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SOLICITORS



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## HKEX PUBLISHES CONSULTATION PAPER ON EX-ENTITLEMENT TRADING

### Introduction

Hong Kong Exchanges and Clearing Limited (**HKEx**) published a consultation paper (**the Consultation Paper**) on 17 December 2010, regarding the possibility of changes to the current market practice of ex-entitlement trading. The Consultation Paper requests feedback from market participants on whether shares should be traded ex-entitlement only after the entitlement has been approved by shareholders. Entitlements are benefits, such as cash or securities, distributed by a company to its shareholders. Some entitlements are announced and then distributed to registered shareholders directly, while others are conditional entitlements, in that they are “proposed” by the board and still require shareholder approval at a general meeting in accordance with statutory or Listing Rules requirements. Under the regulatory regime presently operating in Hong Kong, there is no restriction on the timing of the record date for a conditional entitlement. The company can set the record date before or after the date of shareholder approval.

A key concern for HKEx is that although the current system has caused no major difficulties, it is out of sync with practices in the Mainland and in leading financial centres (e.g. New York and Singapore). The market practice in those regions is to require that a share not go ex-entitlement until after shareholder approval has been obtained. However, HKEx state that at present they have an open mind as regards the regulation of ex-entitlement trading in Hong Kong and are awaiting market responses before formulating a course of action.

### Background To The Consultation Paper

The stocks of listed companies are traded very frequently on the Hong Kong market, with the consequence that their shareholder lists are constantly changing. When entitlements are distributed the company designates a record date, with those who are registered shareholders on that date receiving the entitlements. If there is a book closure period<sup>1</sup>, the record date can fall on any day during the period, but it normally falls on the last book closing date. Under Hong Kong’s T+2 settlement, the Ex-date is usually the business day before the record date (when there is no book closure) or the last registration date (when there is a book closure).

Sellers on the ex-date remain registered shareholders on the record date, which means they are entitled to the distribution even if their shares have been sold to others. However, buyers on or subsequent to the ex-date will not be registered shareholders on the record date, with the result that they will not obtain the entitlement, despite their ownership of the stock. The effect of this is that, in theory, with all other factors remaining equal, the share price should decline on the ex-date by an amount corresponding to the value of the entitlement, discounted for time value.

With regard to book closing dates, share registration may take time to complete where physical certificates exist. However, modern technology permits issuers and their share registrars to identify registered shareholders by closing the register for a single day or by taking a snapshot of the register books at the end of the record date. This in turn permits the issuer to identify those registered security holders who are to be

<sup>1</sup> Period during which the book is closed for share transfers

recipients of entitlements. The effect of this is that issuers may select a record date without a book closure. Under the current system employed in Hong Kong, the register is closed for inspection during the book closure period. However, if there is only a record date (i.e. without a book closure), the register will effectively be available for inspection without interruption.

As noted in the introduction to this newsletter, various entitlements (such as interim dividends) are announced and then distributed to registered shareholders directly. In contrast there are some entitlements which are only "proposed" by the board and which then must be approved by shareholders at a general meeting, in order to comply with statutory or Listing Rules requirements. There are two categories of conditional entitlements:

- Some entitlements, such as the final dividend and rights issues or open offers which will increase the issued share capital or market capitalisation by more than 50%, intrinsically demand approval by shareholders at a general meeting before implementation.
- Some entitlements distributed by the company are contingent on a major transaction or very substantial acquisition/disposal being approved by shareholders at a general meeting.

HKEx identify the method by which a company selects its record date for conditional entitlements as a key issue, as this may have an impact on the orderly trading of its stocks. If the record date (and thus the ex-date) is set before the date of the general meeting, sellers on the ex-date will be subject to a risk of uncertainty; i.e. they may not receive the entitlement as expected and the shares would turn out to have been sold at a discount to the buyers if the distribution is blocked by shareholders at the general meeting. If the record date (and thus the ex-date) is set after the general meeting at which the entitlement is approved, sellers on the ex-date will not be exposed to any such risk of uncertainty and the trading of stocks would be conducted in a fair manner to both buyers and sellers. At present, the listing and trading regulatory framework in Hong Kong permits setting the record date for a conditional entitlement before or after the general meeting date, with the result that the risk to sellers described above remains a real one.

## Current Market Practices And Regulatory Framework In Hong Kong For Ex-Entitlement Trading

HKEx note that 95% of the distribution of entitlements in 2009 set a record date for the entitlement before the date of shareholder approval, with only 5% setting a post general meeting ex-entitlement date. The majority of this 5% were Mainland issuers, who must comply with the Mainland's regulatory requirements regarding ex-entitlement. HKEx also highlight the fact that of 605 distributions, only three of them were subsequently blocked by shareholders, including one rights issue, one open offer and one final dividend. Rights issues and open offers however face a higher risk exposure calculated by price adjustment on the ex-date. In 2009, the median of ex-date price adjustment for rights issues was 37.78% of the previous closing price and that for open offers was 35.07%, whereas for final dividend cases the median ex-date price adjustment was just 2.2% of the previous closing price.

The Listing Rules which frame the current regulatory system in Hong Kong governing distributions of entitlements and shareholder approvals are detailed in Appendix I to the Consultation Paper. The principal regulations are contained in Main Board Rules 7.19 (6) and (7), 7.21 (2), 7.24 (5) and (6), 7.26, 7.26A (2), 13.36 (1) (a), 13.36 (2), 15.02, 14.40, 14.06 (3), (4),(5) and (6), 14.49, 14.55, 14A.18, 14A.31 (2) and paragraphs 3(e)1 and 3(f) of Practice Note 15.

The equivalent GEM Board Rules are 10.29, 10.31 (2), 10.39, 10.41, 10.42 (2), 17.39, 17.41, 21.02, 19.40, 19.06 (3), (4), (5), and (6), 19.49, 19.55, 20.18, 20.31 (2) and paragraphs 3(e)1 and 3(f) of Practice Note 3.

## HKEx'S Examination Of The Principal Issues

### *Positive features of the current regime noted by HKEx*

- *Current system works*

The current regulatory framework for ex-entitlement trading has been in place for many years and has attracted few complaints from market participants.

- *Minimal risk of blockage*

As the figures noted above from 2009 demonstrate (3 subsequent blockages by shareholders from 605 distributions), the risk of shareholder disapproval after ex-entitlement trading is slight.

- *Disclosure of risk*

The possibility of subsequent obstruction by shareholders must be disclosed by the issuer in the circular to shareholders, meaning that any shareholders who choose to trade regardless of the risk should arguably take responsibility for their decision.

- *Delay to distribution procedure*

Imposing an obligation to set a post general meeting record date for the entitlement draws out the distribution process, by at least three business days (i.e. assuming at least one cum-trading day after the general meeting), causing listed issuers to incur extra costs in time-sensitive deals as they may have to pay higher fees to underwriters for the added risk they take on as a consequence of their increased exposure under an extended timetable.

- *Confusion to shareholders*

Currently an identical list is used for voting and entitlements. Changing the system may confuse retail investors, who have become accustomed to a single record date for voting and entitlements, and will also create a situation where those shareholders voting at the general meeting will determine the distributions due to an entirely separate group of shareholders.

- *Risk of uncertainty from other factors*

The possibility remains that regardless of the record date for entitlement being set for after the general meeting, the distribution may still face a risk of uncertainty due to its being contingent on other factors.

### **Arguments noted by HKEx for changing the regime governing ex-entitlement trading**

- *Need for convergence*

Hong Kong should bring its practices into line with those used internationally and on the Mainland.

- *Removal of unnecessary risk*

A particularly strong argument may be made that trading ex-entitlement prior to shareholder approval creates an unnecessary risk for investors, the removal of which would increase the attractiveness of Hong Kong's securities

market. The fact that in the period between the ex date and the general meeting, investors cannot be sure if they are trading with or without entitlement creates a disorderly market and creates a risk for investors that is specific and easily removed.

- *Effect on derivatives products*

Trading ex-entitlement before shareholder approval may increase the risk of uncertainty for the trading arrangements of the associated derivatives products. Under the current system capital adjustments will also be made to the Exchange's related derivatives products, such as options, futures contracts and/or structured products, based on the ex-date of the corporate action publicised by the listed company. At present these contracts or structured products will not be re-adjusted if the entitlement is voted down by shareholders at the general meeting. Prohibiting ex-entitlement trading of shares without prior shareholder approval eliminates the risk of uncertainty and permits a consistent approach to entitlements for the cash and derivatives markets.

- *Possibility of market manipulation*

Pre shareholder approval ex-entitlement trading may increase opportunities for market manipulation, as parties with a vested interest attempt to make free gains through influencing the voting on the corporate action, particularly in those corporate actions where major shareholders are obliged to abstain from voting.

- *Increased shareholder activism*

The evolving character of share ownership in Hong Kong, coupled with the recent increase in shareholder activism, may make the outcomes of shareholder votes on ex-entitlement trading of shares more and more unpredictable, increasing the risk of disorderly markets and negative outcomes.

- *A new regime for higher risk actions only*

Several market participants recommended imposing an obligation to set a post general meeting record date for entitlement only on those corporate actions exposed to (i) a higher risk of shareholder disapproval (e.g. major shareholders must abstain from voting) and (ii) a more substantial price adjustment on the ex-date.

- *Absence of extra operational problems or costs*

Share registrars have indicated that there would not be any operational difficulties in arranging ex-entitlement after the general meeting, nor would there be any additional costs involved in processing two separate lists of shareholders (i.e. one for voting and the other for entitlements).

### **Feedback Sought By HKEx**

HKEx explicitly state that they are open minded as regards the reform of the framework regulating ex-entitlement trading and are eager to test the opinion of the market on the matter. The Consultation Questions are listed at the back of the Consultation Paper but, broadly speaking, they ask whether shares should only be traded ex-entitlement after shareholder approval and, if so, how long after the date of approval the record date should be set. A corollary to this question is whether a failure on the part of the issuer to publish its voting results on the HKEx news website by 11pm on the date of the general meeting should result in the extension of the last cum-trading day to, at minimum, the second business day after the meeting.

The second key question raised by HKEx is whether any obligation to trade shares ex-entitlement only after shareholder approval has been given should be applied to all conditional entitlements or only to some of them.

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