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Exchange Publishes Guidance on Issue of Convertible Securities by Listed Issuers

The Stock Exchange of Hong Kong Limited (the **Exchange**) has published guidance letter HKEx-GL80-15[1] (the **Guidance Letter**) providing guidance on the Listing Rules' requirements for issues of convertible securities, including convertible and exchangeable bonds, notes and loans and convertible and exchangeable preference shares which are convertible into issuers' new shares listed on the Exchange (collectively **convertible securities**). The Guidance Letter does not however cover the listing of the convertible securities.

Relevant Listing Rules

- Main Board Rule 13.36 (GEM Rules 17.39 to 17.41) provides that an issue of convertible securities must be approved by the issuer's shareholders either under the issuer's general mandate or by a shareholders' resolution approving the issue passed at general meeting.
- Main Board Rules 8.20, 16.01 and 28.01 (GEM Rules 11.30(2), 22.01 and 34.05) provide that the Exchange's prior approval is required for: (i) the issue of the convertible securities; and (ii) the listing of the shares issuable upon conversion under the terms of the convertible securities (**conversion shares**), irrespective of whether the convertible securities themselves will be listed.
- Main Board Rules 16.03 and 28.05 (GEM Rules 22.03 and 34.05) further require a listed issuer to obtain the Exchange's prior consent for any proposed change in the terms of the convertible securities, unless the change occurs automatically in accordance with the terms of the convertible securities.
- Main Board Chapters 16 and 28 of the Listing Rules (Chapters 22 and 34 of the GEM Rules) set out other specific requirements which must be met by issuers issuing convertible securities.

Pre-emptive rights

Main Board Rules 2.03(6) and 13.36 (GEM Rules 2.06(6), 17.39, 17.40 and 17.41) require an issuer to obtain prior shareholder approval of any new issue of shares (including securities convertible into shares) on a non-pre-emptive basis, either by a specific mandate (i.e. an approval of a specific transaction in general meeting) or under a general mandate.

General Mandate

To issue convertible securities under a general mandate, an issuer needs to ensure that it has enough unused mandate to cover all conversion shares, after taking into account factors such as the conversion price and the adjustment mechanism which may affect the number of conversion shares. The

1 HKEx Guidance Letter HKEx-GL80-15 "Guidance on the issue of convertible securities by listed issuers"

Guidance Letter describes the Exchange's approach in assessing the issue size of the conversion shares for two broad categories of terms of convertible securities.

Type 1: Conventional convertible securities with fixed initial conversion price subject to adjustments triggered by events within the issuer's control

a) Initial conversion price for the convertible securities is at a fixed dollar amount and subject to customary adjustment provisions triggered by corporate actions within the issuer's control, including share consolidations or subdivisions, capital distributions, further issues of securities at less than current market price, etc.

b) Generally, an issuer may issue Type 1 convertible securities under a general mandate if it has enough unused general mandate to cover the number of conversion shares based on full conversion of the convertible securities at the time when the convertible securities are issued.

c) Since events triggering adjustments of conversion price are within the issuer's control, the issuer should ensure that it does not take any corporate action that would raise the number of conversion shares above the mandate limit.

d) The Exchange will generally grant listing approval in respect of a specific number of conversion shares within the mandate limit. Issuers should therefore put in place measures to monitor the number of issued and issuable conversion shares under the terms of the convertible securities and take these figures into account before taking any action that would trigger the adjustment provisions.

e) Issuers' monthly returns should show: (i) the number of conversion shares issuable upon full conversion of outstanding convertible securities as at the close of the month; and (ii) sufficiency of the general mandate to cover these shares.

Type 2: Convertible securities with an automatic price re-set or adjustment mechanism not triggered by events within the issuer's control

A "toxic" convertible where the conversion price is re-set with reference to the future trading price of the issuer's shares is an example of Type 2 convertible securities.

a) Issuers with no control over any adjustment of the conversion price after issuing the convertible securities should calculate the maximum number of conversion shares issuable upon full conversion of the convertible securities using the lowest possible conversion price.

b) Issuers who cannot demonstrate sufficient general mandate to cover all conversion shares at the time of issue of the convertible securities must obtain a specific mandate from shareholders for the issue of the convertible securities.

Proposed changes to convertible securities

Under Main Board Rules 16.03 and 28.05 (GEM Rules 22.03 and 34.05), listed issuers are required to obtain the Exchange's prior consent for any proposed change in the terms of convertible securities, unless the change is triggered automatically by the terms of the convertible securities.

The Exchange will treat the proposal as a new issue of convertible securities if it considers the proposed change in the terms to be material. The issuer will then have to obtain fresh shareholder approval of the new issue unless it has sufficient, and is permitted to use, unused general mandate to cover the number of conversion shares based on full conversion of the proposed convertible securities at the time of the new issue. (See also Listing Decision LD54-2013[2]).

Disclosure requirements

Announcement for issue of convertible securities

Main Board Rule 13.28 (GEM Rule 17.32) sets out information that issuers must disclose in an announcement of an issue of convertible securities for cash which includes:

i) all material terms of the convertible securities, including the conversion price and a summary of the provisions for adjustments of the price and/or the number of shares to be issued;

ii) the maximum number of shares that could be issued upon exercise of the conversion rights; and

iii) if the convertible securities are to be issued under a general mandate, details of the mandate. The information should show that the issuer has enough mandate to cover the conversion shares to be issued, such as the

2 A summary of the decision can be found in a previous issue of Charltons Newsletter.

date of the general meeting approving the mandate, the number of shares that the issuer is authorised to allot or issue under the mandate and other terms and conditions of the mandate, and the unused mandate available for the proposed issue.

Chapter 14 of the Main Board Rules (Chapter 19 of the GEM Rules) also makes disclosure of the above compulsory in a notifiable transaction announcement if consideration for the transaction involves the issue of convertible securities.

Announcement for change in terms of convertible securities

After issuing convertible securities, an issuer is required to timely announce the following:

i) any change in the terms of the convertible securities (including any adjustment of the conversion price according to the terms of the convertible securities); and

ii) the effect of the change.

The issuer should also ensure that it has enough mandate to cover the issue of conversion shares after the change takes effect if the convertible securities were issued under the general mandate.

Disclosure in financial reports

In order to alert investors of the dilutive impact on the issuer's shares if all outstanding convertible securities were converted as at the relevant year end or period end, the issuer is required to disclose, after taking into account provisions permitting payment of interest in kind (assuming a worst-case scenario), in its annual and interim reports:

- the number of shares that may be issued upon full conversion of the outstanding convertible securities;
- impact of the dilution on the then number of its issued shares and respective shareholdings of its substantial shareholders;
- the dilutive impact on earnings per share;
- an analysis on its financial and liquidity position discussing its ability to meet its redemption obligations under the convertible securities; and
- an analysis on its share price at which the financial advantages for security holders of converting or redeeming the convertible securities based on their implied internal rate of return would be the same (so that it would make no difference to security holders whether the convertible securities were converted or redeemed) at a series of future dates.

Public float

Main Board Rules 8.08 and 13.32 (GEM Rule 11.23(7)) set out the public float requirements designed to maintain an open market in the securities for which listing is sought and listing approval will not be granted if doing so may lead to a breach of the requirement.

For example, where an issuer could breach the public float requirement as a result of issuing convertible securities to its connected person(s) or a person who would become its substantial shareholder upon conversion of the convertible securities, the Exchange would reject the application to list the conversion shares. The Exchange may however approve the listing if concrete arrangements are made to ensure maintenance of the public float, such as including in the terms of the convertible securities restrictions on any conversion of the convertible securities that would lead to non-compliance with the public float requirement (see also Listing Decision LD56-2013[3]).

3 See note 2 above.

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