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Rights Issues and Open Offers that Significantly Dilute Minority Shareholding Interests Face Closer SFC and HKEx Scrutiny

In a Joint News Release published on 9 December 2016, the Securities and Futures Commission (**SFC**) and the Stock Exchange of Hong Kong Limited (the **Exchange**) said that they are paying close attention to rights issues and open offers that significantly dilute the interests of non-subscribing minority shareholders. The two regulators re-emphasised the importance of fair and equal treatment of all shareholders in general, and specifically in relation to rights issues and open offers, as required by the Listing Rules of the Exchange.

Concerns that rights issues and open offers are being conducted in a manner that is unfair to minority shareholders have led the Exchange to vet draft announcements more rigorously. The SFC has made enquiries where proposed offer terms were highly dilutive and/or where issuers conducted repeated fundraisings over a relatively short period.

The Exchange has published two listing decisions relating to a rights issue and a share subdivision, respectively, that were not approved because the Exchange considered them to be unfair to minority shareholders.

Listing Approval for a Dilutive Rights Issue (Listing Decision LD102-2016)

The Facts

In listing decision LD102-2016, Company A proposed to raise HK$300 million by consolidating 20 existing shares into 1 consolidated share and issue 20 rights shares for 1 consolidated share at a subscription price of HK$0.30 per rights share (**Proposed Rights Issue**). The subscription price represented a 90% discount to the closing share price at the time, which was meant to encourage shareholders to participate in the rights issue. The dilution effect of the rights issue was approximately 85%.

The Exchange noted that Company A had completed another rights issue only a few months before (**Previous Rights Issue**), which also featured a deep discount to the market share price, and a dilution effect of over 80% on the interests of non-participating shareholders. The dilutive effect caused a significant transfer of value from the non-participating shareholders to the subscribing shareholders (including the controlling shareholder) and the underwriter.

Although the Previous Rights Issue was approved in general meeting by many of the voting shareholders, the meeting was only attended by about 20% of shareholders. Most of the public shareholders did not subscribe for the rights shares, which were undersubscribed by 52%.

The Decision

The Exchange did not approve the Proposed Rights Issue because it was a highly dilutive offer that followed another highly dilutive rights issue. The listing decision cited Listing Rule 2A.03, which requires the Exchange to act in the best interests of the market as a whole and in the public interest. The Exchange noted that highly dilutive offers are detrimental to the interests of shareholders who do not participate in them; non-participating shareholders suffer dilution to their investment as the value from the discount is transferred to the underwriters and participating shareholders. The larger the discount to market price and/or the higher the subscription ratio, the larger the value transfer and dilution of the non-participating shareholder's interest. The Exchange considered that Company A did not justify its deeply discounted and highly dilutive fundraising.

The Revised Proposal

Company A revised the terms of the rights issue to lower the subscription ratio to 3 rights shares for 1 consolidated share and the subscription discount was reduced to 72%. The dilution effect was therefore lowered to 55%, reducing the net proceeds to HK$200 million.

Approval for a Share Subdivision (Listing Decision LD103-2016)

The Facts

Listing decision LD103-2016 relates to Company B's announcement of a rights issue at a discount to market price and a 10 to 1 share consolidation aimed at cancelling out a drop in the theoretical ex-rights price to about HK$0.1 (based on the existing share price) to ensure compliance with Listing Rule 13.64.[1]

One month after the completion of that share consolidation, Company B proposed a 1 to 5 share subdivision and a board lot size change from 2,000 shares to 8,000 shares. The Company considered that share trading activity in its shares was low because of the high share price and board lot value compared to similar companies. It consulted the Exchange on its proposed subdivision under Listing Rule 13.52B(1) which requires an issuer to consult the Exchange where a document's subject matter "may involve a change in or relate to or affect arrangements regarding trading in the issuer's listed securities". The document must not include any reference to a specific date or specific timetable in respect of the matter which has not been agreed in advance with the Exchange.

The Analysis

Listing Rule 2.03 requires the fair and equal treatment of all shareholders, including minority shareholders.

The decision acknowledges that share consolidation or subdivision to raise or lower share trading price can increase trading activity and improve market efficiency. It also recognises that while share consolidation or subdivision itself does not change shareholders' proportionate interests in an issuer, these corporate actions involve costs and result in existing shareholders holding odd lots or fractional shares, which are usually traded at prices lower than those in complete board lots. While some issuers arrange for intermediaries to offer matching services, this cannot eliminate the negative effect of such corporate actions for the shareholders, particularly for smaller shareholders holding one or a few board lots.

The decision states therefore that before implementing a share consolidation or subdivision, the directors should consider all relevant factors and ensure that the consolidation/subdivision will serve its intended purpose and be in the best interests of the issuer and its shareholders. Factors to be taken into account include, but are not limited to:

- whether the proposed consolidation/subdivision is justifiable in view of the costs and negative impact of creating odd lots of shares;
- keeping the frequency of share consolidations/subdivisions to reasonable levels;
- whether the proposed share consolidation/subdivision may offset any prior or simultaneous corporate action (e.g. share consolidation followed by share subdivision within a relatively short time span, or share subdivision made in conjunction with an increase in board lot size);
- whether there is a sufficient demonstration period to support that the share trading price is not temporary and that a share consolidation/subdivision is justified; and
- whether an alternative corporate action is feasible.

Although Company B claimed that the purpose of the share subdivision was to increase trading liquidity, the Exchange decided that there was insufficient evidence to support that as the true purpose. The Exchange did not approve the share subdivision, given that:

- the simultaneous increase in board lot size would dilute the effect of the share subdivision to an almost equal extent;
- the increase in Company B's share price was only temporary and insufficient to justify a share subdivision;

1 Rule 13.64 requires that where the market price of an issuer's securities approaches the extremities of HK$0.01 or HK$9,995.00, the Exchange has the right to require the issuer either to change the trading method or to proceed with a consolidation or splitting of its securities.

- there was no justification for a share subdivision shortly after the completion of a share consolidation; and
- Company B did not consider alternative corporate actions to increase the trading liquidity of its shares.

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