



SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

Offer Mechanisms Consultation Conclusion – Hong Kong

February 1998



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Introduction

1. On 25 June 1997 the Securities and Futures Commission (the " SFC ") and the Stock Exchange of Hong Kong Limited (the " SEHK ") issued a consultation paper relating to offer mechanism in initial public offerings (" IPOs "). The paper sought views on the following issues:
 - (a) minimum size for the subscription tranche;
 - (b) division of any over-allocation of shares between the subscription tranche and the placing tranche;
 - (c) SEHK's discretion on the use of placing;
 - (d) eligibility to apply for shares in the subscription tranche and the placing tranche;
 - (e) underwriters' discretion on the allocation of shares in the placing tranche;
 - (f) extent of over-allocation of shares;
 - (g) flexibility in adjusting the price, size and timing of an offer during the subscription period; and
 - (h) announcement of indications of interest in the placing tranche.
2. The consultation period, initially scheduled to last until 8 August 1997, was extended until 22 August at the request of a number of market participants. A total of 8 written submissions were received. These included one submission made on behalf of 15 financial institutions as well as submissions from professional bodies and market practitioners. A summary of the responses received is set out in the appendix to this paper.
3. This document analyses the comments received in response to the consultation paper and explains the conclusions reached by the SFC and the SEHK.



Summary of Comments and Conclusion

I. General comments

1. One association noted that the current system combining a public offer by way of subscription with an international book-building placement represents a compromise of two vastly different mechanisms. This association reported a general consensus amongst its members for the SFC, the SEHK and the HKMA to set a medium term policy goal of revamping the system for public subscription by :-
 - (a) opening CCASS to all investors to eliminate the need for physical delivery; and
 - (b) allowing subscription applications through bank ATMs to remove the credit risk issues arising from the requirement of payment in full with all applications.
2. The SFC and the SEHK will seek to continuously improve the structure of IPOs in Hong Kong and would welcome suggestions from issuers and underwriters in this regard.

II. Determination of the subscription tranche

3. The consultation paper suggested that the minimum subscription tranche should be determined by:-
 - (a) an initial allocation of 10% of the shares offered in the IPO; and
 - (b) a clawback structure that increases the allocation to the subscription tranche to 30% of an issue when demand in the subscription tranche is 15 times the initial allocation (the "30% clawback"), and to 50% of an issue when demand in the subscription tranche is 50 times the initial allocation, (the "50% clawback").
4. Where an IPO also provides an over-allotment option to the underwriters, the consultation paper suggested that the initial over-allocation of shares be pro-rated between the subscription and placing tranches in the same initial ratio for the two tranches.

(a) Initial allocation of 10% of an issue

5. There was general support for an initial allocation of 10% of the shares to the subscription tranche. There was one suggestion for an initial allocation to be the lower of 10% of the offer and HK\$100 million. The SFC and the SEHK consider that a 10% initial allocation is appropriate.

(b) Clawback to increase allocation to 30% and 50% of the IPO

6. Commentators supported the use of a clawback mechanism to increase the size of the subscription tranche where such tranche is oversubscribed. However, commentators suggested that the trigger point for the 30% clawback should be higher than the proposed 15 times subscription and that the clawback levels should depend on the total value of the IPO. There is a wide divergence of views as to what constitutes a large IPO.



7. The SFC and the SEHK consider that it is more appropriate to have a single structure providing a benchmark minimum allocation to the subscription tranche for all IPOs than to have a scaled structure. The SEHK will consider allowing a smaller allocation to the subscription tranche than the benchmark formula and will treat the size of the IPO as a factor that may justify a deviation from the benchmark. Similarly, the SEHK may decide that the special circumstances of an issue would warrant a larger allocation to the subscription tranche than provided by the benchmark formula. Such circumstances include where an issuer is likely to attract significant demand from local retail investors.
8. Commentators suggested three clawback formulas that would reduce the percentage clawback for larger IPOs.

IPO size HK\$ million	Initial allocation	Clawback times		Clawback times		Clawback times	
		% subscribed	% subscribed	% subscribed	% subscribed	% subscribed	% subscribed
First suggestion							
0-800	15%	30%	20 x				
800-2,400	10%	25%	20 x				
2,400 +	10%	20%	20 x				
Second suggestion							
0-1,000	10%	20%	15 x	30%	30 x	50%	200 x
1,000-4,000	HK\$100 m	20%	15 x	30%	30 x	50%	200 x
4,000 +	HK\$100 m	20%	15 x	30%	30 x		
Third suggestion							
0-800	10%	20%	15 x	30%	30 x	50%	250 x
800-3,900	10%	20%	15 x	30%	30 x		
3,900 +	10%	15%	15 x	20%	30 x		

9. Commentators suggested that much of the demand in the subscription tranche of recent IPOs was inflated in anticipation of high over-subscription levels which would result in the applicants' allocation being scaled back. They argued that a 50% clawback greatly increases the risk that retail investors will obtain more shares than they actually want, causing them to sell in the after market.
10. Commentators also argued that the prospect of the 50% clawback will affect the behaviour of institutional investors, thus:
- discouraging institutions from participating in an IPO, with the negative institutional sentiments flowing through to the subscription tranche and jeopardising the success of the offer; or
 - encouraging institutions to inflate their demand in anticipation of the clawback; if the clawback is not triggered the institutions will have more shares than they want and will likely sell in the after market.
11. Commentators were concerned that heavy selling by both institutional and retail investors when they receive more shares than anticipated would lead to a weakening of prices in the after market, with all investors suffering equally as well as the issuer. In light of such concern, the SFC and the SEHK consider it appropriate to amend the proposed formula by :-
- reducing the minimum allocation when the subscription tranche is 50 times subscribed from 50% to 40%; and



- (b) requiring that 50% of the issue is allocated to the subscription tranche when the subscription tranche is 100 times subscribed.

This would ensure that the subscription tranche would be increased to 50% of an IPO in cases where there is significant demand.

(c) Division of any over-allocation of shares between the subscription tranche and the placing tranche

12. To maintain the balance between the subscription tranche and the placing tranche the SFC and the SEHK currently require that, except in exceptional cases, any over-allocation of shares at the time of the listing be divided between the subscription tranche and the placing tranche in such a way as to retain the original ratio between the tranches. Thus, where the level of demand in the subscription tranche triggers the 30% clawback, 30% of the shares over-allocated at the time of the listing would be allocated to the subscription tranche.
13. Commentators noted that any over-allocation of shares requires the underwriters to (i) borrow shares from a major shareholder or strategic investors, (ii) exercise the Greenshoe option; or (iii) delay delivery of shares to institutional shareholders. Shareholders in the subscription tranche must receive all shares prior to the commencement of trading. It is argued that this is unfair to the investors in the placing tranche as they bear the entire risk of delayed delivery but would only receive a portion of the over-allocated shares under the suggested pro-rata division. It is also argued that an early exercise of the Greenshoe option defeats the purpose of having such option as it reduces the number of shares that an underwriter may purchase in the after market.
14. Commentators argued that the current system of pro-rata division of any over-allocation of shares acts as an additional clawback and confuses institutional and retail investors. It would be simpler to design the clawback arrangements to cater for retail investors.
15. In the light of these comments, the SFC and the SEHK consider it appropriate to address the interest of the subscription tranche by a clawback mechanism that dispenses with pro-rata division of any over-allocation of shares.

(d) Benchmark formula for the allocation of shares to the subscription tranche

16. The SFC and the SEHK consider that the benchmark formula for the allocation of shares to the subscription tranche should be :-
 - (a) an initial allocation of 10% of the shares offered in the IPO;
 - (b) a clawback mechanism that increases the number of shares to 30% when the total demand for shares in the subscription tranche is 15 times the initial allocation;
 - (c) a clawback mechanism that increases the number of shares to 40% when the total demand for shares in the subscription tranche is 50 times the initial allocation; and
 - (d) a clawback mechanism that increases the number of shares to 50% when the total demand for shares in the subscription tranche is 100 times the initial allocation.



17. The elimination of the pro-rata division of any over-allocation of shares has the effect of reducing the size of the subscription tranche compared to that proposed in the consultation paper. Accordingly, the SFC and the SEHK do not consider it necessary to increase the trigger for the 30% clawback as suggested by some commentators.
18. The SFC and the SEHK also confirm that the requirement for a 10% initial allocation of shares to the subscription tranche does not preclude transfer of these shares to the placing tranche where there is insufficient demand in the subscription tranche to take up the initial allocation.

III. SEHK's discretion on the use of placing

19. Underwriters argued that the SEHK should not disallow the use of placement in IPOs and that the decision whether or not to have a placing tranche was one for the underwriters. It was suggested that if the SEHK retains such discretion it should provide clear guidelines and only exercise such discretion in exceptional circumstances. It was suggested that a placing tranche should always be allowed for IPOs over HK\$800 million.
20. As explained in the consultation paper, the use of a combination of a subscription tranche and a placing tranche in IPOs was approved by the SFC and the SEHK for the purpose of facilitating large scale multi-jurisdictional offers. It was not intended that the combined offer mechanism be used in relation to all IPOs on the SEHK.
21. In 1996 there were 44 IPOs on the SEHK. Of these only 20 were global equity offers involving a placing tranche. IPOs consisting purely of a public subscription ranged in size from HK\$50 million to HK\$355 million with an average size of HK\$110 million.
22. The SFC and the SEHK do not consider it necessary to change the criteria set out in Rule 7.10 of the Listing Rules that provides that "the Exchange may not permit a new applicant to be listed by way of placing if there is likely to be significant public demand for the securities". A key factor that the SEHK will consider in reaching such a determination is the size of an IPO.

IV. Eligibility to apply for shares in the subscription tranche and the placing tranche

23. Most commentators expressed a preference for the second option proposed in the consultation paper concerning eligibility to apply for shares in the subscription tranche and the placing tranche. Under this option there would be no restriction on any investor, whether individual or institutional, applying in either the placing tranche or the subscription tranche. The subscription tranche would consist of two pools: Pool A and Pool B. The total allocation to the subscription tranche would be determined by the total level of demand within the subscription tranche and the clawback structure. Once calculated the total allocation to the subscription tranche would be divided equally between the pools. Shares in Pool A will cater to mainly retail investors and be allocated on an equitable basis to applicants for up to HK\$5 million worth of shares. Shares in Pool B will be allocated on an equitable basis to applicants for over HK\$5 million worth of shares. Where the demand in one pool is less than the shares allocated to that pool the surplus shares would be allocated to the other pool. Where total demand in both pools is less than the allocation to the subscription tranche the surplus may be transferred to the placing tranche. No investor may apply for more than the total



number of shares initially allocated to each pool, being half the shares initially allocated to the subscription tranche.

24. There was a divergence of views as to the appropriate value to be used in distinguishing retail from other investors. The values suggested by commentators varied from HK\$1 million to HK\$8 million. In light of this range and the support from other commentators for the current criteria of HK\$5 million as the cap for a retail investor, the SFC and the SEHK consider that Pool A should be limited to applications for shares worth up to HK\$5 million.
25. Some commentators suggested a "bottom-up" methodology for both pools to give preference to smaller investors on a pro-rata basis over larger investors. They argued that a "bottom-up" allocation methodology ensures that retail investors are fairly treated and has the advantage of discouraging investors from putting in large inflated subscriptions. The formulas currently adopted by underwriters to allocate shares in the subscription tranche result in applications for one board lot of shares receiving a higher portion of the shares applied for than applications for more board lots. The SFC and the SEHK consider that these methods are already weighted in favour of small investors and do not consider it necessary to mandate a "bottom-up" methodology. Issuers may discuss with the SEHK if they wish to adopt alternative methods that are different from those currently used. Appropriate disclosure in prospectus will be necessary for any new methodology that is different from the current norms.
26. The consultation paper noted that under this system it would be necessary to introduce rules against "double-dipping" (applying for shares under more than one tranche). At present, rules against multiple applications in the subscription tranche prohibit investors applying to both Pool A and Pool B of the subscription tranche as well as multiple applications within one of the pools. Additional requirements, however, would have to be introduced to ensure that an investor does not obtain shares under both the subscription tranche and the placing tranche of an IPO.
27. The consultation paper suggested that this could be done by requiring investors under the subscription tranche to undertake and confirm in the application form that they have not indicated an interest in buying shares under the placing tranche. Similarly, investors in the placing tranche would be required to give an undertaking or confirmation to underwriters before they are allotted shares that they have not applied for and will not apply for shares under the subscription tranche.
28. Some commentators suggested that there was no reason why investors should not be able to apply in both tranches. Other commentators suggested that rules against "double-dipping" should not prevent an unsuccessful applicant for shares in the placing tranche applying in the subscription tranche. It was noted that, whilst many institutional investors do not normally participate in the subscription tranche, others do participate, in some instances to "top-up" allocations received in the placing tranche. It is further noted that the participation of institutions in Pool B should not have an adverse effect on retail investors.
29. Commentators suggested that it would be difficult to obtain representations from investors in the placing tranche that they have not and would not participate in the subscription tranche. Instead, if investors are to be restricted from participating in the placing tranche and the subscription tranche, the most effective policing mechanism would be through representation contained in the subscription application.



30. The SFC and the SEHK consider that it would not be appropriate to allow multiple applications between tranches. There is no justification for allowing multiple applications between the subscription tranche and the placing tranche whilst at the same time prohibiting multiple applications within the subscription tranche.
31. The SFC and the SEHK consider that investors who were unsuccessful in their applications for shares in the placing tranche may apply for shares in the subscription tranche. In cases where the placement of shares is completed prior to the opening of the subscription tranche, each investor would undertake and confirm in the application form that he has not received any shares under the placing tranche. In cases where the placement of shares is completed after the subscription tranche is concluded the underwriters may elect to:-
- (a) require each investor in the subscription tranche to undertake and confirm that he has not indicated and will not indicate an interest for shares under the placing tranche; or
 - (b) require each investor in the subscription tranche to provide either:-
 - (i) the undertaking and confirmation referred to in (a); or
 - (ii) to state that an indication of interest for shares has been made in the placing tranche and provide sufficient information to allow the underwriters to match the application in the subscription tranche with that in the placing tranche and to exclude any application in the subscription tranche if shares are placed to that investor as a result of an application in the placing tranche; or
 - (c) require each investor who has been offered shares in the placing tranche to either:
 - (i) confirm he has not applied for shares in the subscription tranche; or
 - (ii) where he has made an application in the subscription tranche to provide sufficient information to the underwriter to allow the underwriter to identify the application in the subscription tranche and ensure that it is excluded from any application of shares in the subscription tranche.
32. Following the principle in Rule 10.08 of the Listing Rules, issuers, their directors, sponsors and underwriters are required to take reasonable steps to identify and reject applications for shares in the subscription tranche from investors that receive shares in the placing tranche.

V. Underwriter's discretion on the allocation of shares in the placing tranche

33. No commentator disagreed with the proposal in the consultation paper that underwriters should act fairly and in the best interests of issuers when allocating shares in the placing tranche, and that rules should not be introduced either to require detailed disclosure on how underwriters' discretion is exercised or to prescribe how underwriters ought to exercise their discretion. One association commented that a minority of its



members consider that the allocation of shares in the placing tranche should be made more transparent, and that information on the type of investor, location, price and time of expression of interest could be disclosed to issuers and members of the selling syndicate. This minority considered a more open approach might improve book-building ability to price issues effectively.

VI. Extent of over-allocation of shares

34. In the consultation paper the SFC clarified that the extent of over-allocation of shares should be limited to that provided under the over-allotment option.
35. Many commentators argued that market stabilisation activities benefit investors and issuers. Major markets such as New York and London allow stabilisation activities provided these are carried out within clearly defined limits. Commentators argued that over-allocation gives underwriters a legitimate and effective tool to assist in an orderly after market, particularly one that is experiencing selling pressure. Genuine purchases in the after market not only serve to cover underwriter's over-allocations but also reduce the excess supply created by investors selling into the after market. Investors, whether retail or institutional, benefit from and are protected by an orderly and efficient after market and benefit from stabilisation activities by underwriters.
36. The SFC has reconsidered whether the powers of the SFC to make rules under Section 137 of the Securities Ordinance are sufficient to enable the enactment of rules governing stabilisation activities, and concluded that there is scope under current legislation to enact rules governing stabilisation activities. The SFC will review such activities and determine whether as a matter of policy it would be appropriate to enact rules under Section 137 relating to stabilisation activities.
37. In the absence of any such rules being enacted, the SFC's position is that the creation of short positions without the benefit of an over-allotment option, or creating short position, in excess of the limit under which shares could be allocated pursuant to such option is, prima facie, subject to the scrutiny of the SFC. The SFC would take necessary action should there be evidence of the creation of a false market. Hence, underwriters should restrict the extent of over-allocation of shares to the limit permitted under the over-allotment option.

VII. Flexibility in adjusting the price, size and timing of an offer during the subscription period

38. Commentators supported the general proposals by the SFC and the SEHK to allow greater flexibility in the offer mechanism for underwriters to adapt to demands from investors during the book-building process. This would allow adjustment in the price range, size or timing of an IPO after the prospectus is issued, without causing disruption to the subscription process.
39. The consultation paper proposed that adjustments of the price range above or below the original price range be limited to a range that is no wider in percentage than the original range. In addition, in the case of an upward adjustment, the lower end of the new range should not be higher than the upper limit of the original price range, and in the case of a downward adjustment, the upper end of the new price range should not be lower than the lower limit of the original price range. Some commentators argued that such proposals were too restrictive. It was pointed out that in recent IPOs such as Beijing Enterprises and Shanghai Industrial the price range increases were significantly



above the originally indicated range. The SFC and the SEHK note that whilst there were significant increase in the price range for these IPOs the changes in price ranges took place during the book-building process before the subscription tranche opened. The SFC and the SEHK do not intend to restrict the ability of underwriters to adjust the price range during the book-building process. The flexibility being considered relates only to the price, timing and size of an IPO set out in a prospectus and do not apply to changes made before the public subscription starts.

40. Some commentators noted that the proposals would provide considerable practical difficulties for share registrars in processing applications in cases where investors are given the right to withdraw applications and make new applications as a consequence of the changes to the terms of an offer.
41. The SFC and the SEHK will discuss with the market the practical issues raised by commentators before introducing specific rules to allow changes in the price range, size or timing of an IPO during the subscription process.

VIII. Announcement of indications of interest in the placing tranche

42. The consultation paper explained the current practice of requiring issuers to include in the announcement of results information regarding the level of demand for shares under the placing tranche. The principal reason for such disclosure is to increase transparency, both on the overall reception of an issue and on the "fairness" of allocation of shares within the placing tranche. The level of demand for shares in the placing tranche may have an impact on trading in the after market. If underwriters cover their short positions or engage in other dealing of shares in the secondary market whilst in possession of unpublished information relating to demand in the placing tranche, such activities could constitute insider dealing under the Securities (Insider Dealing) Ordinance.
43. Many commentators, particularly underwriters, contended that non-disclosure of the total value of indications of interest by investors in the placing tranche is unlikely to raise issues under the Securities (Insider Dealing) Ordinance.
44. In addition underwriters argued that disclosure of the level of indications of interest is inappropriate and could adversely affect the after market as:-
 - (a) such information is not meaningful and in many instances may be misleading;
 - (b) the level of interest reflected in the book is only one of the many factors that can affect the level at which the shares will be priced or traded in the after market; and
 - (c) underwriters cannot provide an accurate numerical disclosure to quantify demand with the degree of reliability that is necessary for public disclosure.
45. Comments from organisations that were not underwriters supported the proposals for greater transparency of the placing tranche. One commentator said that transparency in the allocation of shares in the placing tranche would enable investors in such tranche to find out whether they have been treated "less preferentially" than other investors who apply for shares under the placing tranche.



46. One underwriter argued that the book-building process is a tool used by the underwriter to build up interest in and demand for an IPO and by its nature is not transparent. Mechanically the method is similar to the Dutch auction process which assumes no disclosure to bidders of the level of other bids. Underwriters argued that if investors were to have access to the book they would be able to use this information to gain leverage over the issue and to drive down the offer price. As a result the salesmen who take orders not only do not have access to the "book" but typically proceed on the basis that the "book" is sizeable and growing regardless of the actual size of the book. It is argued that this method produces the optimal results for both issuers and investors because it produces the highest level of demand for both the IPO and the shares in the after market.
47. The SFC and the SEHK consider that the level of indications of interest should be disclosed before trading in the shares commence. In light of underwriters' assertions that an accurate number for the total indications of interest could not be available the SFC and the SEHK will accept a qualitative description of the extent of demand as currently required. If issuers and underwriters consider that announcement of the level of demand may be misleading they should provide sufficient additional information as is necessary to avoid misleading the market.

IX. Further action

48. The SFC and the SEHK have issued a joint policy announcement summarising the policy conclusions set out in this paper. The next section of this paper sets out the policy conclusions that will be reflected in amendments to the Listing Rules.



Amendments to the Listing Rules

1. The SEHK will prepare the necessary amendments to the Listing Rules setting out the requirements that follow from the policy conclusions discussed in this paper.
2. Prior to enactment of such amendments issuers and underwriters will be required to comply with the policies set out in this paper as summarised below.

Determination of the subscription tranche

3. The issuers should use the formula set out below to calculate the minimum allocation of shares to the subscription tranche:
 - (i) an initial allocation of 10% of the shares offered in the IPO;
 - (ii) a clawback mechanism that increases the number of shares to 30% when the total demand for shares in the subscription tranche is 15 times the initial allocation;
 - (iii) a clawback mechanism that increases the number of shares to 40% when the total demand for shares in the subscription tranche is 50 times the initial allocation; and
 - (iv) a clawback mechanism that increases the number of shares to 50% when the total demand for shares in the subscription tranche is 100 times the initial allocation.

Eligibility to apply for shares in the subscription tranche and the placing tranche

4. The subscription tranche should be divided into two equal pools: Pool A and Pool B. The total allocation to the subscription tranche should be calculated using the above formula with reference to the total demand for shares in Pool A and Pool B. Shares in Pool A should be allocated to applicants for up to HK\$5 million worth of shares. Shares in Pool B should be allocated to applicants for over HK\$5 million worth of shares. Where demand in one pool is less than the shares allocated to that pool the surplus should be allocated to the other pool. No applications should be accepted from investors applying for more than the total number of shares originally allocated to each pool.
5. Issuers should reject multiple applications within either pool or between pools. Any investors that have not received shares in the placing tranche may receive shares from the subscription tranche. Issuers, their directors, sponsors and underwriters are required to take reasonable steps to identify and reject applications in subscription tranche from investors that receive shares in the placing tranche.

Extent of over-allocation of shares

6. Underwriters should restrict the extent of over-allocation of shares to the limit provided under the over-allotment option.

Announcement of indications of interest in the placing tranche

7. Before trading in the shares commences issuers should disclose the level of indications of interest for shares in the placing tranche. Disclosure may consist of either a numerical or qualitative description.



Appendix

Summary of responses to consultation paper

Issue for consultation	Response		
	Agreed	Disagreed	No comment
1. Size of public subscription tranche			
10% initial allocation	6	1	1
30% clawback at 15 times subscribed	3	4 (note)	1
50% clawback at 50 times subscribed	3	4 (note)	1
<i>Note Three responses suggested different clawback formulas, these are set in paragraph 8 of the report.</i>			
2. SEHK to retain discretion on whether to allow use of placing.	1	6	1
3. Underwriters to have discretion on the allocation of shares in the placing tranche.	5		3
4. Over-allocation of shares by underwriters to be limited to the size of the over-allocation option (the Greenshoe option) granted by the issue (i.e. no "naked short" positions).	2	3	2
<i>Note: One organisation reported that there was no consensus within its members on the need to create "naked short" positions.</i>			
5. Over-allocation of shares by underwriters to be pro-rata between the subscription tranche and the placement tranche.	1	5	2
6. Allow greater flexibility for underwriters to adjust the price, size and timing of an offer after the prospectus is issued.	7 (note)	0	1
<i>Note: As discussed in the main body of the paper commentators noted that some of the proposals may provide significant practical problems.</i>			
7. Eligibility to apply for shares in the subscription tranche and placement tranche.			
Option 1			
(1) no multiple applications			
(2) in the subscription tranche all investors eligible to apply			
(3) Pool A for applications less than HK\$5M, Pool B for application greater than HK\$5M.			
(4) Restricted eligibility for individuals to apply in the placement tranche			
Option 2			
As for option 1 except for (4) i.e. all investors eligible to apply in placement tranche.			
Option 3			
(i) applications not exceeding HK\$5M to go in the subscription tranche.			
(ii) applications above HK\$5M to go in the placement tranche			
8. Level of indications of interest should be disclosed.			
(i) with a qualitative description			
(ii) with a numerical description			