

Hong Kong Capital Markets Update

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HKEX's consultation conclusions on capital raisings by listed issuers

On 4 May 2018, the Hong Kong Stock Exchange (the Exchange) published the [conclusions](#) of its [consultation](#) on capital raisings by listed issuers.

The consultation sought to address market concerns revolving certain problematic share issuance practices, including deeply discounted fundraisings as well as share consolidations and subdivisions. It was widely supported by respondents and the Exchange will be implementing the amendments proposed in the consultation together with several minor modifications. The revised Listing Rules will come into effect on 3 July 2018.

This Capital Markets Update provides an overview of the amendments to the Listing Rules following the consultation conclusions.

Key amendments

Highly dilutive capital raisings:

- Disallow rights issues, open offers and specific mandate placings (individually or when aggregated within a rolling 12-month period) that would result in a cumulative value dilution of 25% or more, unless there are exceptional circumstances such as the issuer is facing financial difficulties

Rights issues and open offers:

- Require minority shareholders' approval for all open offers not covered by a general mandate
- Remove mandatory underwriting requirement for all rights issues and open offers
- Require underwriters for rights issues and open offers to be SFC-licensed and independent from issuers and their connected persons
- Remove the connected transaction exemption currently available to connected persons acting as underwriters
- Require issuers to adopt excess application arrangements or compensatory arrangements for disposal of unsubscribed shares
- Require issuers to disregard excess applications made by controlling shareholders and their associates that are in excess of the offer size minus their pro-rata entitlements

Placing of warrants or convertible securities under general mandate:

- Disallow the use of general mandate for placing of warrants
- Prohibit the use of general mandate for placing of convertible securities with an initial conversion price that is not less than the market price at the time of placing

Others:

- Enhance disclosure of the use of proceeds from equity fundraisings in financial reports
- Restrict subdivision or bonus issues of shares if the theoretical share price is below HK\$1 post-issuance.

Consultation conclusions on capital raisings by listed issuers¹

On 9 December 2016, the Exchange and the Securities and Futures Commission (the SFC) issued a joint statement, highlighting concerns that highly dilutive rights issues and open offers (collectively known as pre-emptive offers) were oppressive to public shareholders. Their review of capital raisings from 2013 to 2016 showed that although these highly dilutive pre-emptive offers were approved, both the turnout rates at shareholders' meetings and subscription by minority shareholders were low. This indicated that the voting results might not have fairly reflected minority shareholders' support of the offers. Certain capital raisings also lacked commercial rationale, raising questions on the purpose of these transactions and whether they were beneficial to the issuer and its shareholders.

Based on market feedback, the Exchange will amend the Listing Rules to: (i) address potential abuses relating to large scale deeply discounted capital raisings; (ii) address specific issues relating to the requirements for rights issues, open offers and general mandates; and (iii) enhance disclosure on use of proceeds and to impose an additional requirement for share subdivision and bonus issue of shares.

Highly dilutive capital raisings

The existing Listing Rules require all new issues of equity securities by a listed issuer to be first offered to existing shareholders, unless the issuer seeks a mandate from shareholders to issue new shares. The Listing Rules protect minority shareholders by requiring issuers to seek from shareholders either i) a mandate specific to the proposed share issues (specific mandate), or ii) a prior mandate for issuing securities up to a maximum of 20% on issue size and price discount (general mandate).

Although pre-emptive offers are open to all existing shareholders, those who do not subscribe to the offer would have their ownership diluted. Moreover, if new shares were offered at a discounted price, this would further dilute the value of non-subscribing shareholders' investments. This raised concerns that offers might be structured in a way that is unattractive to minority shareholders so as to enable insiders to acquire a large number of unsubscribed shares at low prices. In addition, some highly dilutive specific mandate placings lacked clear commercial rationale, raising questions on whether they were for the purposes of facilitating other activities, rather than to meet the issuer's capital requirements.

In response to the concerns above, the Exchange concluded that an issuer may not undertake highly dilutive pre-emptive offers or specific mandate placings that would result in a value dilution of 25% or more to non-subscribing shareholders (unless the issuer can convince the Exchange of exceptional circumstances). The value dilution of an offer is calculated by the following formula²:

$$\frac{\text{Number of new shares to be issued} \times \text{Percentage price discount}^3}{\text{Number of issued shares as enlarged by the offer}}$$

To discourage issuers from circumventing the rule above, value dilution will be calculated on a cumulative basis, aggregating all pre-emptive offers and specific mandates over a rolling 12-month period immediately prior to the date of the currently proposed share offer⁴.

¹ Please refer to Appendix I for a summary of amendments to the Listing Rules in regards to capital raisings by listed issuers

² This does not take into account the value of nil-paid rights in a rights issue.

³ The price discount is determined by reference to the higher of:

- (i) the closing price of shares on the date of agreement; and
- (ii) the average closing price in the 5 trading days immediately prior to the date of announcement, the date of agreement or the price determination date. *This is consistent with the calculation of price discount under the existing general mandate rules.*

⁴ The cumulative value dilution is calculated by reference to:

- (i) the aggregate number of shares issued during the 12-month period, compared to the number of issued shares immediately prior to the first offer or placing; and
- (ii) the weighted average of the price discounts (each price discount is measured against the market price of shares at the time of the offer)

Rights issues and open offers

Minority shareholders' approval for all open offers

An open offer is non-renounceable. Unlike a rights issue, shareholders cannot transfer their rights for subscription to a third party. Therefore, non-subscribing shareholders cannot recoup their value dilution by selling their rights, and would instead be forced to sell their shares in order to avoid a loss in value. If the terms of an open offer are highly dilutive, shareholders' losses may be exacerbated as a mass exodus of shareholders would further depress the share price.

The Exchange will amend the Listing Rules to require minority shareholders' approval on all open offers, unless the new shares are issued under an existing general mandate. Controlling shareholders (or where there are no controlling shareholders, directors (excluding INEDs) and chief executives) and their associates cannot vote in favour of the resolution.

Underwriting of rights issue and open offers

The current Listing Rules require all pre-emptive offers by Main Board-listed issuers to be fully underwritten under normal circumstances. This provides a degree of certainty to an issuer, enabling it to plan on the basis of assured funds. Where an independent professional underwriter is engaged, it ensures the pre-emptive offers are negotiated at an arm's length basis. A connected person taking up any securities in a pre-emptive offer as an underwriter or sub-underwriter is exempted from the connected transaction rule, subject to the adoption of either excess application arrangement⁵ or compensatory arrangement⁶.

The Exchange will remove the compulsory underwriting requirement for all Main Board listed issuers' pre-emptive offers. However, in the case of a non-underwritten rights issue or open offer, 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.

If an issuer decides to engage an underwriter, the underwriter must be persons licensed by or registered with the SFC⁷ for Type 1 regulated activity (dealing in securities). In addition, their ordinary course of business must include underwriting of securities, while they are also required to be independent of the listed issuer. Controlling or substantial shareholders of the issuer may continue to act as underwriters provided that they adopt mandatory compensatory arrangement⁶ for unsubscribed shares.

A statement confirming whether the underwriters comply with either of the options above will be required in the rights issue announcement, listing document and circular.

The Exchange will also remove the exemption under the current Listing Rules, such that the underwriting or sub-underwriting arrangement by a connected person would be subject to independent shareholders' approval and the issuer would be required to appoint an independent financial adviser to opine on the terms of the arrangement.

Disposal of unsubscribed shares in pre-emptive offers

Under the current Listing Rules, issuers may arrange excess application arrangements⁵ or compensatory arrangements⁶ for the disposal of any unsubscribed new shares of a pre-emptive offer. In the absence of these arrangements, the value of price discount of the unsubscribed shares would be transferred to the underwriters. The Exchange will make these currently optional arrangements for the disposal of unsubscribed shares mandatory for all pre-emptive offers, and issuers must adopt one of the arrangements above.

⁵ Arrangement to allow shareholders to apply for the unsubscribed shares in excess of their pro rata entitlement, where issuers are required to allocate the unsubscribed shares to the applicants on a fair basis.

⁶ Arrangements to sell the unsubscribed shares to independent investors and return any premium to the non-subscribing shareholders.

⁷ As a SFC licensed person, the underwriter is subject to the SFC Code of Conduct which requires licensed intermediaries to act fairly, honestly, with due skill and diligence and in compliance with relevant regulatory requirements so as to promote the best interest of the issuer and the integrity of the market. Further, these persons are subject to supervision by the SFC, enabling an integrated approach to the regulation of capital raising activities.

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In addition, the issue that controlling shareholders may be in a position to take advantage of the excess application arrangement through their knowledge of subscription levels by acquiring unsubscribed shares at a discount has been addressed. The Exchange will amend the Listing Rules to require issuers to take steps to identify excess applications made by controlling shareholders and their associates, and to disregard their excess applications if they are in excess of the offer size minus their pro rata entitlement.

Placing of warrants or convertible securities under general mandate

Issuers may seek a general mandate from its shareholders for the issuance of new securities (up to 20% of the number of issued shares, with a 20% discount limit on the issue price³) under the existing Listing Rules. The general mandate rule provides issuers with the flexibility to raise funds quickly from the market, while the 20% discount limit protects shareholders from value dilution. However, there are concerns over the abuse of general mandates when applied to warrant issues, which benefit subscribers, rather than the issuer.

The Exchange will amend the Listing Rules to disallow the use of general mandates for the placing of warrants or options for cash. Instead, issuers will have to obtain a specific mandate to do so. In addition, the placing of convertible securities under a general mandate is only allowed if the initial conversion price is equal or greater than the shares' benchmarked price⁸ at the time of the placing. A specific mandate is required for all other scenarios.

Other rule amendments

Disclosure of use of proceeds from equity fundraisings in issuers' interim and annual reports

Under the current regime, issuers are only required to disclose information in regards to their equity fundraisings in announcements, shareholders' circulars (for specific mandates) and annual reports. The Exchange will be implementing a more stringent disclosure framework, requiring disclosure of the detailed use of proceeds from all equity fundraisings in the interim and annual reports, which would include:

- (i) a detailed breakdown and description of the use of proceeds for different purposes during the year;
- (ii) a detailed breakdown, description and timeline of the intended use of unutilised proceeds (if any); and
- (iii) whether the proceeds were used, or are proposed to be used, in accordance with the intended use as previously disclosed (and the reasons for any material change or delay, if any)

Subdivision or bonus issue of shares

Although share consolidations, subdivision or issuance of bonus shares do not change shareholders' proportionate interest in an issuer, they may result in odd lots or fractional shares, which are normally traded at a lower price compared to full board lots. The Exchange will prohibit subdivisions or bonus issues of shares if the theoretical share price after adjustment is less than HK\$1 based on the lowest daily closing price of the shares during the six-month period before the announcement of the subdivision or bonus issue.

⁸ Benchmarked price is the higher of:

- (a) the closing price on the date of the relevant placing agreement or other agreement involving the proposed issue of securities under the general mandate; and
- (b) the average closing price in the 5 trading days immediately prior to the earlier of:
 - i) the date of announcement of the placing or the proposed transaction or arrangement involving the proposed issue of securities under the general mandate;
 - ii) the date of the placing agreement or other agreement involving the proposed issue of securities under the general mandate; and
 - iii) the date on which the placing or subscription price is fixed.

Appendix I – Overview of Changes to the Listing Rules

The following is a comparison between current and the amended Listing Rules relating to capital raisings following the consultation conclusion.

Capital Raisings by Listed Issuers

Topic	Affected type of fundraising / corporate action	Current Listing Rules	Amended Listing Rules
Highly dilutive capital raisings	Rights issue, open offer, specific mandate placing	<ul style="list-style-type: none"> No specific restriction on highly dilutive capital raisings 	<ul style="list-style-type: none"> Disallow rights issues, open offers and specific mandate placings, individually or when aggregated within a rolling 12-month period, that would result in a cumulative dilution effect of 25%, unless there are exceptional circumstances
Minority shareholders' approval	Open offer	Shareholders' approval is required for open offers that 1) would increase the issuer's number of issued shares or market capitalisation by more than 50% ⁹ ; or 2) are not offered to existing holders in proportion to their existing holdings, unless it is issued under the authority of a general mandate	Minority shareholders' approval is required for all open offers, unless it is issued under the authority of a general mandate
Underwriting of rights issue and open offers	Rights issue, open offer	<ul style="list-style-type: none"> All Main Board issuances must be fully underwritten under normal circumstances No restrictions on identity or qualifications of the underwriter A connected person acting as an underwriter is fully exempt from the connected transaction rules if the issuer has adopted excess application arrangement⁵ or compensatory arrangement⁶ for unsubscribed shares 	<ul style="list-style-type: none"> Compulsory underwriting requirement has been removed Underwriter (if one is engaged) must be licensed by the SFC for Type 1 regulated activity, has underwriting securities as part of their ordinary course of business and are independent of the listed issuer; Controlling or substantial shareholders of the issuer may continue to act as underwriters provided they adopt mandatory compensatory arrangement⁶ for the unsubscribed shares Connected transaction exemption removed, independent shareholders' approval and independent financial adviser's opinion are required for controlling or substantial shareholders to act as underwriter (including sub-underwriting)
Disposal of unsubscribed shares in pre-emptive offers	Rights issue, open offer	<ul style="list-style-type: none"> Excess application⁵ and compensatory arrangements⁶ are not mandatory 	<ul style="list-style-type: none"> Require to adopt either excess application⁵ or compensatory arrangements⁶ to dispose of unsubscribed shares. If the controlling shareholder acts as the underwriter, then only compensatory arrangement⁶ may be adopted. Excess applications made by controlling shareholders and their associates is limited to the offer size minus their pro rata entitlements
Placing of warrants or convertible securities under general mandate	Warrants and convertible securities	<ul style="list-style-type: none"> Issuers may seek a general mandate from its shareholders for the issuance of new securities (up to 20% of the number of issued shares, with a 20% discount limit on the issue price) Placing of warrants may be conducted under general mandate only if the warrants are issued at or approximate fair value 	<ul style="list-style-type: none"> Placing of warrants or options for cash require the issuer to obtain specific mandate Placing of convertible securities may use general mandate only if the initial conversion price is equal or greater than the listed shares' benchmarked price⁸, all other cases would require a specific mandate
Disclosure of use of proceeds from equity fundraisings	All equity fundraisings	<ul style="list-style-type: none"> General mandate – announcement of terms, proposed use of proceeds at the time of fund raising, followed by actual use of the proceeds disclosed in the annual reports Specific mandate – more detailed disclosure on the terms of the fund raising, the proposed use of proceeds in the shareholder circular, followed by 	<ul style="list-style-type: none"> In addition to the existing disclosure requirements, disclosure on details of the use of proceeds from all equity fundraisings in interim and annual reports, including: <ul style="list-style-type: none"> (i) detailed breakdown and description of actual use of proceeds (ii) detailed breakdown, description and timeline of the intended use of unutilised proceeds (if any)

⁹ On its own or when aggregated with any other open offers or rights issues announced by the issuer (i) within the 12 month period immediately preceding the announcement of the proposed open offer or (ii) prior to such 12 month period where dealing in respect of the shares issued pursuant thereto commenced within such 12 month period, together with any bonus securities, warrants or other convertible securities (assuming full conversion) granted to or to be granted to shareholders as part of such rights issues or open offers

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		actual use of proceeds disclosed in annual reports as a "significant event"	(iii) whether the proceeds were used, or are proposed to be used, in accordance with the intended use as previously disclosed
Subdivision or bonus issue of shares	Subdivision and bonus issue	<ul style="list-style-type: none">• No specific requirement of the adjusted share price after subdivisions or bonus issues	<ul style="list-style-type: none">• Prohibit subdivisions or bonus issues of shares if the theoretical share price after adjustment is less than HK\$1.00 based on the lowest daily closing price of the shares during the six-month period before the announcement of the subdivision or bonus issue.

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