medical insurance, unemployment insurance, housing fund etc.), the revised IIT Law also allows PRC tax residents to claim itemized deductions for their children's education expenses, continuing education expenses, serious illness medical expenses, housing mortgage interest and rental etc.

The Annual IIT for Comprehensive Income derived by PRC tax resident is calculated as follow:

$$\begin{aligned} \text{Annual Taxable} &= \text{Annual Comprehensive Income} - \text{RMB 60,000} \\ \text{Comprehensive} &= \text{(Standard Deduction) - Specific Deductions -} \\ \text{Income} &= \text{Itemized Deductions for Specific Expenditure} \end{aligned}$$

$$\begin{aligned} \text{Annual IIT} &= \text{Annual Taxable Comprehensive Income} \times \text{Tax} \\ \text{Payable} &= \text{Rate - Quick Reckoning Deduction} \end{aligned}$$

Range of Annual Taxable Income RMB	Tax Rate %	Quick Reckoning Deduction RMB
0 - 36,000	3	0
36,001 - 144,000	10	2,520
144,001 - 300,000	20	16,920
300,001 - 420,000	25	31,920
420,001 - 660,000	30	52,920
660,001 - 960,000	35	85,920
Above 960,000	45	181,920

For PRC non-residents, their IIT on Comprehensive Income will be taxed on a monthly basis or when taxable income arises. No specific deductions or itemised deductions for specific expenditure will be allowed, and

only income from salary and wages will be eligible to claim IIT standard deduction of RMB 5,000 per month.

IIT Tax Rate Table for PRC Non-Residents

Range of Monthly Taxable Income RMB	Tax Rate %	Quick Reckoning Deduction RMB
0 - 3,000	3	0
3,001 - 12,000	10	210
12,001 - 25,000	20	1,410
25,001 - 35,000	25	2,660
35,001 - 55,000	30	4,410
55,001 - 80,000	35	7,160
Above 80,000	45	15,160

The following categories of taxpayers are also obliged to perform an annual IIT filing with the PRC tax authorities on a self-assessment basis:

- taxpayers with an annual income of more than RMB120,000;
- taxpayers with employment income derived from more than one source in the PRC;
- taxpayers with income derived from overseas;
- taxpayers with taxable income derived from the PRC but with no tax withholding agent; and
- categories of taxpayers that the PRC State Council specially identifies.

The PRC IIT filing and payment deadlines are as follow:

Type of tax	Basis period	Filing and payment deadline
Individual income tax	Monthly/quarterly return	Within 15 days after the end of each month
	Annual return	Tax filing and payment made within three months after the end of each year

Projects/industries	CIT reduction/exemption	Valid period
(f) Integrated circuit design enterprises	The first two years are CIT exempted and the subsequent three years enjoy a 50% CIT reduction	Starting from the first profit-making year
(g) Qualified energy-saving services enterprises	The first three years are CIT exempted and the subsequent three years enjoy 50% CIT reduction	Starting from the first income-making year

Specifically, the following types of income would be subject to CIT reduction or exemption.

Type of income	CIT reduction/exemption
(a) Income derived from a tax resident enterprise from the transfer of qualified technology in a tax year	The first RMB 5 million is exempted from CIT. The remaining portion, if any, will enjoy 50% reduction of CIT
(b) Dividend derived from a tax resident enterprise from the direct investment in another tax resident enterprise ⁴	Exempt from CIT
(c) Income derived from non-profit making activities by a non-profit-making organisation	Exempt from CIT

(2) Reduced tax rate

In China, the standard CIT rate is 25%. In certain specific industries, companies may be entitled to reduced tax rates. For example:

⁴ This is not applicable to the case where the investment income is from stocks traded on the recognised stock exchange and the holding period is less than 12 months.

- qualified “high-and-new-technology” enterprises are eligible for a reduced CIT rate of 15%. A set of prescribed qualification conditions has to be fulfilled. Qualification as a “high-and-new-technology” enterprise has to be assessed and approved by the relevant PRC authorities;
- integrated circuit production enterprises with a total investment exceeding RMB8 billion or which produce high technology integrated circuits are eligible for a reduced CIT rate of 15%; and
- qualified key software production enterprises are eligible for a reduced CIT rate of 10%. The qualifications of a key software production enterprise have to be assessed and approved by the relevant PRC authorities.

¶ 8-230 Tax treaty network

International trade, services and investment could be hindered by double taxation, which refers to taxation by two or more countries on the same income, asset or transaction. A double taxation agreement (“DTA”) is an agreement between two countries that aims to eliminate double taxation of income or gains arising in one territory and paid to residents of another territory. It allocates the right to tax between two countries on a reasonable basis. Once the right to tax has been allocated, the respective domestic taxation legislation will be applied by tax administration and enforcement, such as in deciding whether certain income should be subject to tax and in computing the assessable income and tax payable. Over 1,300 DTAs exist worldwide.

Some international tax treaties provide a reduced withholding tax rate on dividends, interest and royalties paid by a resident of a contracting jurisdiction to another contracting jurisdiction. Some may even provide a tax right exemption on capital gains arising from the disposal of shares of a resident of a contracting jurisdiction by another resident of the other contracting jurisdiction. To examine the tax efficiency of its operations, a company’s management should have a clear understanding of the international treaty network of countries in which its group companies operate.

- abuse of organisational structure;
- use of tax havens for tax avoidance purposes; and
- other business arrangements not supported by a reasonable commercial purpose.

The tax officials would adopt the “substance-over-form” principle in evaluating whether an enterprise has conducted tax driven arrangements or transactions.

To provide a more comprehensive and transparent framework for the operation of GAAR, the State Administration of Taxation (SAT) released SAT Order [2014]32 on 2 December 2014. This describes the process of a GAAR investigation and clearly set out the rights and obligations of the tax authorities and the taxpayers in each major phase.

¶8-330 Transfer pricing

Nowadays, with the globalisation of trade, cross-border transactions are common and have been made very convenient to conduct. It is common for multinational corporations to establish entities in different jurisdictions to take advantage of the various attributes in those jurisdictions, such as low costs, political stability, proximity to the market and rapid economic development. The upsurge in related party transactions has led to the enactment of more comprehensive transfer pricing laws and guidelines on disclosure requirements around the world.

During the IPO planning stage, it is important for management to conduct a transfer pricing analysis and estimate the impact of transfer pricing exposure with prudence. More importantly, they should maintain a complete set of transfer pricing documentation to defend against potential challenges that may be raised by tax authorities and other stakeholders.

¶8-340 OECD guidelines – Arm’s length principle

There are a number of fundamental concepts which one must comprehend when dealing with transfer pricing. Guidelines have been developed by the OECD on the acceptable transfer pricing and documentary requirements, since they have been adopted by the governments in many jurisdictions. The arm’s length principle is the internationally

accepted standard for transfer pricing between related parties. Article 9 of the OECD Model Tax Convention on Income and on Capital provides:

“[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations that differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

The assessment of the application of the arm’s length principle is based on a comparison of the conditions in a controlled transaction with the conditions in a transaction between independent enterprises. For such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently compared. Attributes or “comparability” factors that are important when determining comparability include the characteristics of the property or services being transferred, the functions performed by the parties (taking into account the assets used and the risks assumed), the contractual terms and the economic circumstances.

¶8-350 Related parties

According to *Hong Kong Accounting Standard 24 “Related Party Disclosures”* issued by the Hong Kong Institute of Certified Public Accountants, a party is related to an issuer if it falls under any of the following situations:

- *individual control* – a person or a close member of that party’s family has control or joint control (the “Control Person”) or significant influence over the issuer (collectively referred to as the “Related Person”), or the party is controlled or jointly controlled by the Related Person, or the Control Person has significant influence over the party or is a member of the key management personnel of the party or of a parent of the party;
- *key management* – the party is a member of the key management personnel of the issuer or of a parent of the issuer;
- *common control* – the party and the issuer are members of the same group;

¶8-370 Purchase and sale of tangible properties

Tangible property refers to any physical asset. Purchase and sale transactions of raw materials, work in progress, and finished products as well as machinery and equipment employed by businesses are examples of possible related party transactions under this category.

¶8-380 Transfer and use of intangible properties

The scope of intangible assets includes:

- patents, trademarks, brand names;
- designs, patented technologies, trade secrets; and
- academic and artistic properties.

Related party transactions on intangible properties are normally undertaken in the following forms:

- (1) *direct sale of intangible properties* – this refers to the direct transfer of rights to a related party, i.e. the related party will possess the ownership rights;
- (2) *provision of right to use intangible properties in return for royalty* – this happens where a right to use is granted generally within a specified time period and within a specific geographical region. The royalty payment is normally based on the volume of production or sales. During the period of the right to use the intangible properties, technical support and training may also be provided; and
- (3) *joint development, cost sharing and use of intangible properties* – under this arrangement, each party has the right to the intangible property since it was developed and no payment is required to be made for its use.

The transfer of intangibles is usually considered in the same way as the sale of tangible properties. In other words, the sales consideration should normally be the fair market price of the property at the time of transfer.

The royalty is sometimes determined with reference to the estimated future income that may be derived from the use of the intangible property.

¶8-390 Provision of services

Services may be rendered between companies, for instance, from the parent company to its subsidiary, from one subsidiary to another subsidiary or from the parent company/appointed service centre to its related entity. To determine if the transaction is at arm's length price, reference may be made to similar independent transactions to find out whether an independent party is willing to pay for a similar service. Examples of services are numerous and may include financial analysis, research and development, intangible assets management, legal advice, accounting services, marketing analysis, audits, information technology services, fund raising, procurement, foreign exchange risk management, recruitment and internal training, etc.

¶8-400 Financing

Financing transactions include loans, loan guarantees, finance leases and factoring arrangements. The amount, currency, loan period, repayment method, interest calculation and credibility of the borrower are the factors that are usually considered in determining whether the fee charged is comparable to that in an arm's length transaction.

¶8-410 Function and risk analysis of contracting related parties

To identify whether a transaction is carried out based on the arm's length principle, it is essential to study how the related parties allocate the relevant risks and related profits. An analysis of the functions and risks that each entity bears is one method of determining whether the transaction adheres to the arm's length principle.

The aim of a function and risk analysis is to identify and analyse:

- (1) *The functions performed by the related parties in the course of business*

The principal functions performed by the respective party under examination should be identified. The functions may include design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing and management;

(2) *The risks assumed by the related parties*

The types of risk to consider include first, market risks, such as input cost and output price fluctuations, risks of loss associated with the investment in and the use of property, plant and equipment; secondly, risks of the success or failure of investment in research and development; thirdly, financial risks such as those caused by currency exchange risks, interest rate variability and credit risk.

Moreover, the types of assets used (such as plant and equipment, the use of valuable intangibles and financial assets) and the nature of the assets used (such as the age, market value, location and property right protection) should also be considered.

There should be a positive relationship between the functions and risks and the return or profit level. The higher the burden of function and risk, the higher the profit level would be. Business functions have different levels of importance. For example, the materials purchasing function, production process and production scheduling functions are the most important for a manufacturing business, while marketing and advertising activities would be more important for a business that is engaged as a distributor of consumer goods. Similarly, the level of risk varies across different industries and geographic markets. For example, no credit risk would be present in a retail business where sales are mainly done in cash or where customers often pay in advance before the title and ownership of goods is transferred.

Based on the above, management should not only consider which entity should have responsibility for a particular function, but also consider the relative significance of the functions in the overall business process for the specific market or industry.

¶8-420 Transfer pricing methods

Tax authorities generally examine prices actually charged between related parties to determine whether adjustments are appropriate. The examination is by comparing (testing) the transfer prices to comparable prices charged among unrelated parties. Such testing may occur on examination by the tax authority; alternatively, taxpayers may be required to conduct such testing themselves in their transfer pricing

documentation in advance. The testing requires a determination of how the comparison was conducted, a process referred to as a transfer pricing method.

The appropriateness of a transfer pricing method depends on the type of transactions that the related parties have entered into. Transactions can be divided into two major categories, i.e. the traditional transaction method and transaction profit method.

The traditional transaction method is the most direct means of establishing whether transactions between associated enterprises are conducted at arm's length. The following are examples of this method:

- comparable uncontrolled price method;
- resale price method; and
- cost-plus method.

For contracts, the transaction profit method is a means of determining whether transactions are conducted at arm's length. The following are the examples:

- transaction net margin method; and
- profit split method.

The key characteristics of transfer pricing methods are summarised in the table below:

Transfer pricing method	Key characteristics
Comparable uncontrolled price method ("CUPM")	<ul style="list-style-type: none"> • Under this method, the transfer price between related parties is compared with the uncontrolled sales made by one of the related parties to unrelated buyers (i.e., uncontrolled transactions) for identical goods, services, or property under identical conditions. • The OECD's report states that this method, if usable, is preferable to all other methods.

type of patent applications is the best fit for the nature and business objectives of the company.

What can be protected by a patent?

An invention protected by a patent is a solution to a technical issue, which may be a product of substance, a device or a method of doing something. A patentable invention must be technical in nature.

For an invention to be qualified as a patent, the invention must at least satisfy the below three criteria:

- **New** - the invention is not publicly disclosed or taught anywhere in the world before the date a patent application of the invention is filed;
- **Inventive** - the invention should not be obvious for a person being skilled in the technological field of the invention; and
- **Industrial applicability** - the invention ought to be made or used in the industry.

In Hong Kong, the following subject matters are expressly excluded from being an invention (Section 9A(2) of the *Patents Ordinance*):

- a discovery, scientific theory or mathematical method;
- an aesthetic creation;
- a scheme, rule or method for performing a mental act, playing a game or doing business, or a programme for a computer; and
- a presentation of information.

These principles are not uniformly applied in different jurisdictions. One example is the patentability of methods for the treatment of the human or animal body by surgery or therapy, or a diagnostic method practice on a human or animal body. In Hong Kong and many other countries, these are not regarded as an invention that has an industrial application. Any inventions related to the treatment/diagnostic method cannot be awarded with a patent. Conversely, treatment and diagnostic methods are considered the patentable subject matter in the US and patent can be granted to such invention.

Patent eligibility and any industry/ technical specific patentability requirements in the territory of interest are important factors and should be carefully examined and considered before proceeding with patent applications.

¶9-014 Design

What is a registered design?

A registered design is the legal exclusive right granted in relation to the shape, configuration, pattern or ornament of an article under the *Registered Designs Ordinance* (Cap. 522). A registered design owner is able to exclude others from commercially exploiting any article which is not substantially different from the registered article.

What can be protected as a registered design?

The design of an article can be registered if it is new. A design is new and therefore registrable if the design has not been published in Hong Kong or elsewhere before the date of the application is filed.

A design protects the overall appearance of an article or product made up of one or more visual features. The visual features include shape, pattern, ornamentation, and/or configuration. Any functional or technical aspect of a product cannot be protected by a design, these aspects are protected by patent. A design protects only the aesthetic component of the external appearance of a product.

What is protected in a registered design is the design to an article. The design must be applied to an article used for an industrial purpose. By contrast, a registered design does not protect a piece of original work itself (as in copyright). As such, a piece of creation cannot be registered as a design if the creation is not used industrially.

There are cases where a matter may be protected by both design and copyright. A pattern in a painting is protected under copyright. When the pattern of that painting is used as a pattern on the industrially manufactured product, e.g. a cup. The pattern is subject to protection under both copyright and registered design.

¶9-015 IP and Competition Law

IP laws confer on the IP owners certain exclusivity over the use of the IP rights; by contrast, competition laws aim to promote competition in the market and discourage exclusivity in general. As a result, IP owners tend to restrict competition by making it difficult for competitors to enter the markets or begin to abuse their dominant position. Hence, abuse of IP rights has become a hot topic in the competition law context worldwide.

The *Competition Ordinance* (Cap. 619) does not expressly refer to abuse of IP rights. Yet, the trading and use of IP rights may be evaluated under the Second Conduct Rule which prohibits an undertaking that has a substantial degree of market power from abusing such power that has an object or effect of preventing, restricting or distorting competition. In the Guideline on the Second Conduct Rule issued by the Competition Commission, paragraph 3.21 states that IP rights do not automatically give rise to legal barriers or otherwise imply substantial market power as companies may be able to invent around the relevant IP rights. Accordingly, IP rights are only indicative of a substantial degree of market power if the product or technology to which the IP rights correspond to a relevant product or technology market and IP rights would only be considered as legal barriers when they prevent or make it more difficult for competitors to enter.

The Hong Kong *Patents Ordinance* also contains provisions to tackle anti-competitive behaviours. In particular, the laws provide for the issuance of compulsory licences, restrictions against oppressive licensing terms, and unjustified threats.

Listing applicants are therefore advisable to review their business practices to avoid contravening the *Competition Ordinance* in IP-related agreements. In particular, listing applicants may have entered into joint R&D agreement to collaborate with other institutions in the sharing of their R&D efforts for effective use of resources. Such agreements should not contain terms that impose serious cartel conducts such as price-fixing or market sharing that are anti-competitive by its very nature.

In addition, “pay-for-delay” or “reverse payment” arrangements which are commonly found in settlement agreements of IP licensees may distort competition by rewarding generic competitors who agree to delay their

entries into the same market even when the licensees’ exclusivity rights have already expired (usually patents).

Lastly, whilst IP owners could seek injunctive relief from the applicable court for the purposes of IP enforcement, IP owners who have substantive market power should not use this as a tactic to restrict competitors’ businesses in breach of the Second Conduct Rule, especially when they are aware that the IP rights relied on are not valid or otherwise vulnerable to challenge.

¶9-020 Pre-IPO IP Filing Strategies

Every company has its own IP rights (e.g. brand name and company logo). Some companies (e.g. pharmaceutical or technology-based companies) may be more IP-centric and have more comprehensive IP portfolios. However, not all matters within a company require IP protection. Therefore, whether IP protection pursued for a matter, the priority in allocating resources for IP protection and which form of IP protection provides the relevant coverage should be assessed by businesses and their advisors on a case-by-case basis by reference to their business types and models.

The key steps involved in devising an effective IP strategy are set out below:-

- (i) Identify the company’s commercial goals;
- (ii) Identify the relevant subject matters protectable by IP rights;
- (iii) Align the company’s goals with the IP rights; and
- (iv) Devise appropriate IP filing and portfolio management strategies for the company.

Identify the company’s commercial goals

A company’s commercial goals help set the priorities for resources in devising the appropriate IP strategies for the company. IPRs relating to a company’s revenue streams need to be protected, registered and maintained. In particular, IP may assist a company in achieving the following:

- (i) protecting the company in its day-to-day activities from third party infringement claims;