



Hong Kong

November 2017

CONSULTATION PAPER ON CAPITAL RAISINGS BY LISTED ISSUERS

Introduction

The Stock Exchange of Hong Kong Limited (the **Stock Exchange**) has published a Consultation Paper on Capital Raisings by Listed Issuers¹ (**Capital Raisings Consultation Paper**). The paper proposes certain changes to the Listing Rules to address potential abuse by some listed issuers in large, deeply discounted fund raisings, and certain share consolidations and subdivisions. The Hong Kong Stock Exchange believes that these capital raising activities materially dilute voting rights and the value of public shareholders' investments.

In order to ensure fair treatment of all shareholders and to promote the market quality of trading and marketing of securities, the Stock Exchange proposes in its Capital Raisings Consultation Paper the following key changes to the Listing Rules:

- A prohibition on rights issues and open offers (referred to as **pre-emptive offers**) and specific mandate placings, which individually or when aggregated in a rolling 12-month period, would cause a cumulative value dilution of 25% or more.
- Introducing a new rule requiring minority shareholders' approval for all open offers not made under an existing general mandate.
- The removal of the requirement for all rights issues and open offers to be underwritten.

- Introduction of a new rule requiring any underwriter of a rights issue or open offers to be SFC-licensed persons who are independent of the issuer.
- Removal of the connected transaction exemption for connected persons acting as underwriters.
- Introduction of a requirement for issuers to adopt either excess application arrangements or compensatory arrangements for the disposal of the unsubscribed shares of rights issues and open offers. These arrangements are currently optional only.
- A prohibition on the use of a general mandate for a placing of warrants.
- Restriction on the use of general mandates to placings of convertible securities with an initial conversion price higher than the market price of the shares at the time of the placing.
- Introduction of a new requirement to disclose the use of proceeds from equity fundraisings in interim and annual reports.
- A prohibition on subdivisions or bonus issues of shares if the share price is below HK\$1 or HK\$0.5 after adjustment for the subdivision or bonus issue.

1. Cap on highly dilutive capital raisings

The Capital Raisings Consultation Paper proposes prohibiting rights issues, open offers or specific mandate placings which individually or when aggregated over a 12-month rolling period, would result in a cumulative material value dilution (proposed to be 25% or more), to non-subscribing shareholders, unless there are exceptional circumstances.

¹ <https://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2017092.pdf>

Background

The Listing Rules require that all new issues of equity securities by a listed issuer must first be offered to existing shareholders pro rata to their shareholdings, unless the shareholders have agreed otherwise.

Under the current Listing Rules, the issuance of new securities by a listed issuer other than pro rata to existing shareholders generally requires shareholders' approval, by way of:

- i) a mandate specific to the proposed share issuance (a **specific mandate**), or
- ii) a prior mandate for issuing securities up to a maximum of 20% of the listed issuer's issued shares as at the date of the shareholders' resolution approving the mandate, where the issue price for securities placed for cash consideration is not at a discount of 20% or more to the securities' benchmarked price² ³(a **general mandate**).

Although all existing shareholders can participate in a rights issue or open offer, the shareholdings of shareholders who do not take up the rights or open offer will be diluted on the issuance of new shares. Currently, shareholder approval is only required for rights issues and open offers that increase the number of issued shares or market capitalisation by over 50%, either alone or when aggregated with other rights issues and open offers in the preceding 12 months.⁴ The issuer's controlling shareholder (or directors and chief executive if there is no controlling shareholder) and their respective associates are required to abstain from voting in favour of shareholders' resolution to approve such rights issues and open offers.

The shareholdings of non-subscribing shareholders are further diluted when the listed issuer offers new shares at a discount price relative to the market price. The Stock Exchange refers to large scale rights issues and open offers at a deep discount to market price as 'highly dilutive pre-emptive offers'.

In December 2016, the Stock Exchange and the Securities and Futures Commission (**SFC**) issued a joint statement regarding their close monitoring of highly dilutive pre-emptive offers due to concerns that they are oppressive to issuers' public shareholders. For details of the joint statement, please

see Charltons' newsletter *Rights Issues and Open Offers that Significantly Dilute Minority Shareholding Interests Face Closer SFC and HKEx Scrutiny*⁵.

The Stock Exchange's review of capital raisings between 2013 and 2016 showed that although minority shareholders had approved highly dilutive rights issues and open offers, there were very low turnout rates at the shareholders' meetings and a low level of subscription by minority shareholders.

Certain recent highly dilutive rights issues and open offers lacked obvious commercial rationale; there often did not appear to be funding needs to justify the high level of dilution. Critics have suggested that these issues were deliberately structured to be unattractive to minority shareholders so as to allow insiders to acquire the unsubscribed shares cheaply. These offers involve a significant transfer of value to company insiders at the expense of the minority shareholders.

Proposed 25% threshold for material value dilution

In the Capital Raisings Consultation Paper, the Hong Kong Stock Exchange proposes that a listed issuer may not undertake a rights issue, open offer or specific mandate placing that would result in a material value dilution to non-subscribing shareholders, unless there are exceptional circumstances. Its review of issuers' fundraising activities between 2013 and 2016 found that 35% of rights issues and open offers had value dilution exceeding 25%, while 69 out of 541 specific mandate placings conducted over the same period were highly dilutive with value dilution of 25% or more.

Under the proposal, value dilution will be the theoretical value dilution calculated with reference to the offer ratio (new offer shares relative to existing shares) and the discount of the offer price to the market price prior to the offer announcement. The threshold for material value dilution will be 25% and the value dilution of an offer will be calculated using the following formula:

$$\frac{\text{Number of new shares to be issued} \times \text{Percentage price discount}}{\text{Number of issued shares as enlarged by the offer}}$$

² Under Listing Rule 13.36, the benchmarked price is the higher of (i) the closing price on the date of the agreement, and (ii) the average closing price in the past 5 trading days.

³ Listing Rule 13.36.

⁴ Listing Rules 7.19(6) and 7.24(5).

⁵ <https://www.charltonslaw.com/rights-issues-and-open-offers-that-significantly-dilute-minority-shareholding-interests-face-closer-sfc-and-hkex-scrutiny/>

The price discount will be determined by reference to the higher of:

- a) the shares' closing price on the agreement date; and
- b) the average closing price in the 5 trading days immediately prior to the earlier of:
 - i) the announcement date;
 - ii) the agreement date; and
 - iii) the price determination date.

Proposed aggregation of fund raisings over rolling 12-month period

The value dilution is proposed to be calculated on a cumulative basis by aggregating all rights issues, open offers and specific mandate placings over a rolling 12-month period immediately before the date of the proposed share offer.

The proposal includes an exceptional circumstances exception, for example where the issuer is in financial difficulty and the proposed issue forms part of the rescue proposal.

The proposed Listing Rules will clarify that the Stock Exchange retains its discretion to withhold approval for, or impose additional requirements on, rights issues, open offers or specific mandate placings, where the offer ratio or price discount appeared unfair to shareholders and the listed issuer. This discretion would only be exercised by the Stock Exchange where the terms of an offer are clearly egregious.

The Hong Kong Stock Exchange decided not to increase the current Listing Rules 50% threshold for minority shareholders' approval of new share issues, noting that in the vast majority of cases reviewed, highly dilutive pre-emptive offers were approved by more than 75% of shareholders attending general meetings, but that shareholders' turnouts were low.

2. Proposals for Rights Issues and Open Offers

2.1 Minority shareholders' approval for all open offers not covered by a general mandate

Under the current Listing Rules, existing shareholders' right to subscribe for new shares is non-renounceable in an open offer. This means that in an open offer, existing shareholders cannot transfer their right to subscribe (i.e. their nil-paid rights) to a third party as is possible in a rights issue. Non-subscribing shareholders in an open offer cannot therefore recoup some of the value dilution through a sale of their nil-paid rights.

They additionally suffer value dilution loss which they can only avoid by selling their shares. Yet in a highly dilutive open offer, the share price may be further depressed by many minority shareholders opting to sell rather than suffer value dilution.

Further, in practice, most open offers do not include excess application arrangements for shareholders to allow them to apply for any unsubscribed shares after the offer period ends. Consequently, controlling shareholders who underwrite the listed issuer's open offer can take advantage of this mechanism to increase their shareholdings at a discounted rate.

In order to address these concerns, the Hong Kong Stock Exchange proposes that all open offers should be conditional on minority shareholders' approval, unless the new shares are to be issued under an existing general mandate. Controlling shareholders and their associates (or where there are no controlling shareholders, directors (excluding independent non-executive directors) and the chief executive and their respective associates) would be required to abstain from voting in favour of the resolution. Issuers would have the option of instead issuing shares by way of rights issue, so that existing shareholders' right to subscribe for new shares is renounceable and their nil-paid rights are freely tradeable on the Stock Exchange.

2.2 Removal of the compulsory underwriting requirement for pre-emptive offers

The Listing Rules require all rights issues and open offers for Main Board listed issuers to be fully underwritten (Rules 7.19(1) and 7.24(1)). The rationale is that underwriting gives the listed issuer a degree of certainty and enables it to plan on the basis of assured funds. Where an independent third party underwriter is appointed, this also ensures that the terms of the issue are negotiated on an arm's length basis. Listing Rule 14A.92(2)(b) exempts an issue of new securities in a rights issue or open offer to a connected person who subscribes in the capacity of an underwriter or sub-underwriter from the Listing Rules' requirements for connected transactions (**Connected Transaction Exemption**). The availability of the exemption is subject to the condition that the connected person and the issuer have adopted either the excess application arrangement or compensatory arrangement.

The Hong Kong Stock Exchange proposes to remove the compulsory underwriting requirement for all rights issues and open offers by Main Board listed issuers.

However, where a rights issue or open offer will not be underwritten, the issuer will have to disclose the risks to shareholders, and the proposed allocation of funds to the proposed uses if the offer is undersubscribed.

2.3 Requiring an underwriter to be licensed by the SFC and independent from the issuer

Conflicts of interest may arise where a listed issuer's controlling shareholders underwrite its rights issues and open offers. Where controlling shareholders are the underwriters, they may acquire control of the listed issuer through the underwriting arrangements. These capital raisings have implications under the Takeovers Code, and listed issuers would normally require a whitewash waiver from the SFC's Executive. The SFC's Executive would not generally grant a whitewash waiver where it believes that a rights issue or open offer is oppressive to the minority shareholders, or otherwise contrary to the General Principles of the Takeovers Code.

Of the rights issues and open offers reviewed by the Stock Exchange between 2013 and 2016, 25% were underwritten by non-licensed persons, 22% were underwritten by controlling or substantial shareholders or directors and 3% were underwritten by other independent persons.

The Hong Kong Stock Exchange proposes that where an underwriter is engaged, it must be an entity licensed by or registered with the SFC for Type 1 regulated activity (dealing in securities) and their ordinary course of business must include underwriting securities. Underwriters would further be required to be independent of the listed issuer – i.e. they must not be connected persons of relevant issuers. SFC licensed persons are subject to the SFC Code of Conduct and are regulated by the SFC. Under the proposal, controlling shareholders could continue to act as underwriters where they adopt the

mandatory compensatory arrangements⁶ for the unsubscribed shares. The Stock Exchange is also seeking market views as to whether this proposal should extend to include substantial shareholders (that are not controlling).

2.4 Removal of the connected transaction exemption for connected persons acting as underwriters

⁶ Compensatory Arrangement allows the unsubscribed shares to be first offered to the independent investors at market price, which may be at a premium to the offer price, and the premium would then be returned to the non-subscribing shareholders.

Under the proposals, the underwriting and sub-underwriting of pre-emptive offers by connected persons would no longer have the benefit of the Connected Transaction Exemption. The underwriting agreement would thus be subject to the Listing Rules' requirements that the underwriting agreement is approved by the issuer's independent shareholders' and that the issuer appoints an independent financial adviser to give an opinion on the underwriting arrangement.

2.5 Excess application and compensatory arrangements

The Hong Kong Stock Exchange proposes that it should be mandatory for issuers to adopt either the excess application arrangement or the compensatory arrangement for the disposal of unsubscribed shares in rights issues and offers. Adoption of these arrangements is currently optional for issuers.

Under a compensatory arrangement, shareholders who do not subscribe for the offer shares or sell their nil-paid rights in the market on a rights issue, may be compensated through a distribution of funds raised from the sale of unsubscribed shares in excess of the offer price.

An excess application arrangement allows the issuer's existing shareholders to apply for the unsubscribed shares in excess of their assured entitlements, and benefit from the price discount.

The Stock Exchange recognises that some controlling shareholders are able to take advantage of their knowledge of the level of pre-emptive offers' subscription and use the excess application arrangements to acquire unsubscribed shares at a discounted rate. It is proposed therefore that issuers should be required to take active steps to identify excess applications made by their controlling shareholders and their associates, whether in their own names or through nominees. Issuers would then be required to disregard controlling shareholders' excess applications in excess of the offer size minus their pro rata entitlement.

3. Use of general mandates for placings of warrants, options or convertible securities

3.1 Prohibition on using general mandates for placings of warrants or options for cash

The Hong Kong Stock Exchange proposes to prohibit the use of general mandates for placings of warrants or options for cash, thus requiring issuers to obtain specific mandates for these placings.

The proposal is intended to deal with concerns that general mandates are being abused in relation to warrant issues. The Stock Exchange's review of warrant placings under general mandate in 2014 noted that while the vast majority of issuers described the purpose of placings as broadening their shareholder base and fund raising, the placings were generally made to only a small number of subscribers. The limited number of subscribers is inconsistent with the stated aim of broadening shareholder base, while the low warrant subscription price meant that the amount of funds raised after transaction costs was not significant. Warrant holders stood to benefit as they would only need to exercise them if there were a clear gain. Hence, the warrant placings appeared to be intended to benefit subscribers rather than the listed issuer.

3.2 Restriction on placings of convertible securities under a general mandate

In relation to convertible securities, the Stock Exchange proposes to restrict the use of general mandates to placings where the initial conversion price of the convertible securities is equal to or higher than the listed shares' benchmarked price at the time of the placing. In all other cases, issuers must obtain a specific mandate.

In the event that this proposal is not implemented, the Stock Exchange would propose amending the general mandate Listing Rules. Specifically, the 20% discount limit on the issue price would be extended to apply to the initial conversion price of convertible securities at the time of placing the securities for cash consideration.

4. New disclosure obligation for the use of proceeds of equity fundraisings

The Hong Kong Stock Exchange proposes to increase issuers' disclosure obligations in relation to the use of proceeds from all equity fundraisings. Under the current regime, issuers are only required to disclose information in the shareholders' circular (for specific mandates) as well as in their annual reports. A more stringent framework is proposed by the Stock Exchange, which would require disclosure of details of the use of proceeds in interim and annual reports. The information to be disclosed would include:

- i) a detailed breakdown and description of the use of proceeds;
- ii) a detailed breakdown and description of the intended use of any unutilised proceeds and the expected timeline (where applicable); and

- iii) whether the proceeds were used, or are proposed to be used, in accordance with the intended use as previously disclosed by the issuer, and the reasons for any material change, or any delay, in the use of proceeds.

5. Share consolidation, subdivision or bonus issues of shares

The Hong Kong Stock Exchange proposes to prohibit subdivisions or bonus issues of shares where the share price adjusted for the subdivision or bonus share is below HK\$1 or HK\$0.5, based on the shares' daily closing price in the six-months before the announcement of the subdivision or bonus issue.

6. Responding to the Consultation Paper

Responses to the Consultation Paper should be submitted before 24 November 2017 to Hong Kong Exchanges and Clearing Limited either by mail or hand delivery to its address at 12th Floor, One International Finance Centre, 1 Harbour View street, Central or by email to response@hkex.com.hk. All responses should be marked "Re: Consultation Paper on Capital Raisings by Listed Issuers".

CHARLTONS

Boutique Transactional Law Firm of the Year 2017

Asian Legal Business Awards

This newsletter is for information purposes only.

Its contents do not constitute legal advice and it should not be regarded as a substitute for detailed advice in individual cases.

Transmission of this information is not intended to create and receipt does not constitute a lawyer-client relationship between Charltons and the user or browser.

Charltons is not responsible for any third party content which can be accessed through the website.

If you do not wish to receive this newsletter please let us know by emailing us at unsubscribe@charltonslaw.com

Hong Kong Office

Dominion Centre

12th Floor

43-59 Queen's Road East

Hong Kong

Tel: + (852) 2905 7888

Fax: + (852) 2854 9596

www.charltonslaw.com