Hong Kong Investment Funds Association
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HK Exchanges and Clearing Limited
8/F Two Exchange Square
Central, Hong Kong

Dear Madam/Sir

Consultation Paper - Proposed Amendments to Listing Rules Relating to Treasury Share

On behalf of the Hong Kong Investment Funds Association (HKIFA), I wish to share the views of fund managers with respect to the captioned proposal.

Overall comments

We understand that the proposal (i.e. removal of automatic cancellation of repurchased shares) can provide issuers with more flexibility in managing the capital structure. There are a number of legitimate reasons for keeping treasury shares: e.g. to defend against hostile anti-takeovers, to fund employee equity compensation program at a lower cost of capital, to sell these for cash as an alternative way of raising funds at a lower cost and also to avail of simpler legal/regulatory procedures and approvals. These are the most common reasons for holding treasury stocks in mainland China, Singapore, US, UK, Japan or Korea.

However, if we take into consideration the state of corporate governance in Hong Kong, the experiences gathered from other markets, and particularly the current macro backdrop of dampened investor sentiment and persistently low market liquidity, we have concerns that the proposal, as it currently stands, may not work in the best interests of minority shareholders or the development of the Hong Kong market.

Hong Kong has been very slow in introducing corporate governance reforms, in particular with respect to enhancing the accessibility and accountability of the boards. And the board quality of issuers has been trailing its international peers. Shareholders' access to boards of issuers has always been challenging, compared to US/UK and even some Asian markets. And this has limited the effectiveness of engagement, which is an important tool for investors to advocate for best practices, such as in capital management.

Against this general backdrop, managers have expressed concerns about the implications of this proposal to minority shareholders. It basically weakens share buybacks as a way to return capital to shareholders. To investors, a key function of share buybacks (under the current regime, under which repurchased shares are automatically cancelled) is that it is a way of returning cash to shareholders. But when repurchased shares are not cancelled but can be conveniently resold on the market, investors typically would expect these treasury shares to return to the market and would not exclude them from EPS calculation (based on experiences of key markets). Members are concerned that under the current proposals, there is not enough incentive to encourage issuers to cancel shares after a buyback and as such, its function as a shareholder return mechanism weakens.

From our members' experience in some markets, investors typically expect treasury shares to return to the market, and hence the market may stop reacting favorably to share buybacks (in the form of treasury shares). This lack of share price reaction could potentially lead to shrinking market capitalization if an issuer continues to repurchase its shares without cancellation. If the market turnover ratio remains constant, shrinking overall market capitalization would result in lower trading volume on the Exchange.

There are also concerns that the heightened risks of insider trading, whether perceived or actual, combined with the weakening of the utility of share buybacks as a capital return mechanism could undermine the confidence of long-only investors when trading in the Hong Kong market, with potential negative impact to market liquidity.

Specific comments – safeguards to protect minority shareholders have to be substantially enhanced

If the HKEX maintains to proceed with this proposal, we would respectfully exhort it to substantially enhance the safeguards so as to accord the necessary protection to minority shareholders.

- With respect to the proposal to introduce a one-month restricted period preceding results announcement, we note the rationale but believe one-month is not adequate. In fact, we would exhort the HKEX to take this opportunity to review the restricted period for shares repurchases as well. Ultimately, an issuer's management is an insider and hence have inherent information advantages over minority shareholders. The information asymmetry warrants a longer restricted period – say two months or even three months. And this should apply equally to resale and repurchases.
- We agree with the HKEX that issuers should not repeatedly repurchase and resell their own shares on market for the motives of making a trading profit or to manipulate the share price. But the proposed 30-day moratorium period is too short to deter companies from doing so. A parallel that can be drawn is the reissuance mandate that allows an issuer to repurchase shares and then re-issue them within a year – investors generally do not consider this to be prudent capital management. If we use this as a reference point, a 30-day moratorium as proposed is woefully inadequate.
- Apart from longer restricted and moratorium periods, there should be a maximum limit on treasury shares (as required in the UK, Singapore, and mainland China). Based on an example in the CP, it seems that an issuer will have the flexibility to prioritize resale of treasury shares for issuance mandates before issuing new shares, or the other way round. If it is the latter, the treasury shares will cumulate year over year if the issuer does not use up its full authority for issuances. We believe that the HKEX should set a cap on issuers for keeping treasury stocks.
  There should be stricter requirements regarding the issuance size and discount limits permitted by general & reissuance mandates and possibly there should be a separate sub-limit on on-market resale of treasury shares to alleviate market overhang. For instance, Singapore has set a cap of 10%; and it mandates cancellation of any excess within 6 months. UK specifies that the shares can only be cancelled, used for employee share scheme or sold for cash. And it also sets a cap of 10% at any time. There should be a sunset mechanism (as seen in China) to cancel treasury shares held for an extended period of time. If an issuer needs to have the flexibility of keeping treasury stocks, investors do not wish to see them get shadowed forever if the issuer does not timely cancel these shares or utilize them properly after a prolonged period.
  In general, there should be requirements so as to enable investors to better understand the rationale that underlines the approach being adopted.
- Having full disclosures is of paramount importance. There are examples in other markets where issuers hoard treasury stocks with limited disclosures. In certain jurisdictions, investors have no idea of how many treasury stocks issuers are holding, and only with the intervention of activists do companies start to reluctantly cancel part of their treasury stocks. Re disclosures, we would suggest:
  - there should be disclosures in the financial statement footnotes (vs just an "explanatory statement") about the reissuance of treasury stock and detailed disclosure about the transaction.
  - there should be additional disclosures of the use of proceeds when the reissuance size exceeds a certain threshold within a particular time frame (say, 6 or 12 months).

    - when a company reissues treasury stocks to insiders or affiliates, the wording "knowingly made with a core person" is not strong enough. Stronger wordings are also required regarding disclosure of gifts, or timing relative to material nonpublic information. The HKEX can take reference from the US SEC's rules.
- Some members have raised it is not clear whether minority investors have a say in the process, and if yes, how and when. For instance, will shareholders have a chance to review and vote on the resale of treasury shares? And if yes, via what means will such resolutions be presented at shareholder meetings?
    - Option A: combined with General Mandate resolution?
    - Option B: intention to resell is only specified in Share Repurchase resolution and no separate approval will be sought from shareholders, namely the board will obtain a so-called 'blanket authority' to treat the treasury shares?
    - Some other options

  Meanwhile, others point out that their understanding is that reissuance of treasury shares would be treated the same as new share issuance, except that they can be issued on the market. Thus, an issuer can use its general mandate to reissue treasury shares, but it could also reissue them in other ways, e.g. specific mandates, rights issue. Furthermore, the issuer still needs to cancel the repurchased shares even with the approval of a reissuance mandate. We would appreciate if HKEX can provide clarifications.

These are some of the preliminary concerns/questions flagged. We wish to underscore that whilst giving issuers greater flexibility in managing their capital structure is important, it is equally important to consider the interests of minority shareholders. If you wish to discuss the aforesaid further, please don't hesitate to contact us. Most welcome to go through in details our suggestions.

Yours sincerely

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