ACUMINOUS

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NEW RESTRICTIONS TO CAPITAL RAISING

In May 2018, the Stock Exchange of Hong Kong Limited (the "**Exchange**") published its conclusions to its Consultation Paper on Capital Raisings by Listed Issuers. The suggested amendments are intended to improve the effectiveness of the fund raising framework under the Listing Rules to prohibit certain market practices that may jeopardize an orderly, fair and informed market for trading and marketing of securities. In this issue, we will go through the new changes in the rules governing capital raising and share issuance transactions.

Executive Summary

The amendments to the rules are an attempt by the regulators to address concerns relating to problematic behaviours which include deeply discounted fundraisings and share consolidations and subdivisions. The new rule changes have taken effect on 3 July 2018. The key changes to the Listing Rules include:

- **Prohibiting right issues, open offers and specific mandate placings**, individually or when aggregated within a rolling 12-month period, **which would result in a cumulative material value dilution exceeding 25%**, unless there are exceptional circumstances, e.g. when issuers are in financial difficulties. There are also additional disclosure requirements under the new rules relating to the use of proceeds;

- **Giving the Exchange more discretion to approve fund raising transactions** by: (i) requiring minority shareholders' approval for all open offers unless it is under general mandate; (ii) removing the mandatory underwriting requirement for rights issues and open offers; (iii) requiring underwriters for rights issues and open offers to be either independent persons licensed under the Securities and Futures Ordinance (SFO) or the controlling or substantial shareholders (subject to compensatory arrangements); (iv) removing the connected transaction exemption currently available to connected persons acting as underwriters of rights issues or open offers; (v) requiring issuers to adopt either excess application arrangements or compensatory arrangements for the disposal of unsubscribed shares in rights issues or open offers; and (vi) requiring issuers to disregard any excess applications made by the controlling shareholders and their associations in excess of the offer size minus their pro-rata entitlements;

- **New restrictions on placing of warrants or convertible securities under general mandate** by (i) prohibiting placing of warrants under the approved general mandate; (ii) restricting the use of general mandate for placing of convertible securities with an initial conversion price that is lower than the market price of the shares at the time of placing; and

- **Disallow any subdivision or bonus issue of shares** if the theoretical share price after the adjustment for the subdivision or bonus issue is less than HK$1 based on the share price during the six-month period before the relevant announcement.

Highly dilutive capital raisings

With the new capital raising requirements, the Exchange will be able to set tighter criterion for issuers to undertake placing of securities.

The Exchange has introduced additional rules related to placing. Issuers may not undertake a rights issue, open offer or specific mandate placing that would result in theoretical value dilution effect of more than 25%. This dilution restriction will apply to all rights issue, open offer or specific mandate placing both individually or will be aggregated with any other rights issues, open offers and/or specific mandate placings announced by issuers within a 12-month period.

Value dilution is calculated by reference to: (i) the aggregated 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).

The restriction will not apply if issuers can satisfy the Exchange that there are exceptional circumstances. Examples of this include when issuers are in financial difficulties or if the proposed capital raising will form part of the rescue proposal.

Right issues and open offers

The Exchange has removed the mandatory underwriting requirement for rights issues and open offers. Under the revised Listing Rules, underwriters must satisfy either of the following requirements: (i) they are persons licensed or registered under the SFO for Type 1 regulated activity, their ordinary course of business includes underwriting of securities, and they are not connected persons of issuers concerned; or (ii) they are the controlling or substantial shareholders of issuers and will be subject to implementing a compensatory arrangement. This would include the placing of the unsubscribing shares to independent placees for the benefit of the unsubscribing shareholders. All the related announcements, listed documents and circulars must contain a statement confirming whether the underwriter(s) complies with the requirements.

All proposed open offers must now be made conditional upon shareholders and minority shareholders' approval at general meeting by resolution. The only exception would be when the securities are issued under the general mandate.

There are also additional disclosure requirements under the new rules. An issuer must disclose all equity fund raising and use of proceeds in their interim and annual reports. The following enhanced disclosure is required: (i) a detailed breakdown and description of the use of proceeds for different purposes during the financial year or period; (ii) a detailed plan for the unused proceeds; and (iii) any reason for any material change or delay in the use of proceeds.

Underwriting or sub-underwriting by connected persons will be treated as connected transaction. Under the new rules, mandatory compensatory arrangements will only apply when pre-emptive offers are underwritten by controlling or substantial shareholders. This is to limit the potential risk of abuse of pre-emptive offers by connected persons. Where offers are underwritten by independent licensed persons, issuers will have the discretion to decide whether an excess application arrangement or compensatory arrangement is included. The Company will have to make arrangements to dispose of unsubscribed shares by means of either: (i) excess application and allocated on a fair basis; or (ii) disposed to independent placees for the benefit of the unsubscribing shareholders. These arrangements (including the basis of allocation of the securities available for excess applications) must be fully disclosed in the relevant announcement, listing document and any circular.

The issuer is also required to take steps to identify any excess application made by any controlling shareholder and its associates, whether in their own names or through nominees of which should be disregard to the extent the total number of excess securities they have applied for exceeds a maximum number equivalent to the total number of securities offered under the right issue minus the number of securities taken up by the relevant shareholders under their assured entitlements.

Placing of warrants or convertible securities under general mandate

The Exchange now states clearly that issuers may only issue convertible securities for cash consideration under a general mandate if the initial conversion price is not lower than the benchmarked price of the underlying shares at the time of the placing. The issuer may use specific mandate to issue convertible securities if the initial conversion price is lower than the benchmarked price of the underlying shares.

Furthermore, issuers may not issue warrants, options or similar rights to subscribe for any new shares or any convertible securities for cash consideration pursuant to a general mandate.

Subdivision or bonus issue of shares

Under the new rules, subdivision or bonus issues will be prohibited if the theoretical share price will be 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. The Exchange will consider a six months demonstration period to ensure that a high share trading price is not temporary and a proposed share subdivision is justified. The purpose of the new restriction is to prevent the creation of low priced securities through share subdivisions or bonus issues, thus ensuring an orderly market for trading securities.

Conclusion

The new amendments to the capital raisings framework clearly indicate the Exchange's intention to tighten the capital raisings framework and determination to regulate and prevent problematic fund raising activities.

In order to preserve the competitiveness of the Hong Kong stock market, the regulators should be mindful of over regulating normal fundraising methods and taking a commercial balance between the fair treatments to shareholders and maximising the effectiveness of the fundraising structure.

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