

Hong Kong Stock Exchange's Consultation on Capital Raisings and Delistings of Hong Kong - Listed Companies

September 2017

1. Introduction

1.1 The Stock Exchange of Hong Kong Limited (the **Exchange**) has recently released two papers to consult the market on [capital raisings](#) by Hong Kong-listed companies (the **Capital Raising Consultation Paper**) and the [delisting framework](#) for Hong Kong-listed companies (the **Delisting Consultation Paper**). The consultation period for both papers will close on 24 November 2017.

1.2 The papers propose to make changes to the Hong Kong Listing Rules that will impact on: (A) capital raisings by listed companies (*i.e.*, rights issues, open offers and placings of securities (including convertible securities and warrants)); (B) disclosure of equity fundraisings in annual and interim reports; (C) share subdivision and bonus share issues; and (D) the delisting and suspension framework.

1.3 This note's main focus is the proposals in the Capital Raising Consultation Paper, which seek to close off some of the loopholes in the capital raising regime that can be used by "insiders" to the detriment of non-subscribing shareholders.

2. Capital Raisings

Rationale

2.1 In the Capital Raising Consultation Paper, the Exchange notes that while access to capital is an important market function, there have been patterns of abuse by a small number of listed companies using share issuances not for genuine capital raising, but for various ulterior purposes or to facilitate insiders in making gains that may not be in the interests of the listed company and all its shareholders.

2.2 The examples noted by the Exchange involved large scale and deeply discounted share issuances that often lacked commercial rationale - such issuances materially diluted the voting rights and value of non-subscribing public shareholders' investments, whilst appearing to benefit "insiders" (*e.g.*, by transferring value to new subscribers at a low price). These transactions, while structured to be compliant with the capital raising regime in the Listing Rules, raised regulatory issues regarding the fair treatment of minority shareholders and an orderly market for securities trading.

2.3 Certain issues with the current regime were highlighted by the Exchange, including the lack of a mandatory excess application or compensatory arrangement for unsubscribed shares (allowing the underwriter - who may be a substantial shareholder or other non-SFC licensed person - to "sweep" up all unsubscribed

shares at the deeply discounted price). The Exchange appeared to indicate that low shareholder turnout and potential “warehousing” of shares by nominees of insiders mean shareholder approval should not be relied upon as the sole means of minority shareholder protection.

Proposed changes

2.4 An overview of the proposals under the Capital Raising Consultation Paper (together with the existing position) is set out in Appendix 1 to this note.

Theoretical dilution effect

2.5 A key proposal being mooted is to prohibit a listed issuer from conducting any: (A) rights issue (RI); (B) open offer (OF); or (C) placing of securities outside the general mandate (**Specific Mandate Placing**), which (individually or with any other such capital raising in a rolling 12-month period) has a “theoretical dilution effect” of 25% or more, unless there are exceptional circumstances such as financial difficulty. The 25% dilution threshold will not cover issuances under general mandates, for which the existing limits will continue to apply¹.

2.6 Theoretical dilution effect takes into account the dilution effect of both the offer size and any discount to market price. The proposed formula is:

$$\frac{\text{Number of new shares to be issued x percentage price discount}^2}{\text{Number of issued shares as enlarged by offer}}$$

To illustrate, an offer of 5 new shares for each existing share at a price discount of 30% would result in a theoretical dilution effect of 25% and be prohibited. The same result applies to an offer of 1 new share for each existing share at a price discount of 50%.

2.7 The 25% threshold would be calculated on a cumulative basis to capture any RIs, OFs and Specific Mandate Placings conducted over a rolling 12-month period. The cumulative value dilution is calculated by reference to: (A) the total number of shares issued during the 12-month period compared to the number of issued shares immediately prior to the first offer / placing; and (B) the weighted average of the price discounts. The formula is:

$$\frac{(\text{No. of shares issued under 1}^{\text{st}} \text{ offer x price discount}) + (\text{No. of shares under 2}^{\text{nd}} \text{ offer x price discount}) \dots \text{etc}}{\text{No. of shares before 1}^{\text{st}} \text{ offer} + \text{No. of shares under 1}^{\text{st}} \text{ offer} + \text{No. of shares under 2}^{\text{nd}} \text{ offer} \dots \text{etc}}$$

Other proposals

2.8 Other proposals include requiring all RIs and OFs to have an excess application arrangement or compensatory arrangement for non-subscribed shares. Issuers can choose between the two options, unless a controlling or substantial shareholder is acting as an underwriter for the offer - in which case, it must implement a compensatory arrangement³.

2.9 The Exchange also proposes to make underwriting an RI or OF optional, but where an underwriter is appointed, it must be: (A) an SFC-licensed independent party; or (B) a controlling or substantial shareholder (provided a compensatory

¹ Under Listing Rule 13.36, the general mandate limits are 20% of the number of issued shares and, on placings for cash, 20% discount on the benchmarked price.

² Price discount is determined by reference to the higher of (i) closing price of shares on the date of agreement; and (ii) average closing price in the 5 trading days immediately prior to the date of announcement, date of agreement or price determination date.

³ A compensatory arrangement involves the issuer making arrangements to sell any unsubscribed securities, if possible, for the benefit of the non-subscribing shareholder.

arrangement is in place and the connected transaction rules have been complied with).

2.10 Unlike RIs, OFs are non-renounceable (*i.e.*, there is no ability for non-subscribing shareholders to sell their entitlements to the shares on the market). The Exchange believes this justifies a more stringent approval process for OFs relative to RIs and therefore proposes requiring minority shareholder approval (at 50%) for all OFs outside the general mandate. This means any controlling shareholder and its associates (or, if there are no controlling shareholders, executive directors and their associates) would not be able to vote in favour of the OF and an independent financial adviser must be appointed. There was no suggestion of imposing a similar requirement for Specific Mandate Placings even though existing shareholders would not have the opportunity to participate in such placings. Ordinary shareholder approval would therefore continue to be sufficient for Specific Mandate Placings, RIs (that do not exceed the existing 50% threshold under Listing Rule 7.19(6)) and general mandates.

2.11 It is proposed that the use of general mandates will be prohibited in the case of placings of warrants and restricted in the case of placings of convertible securities. In the latter case, a general mandate can only be used if the initial conversion price of the convertible security is no less than the benchmarked price⁴ of the underlying shares at the time of the placing. Otherwise, the placing will require a specific mandate.

3. Delisting Framework

Rationale

3.1 The primary motivation behind the Delisting Consultation Paper is to address the issue of prolonged trading suspension. Delistings may result in minority shareholders holding shares in an unlisted vehicle with no exit - therefore, the existing framework is more focussed on requiring issuers to take remedial steps to resume trading, rather than facilitating delisting. However, the market has been left with companies that have been subject to prolonged suspensions with no certainty about whether and when they would be relisted or delisted. The Exchange views this situation as undermining the proper functioning and reputation of the market.

Proposed changes

3.2 The Exchange proposes to add a new delisting criteria to allow the Exchange to delist an issuer after a continuous suspension exceeding a prescribed fixed period (**Fixed Period Criteria**). The Exchange is seeking feedback on whether this fixed period should be 12, 18 or 24 months in the case of Main Board issuers, or 6 or 12 months in the case of GEM issuers.

3.3 It is proposed that for issuers falling under the existing delisting criteria under Listing Rule 6.01 (*e.g.*, no longer suitable for listing, insufficient public float or insufficient operations / assets), the Exchange may publish a delisting notice specifying either a remedial period or (in exceptional circumstances) immediate delisting. Practice Note 17 dealing with issuers with insufficient operations / assets will be deleted.

3.4 The Exchange envisages that it would normally apply the Fixed Period Criteria

⁴ The benchmarked price would follow the formulation under the existing general mandate rules - *i.e.*, the higher of (i) the closing price on the date of the agreement and (ii) the average closing price in the 5 previous trading days.

to give issuers a reasonably long period of time to remedy issues and resume trading. Where appropriate, it may give an issuer some other remedial period under Listing Rule 6.01. Only in exceptional circumstances would the Exchange specify immediate delisting.

4. Remarks

4.1 Although there are existing Exchange guidance materials that address various aspects of the capital raising regime, the Capital Raising Consultation Paper seeks to address potential abuses in a comprehensive manner and via specific changes to the Listing Rules. It is of note that both the Exchange and the Securities and Futures Commission (SFC) have broad

discretion to object to follow-on equity offerings and have exercised these rights on recent highly dilutive fundraisings. By introducing a bright line test in the form of a 25% dilution threshold, listed companies and their advisers will be able to obtain more clarity on how they should structure their capital raisings in a manner that is less likely to raise concerns with the Exchange and the SFC.

4.2 However, it remains to be seen whether market feedback considers the proposed threshold has been set at a level that appropriately balances minority shareholder protection and listed companies' genuine capital raising needs.



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Appendix 1

Overview of Proposals in the Capital Raising Consultation Paper

| TYPE OF FUNDRAISING | AREA OF LISTING RULES | EXISTING POSITION | PROPOSED CHANGE |
|-------------------------------------|----------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| RI, OF and Specific Mandate Placing | Threshold triggering prohibition | No specific threshold triggering prohibition | <ul style="list-style-type: none"> Prohibited if “theoretical dilution effect” of 25% or more To be calculated cumulatively with any other RI, OF or Specific Mandate Placing in previous 12 months Exception for exceptional circumstances such as financial difficulty |
| RI | Shareholder approval | <u>Minority</u> shareholder approval (50%) required if RI: (a) would (together with any RI or OF in previous 12 months) increase number of issued shares or market capitalisation by more than 50%; or (b) is within 12 months of listing | No change |
| OF | Shareholder approval | <ul style="list-style-type: none"> <u>Minority</u> shareholder approval (50%) required if OF: (a) would (together with any RI or OF in previous 12 months) increase number of issued shares or market capitalisation by more than 50%; or (b) is within 12 months of listing Shareholder approval (50%) required if OF is not pro-rata or not under general mandate | <u>Minority</u> shareholder approval (50%) required for all OFs unless it is under general mandate |
| Placing | Shareholder approval | Either (a) general mandate or (b) shareholder approval (50%) to specifically authorise the placing | No change |
| RI and OF | Underwriting | <ul style="list-style-type: none"> Must usually be fully underwritten in the case of Main Board issuers No express restrictions on identity of underwriter If a connected person acts as underwriter / sub-underwriter on a RI or OF, it is fully exempt from connected transaction rules if there is excess application or compensatory arrangement in place for unsubscribed shares | <ul style="list-style-type: none"> Remove compulsory underwriting requirement Underwriter (if there is one) must either be (a) SFC-licensed (Type 1) and independent from issuers and their connected persons; or (b) controlling or substantial shareholders - but only where there is a <u>compensatory arrangement</u> in place Connected person acting as underwriter / sub-underwriter will be removed as a connected transaction exemption - any underwriting or sub-underwriting by controlling / substantial shareholder will be subject to independent shareholder approval and appointment of IFA |
| RI and OF | Unsubscribed shares | <ul style="list-style-type: none"> Excess application and compensatory arrangements are in place in the Listing Rules but they are not mandatory Absence of such arrangements require shareholder approval | <ul style="list-style-type: none"> Must adopt <u>either</u> excess application or compensatory arrangement But must be compensatory arrangement if controlling / substantial shareholder act as underwriter or sub-underwriter Excess application by controlling shareholder and its associates is limited to offer size minus their pro rata entitlement (to avoid manipulation of excess application) |
| Placing of warrants, | General Mandate | Placing of warrants, options and convertible securities under a general | <ul style="list-style-type: none"> Placing of warrants and options for cash - only specific mandates can be used |

| TYPE OF FUNDRAISING | AREA OF LISTING RULES | EXISTING POSITION | PROPOSED CHANGE |
|------------------------------------|----------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| options and convertible securities | | mandate is permitted subject to: (i) general mandate limits of 20% of number of issued shares and 20% discount on benchmarked price; and (ii) in the case of warrants, demonstrating to Exchange they are issued at or approximate fair value (as per a 2015 Listing Decision) | <ul style="list-style-type: none"> Placing of convertible securities - can use general mandate only if initial conversion price is no less than benchmarked price of the underlying shares at the time of placing⁵. Otherwise, use specific mandate |
| All equity fundraisings | Disclosure | <ul style="list-style-type: none"> General mandate - announcement including proposed use of proceeds, followed by disclosure in Annual Report with actual use of proceeds Specific mandate - shareholder circular including proposed use of proceeds, typically followed by disclosure in Annual Report as a “significant event” with actual use of proceeds | <ul style="list-style-type: none"> Requirement to disclose all equity fundraisings and use of proceeds in interim and annual reports Enhanced disclosure to include: (a) detailed breakdown and description of actual use of proceeds and intended use of any unutilised amount; and (b) whether the proceeds were used (or are intended to be used) according to intentions previously disclosed; and (c) reasons for any material change or delay |
| N/A | Share subdivision or bonus issue | Issuers may subdivide share or issue bonus shares, but Exchange has the right to require a share consolidation if the market price approaches HK\$0.01 per share or may not grant approval if it feels it is not justified given the impact on minority shareholders of holding odd lots / fractional shares (as per a 2016 Listing Decision) | <ul style="list-style-type: none"> Prohibit subdivisions or bonus issues if theoretical share price would be less than HK\$1 Demonstration period of 6 months of a high share trading price to justify a share subdivision |

⁵ Even if the proposed changes are not implemented, the Exchange clarified the 20% price discount limit under the existing general mandate rules should also apply to the initial conversion price of convertible securities at the time of placing.