Webb-site responds to HKEX's consultation which, while positive, ignores several key issues and does not go far enough in others. Have your say!

Submission on Capital Raisings by Listed Issuers

24 November 2017

On 22-Sep-2017, Hong Kong Exchanges and Clearing Ltd (**HKEX**, 0388), owner of the monopoly Stock Exchange of Hong Kong Ltd, published a consultation paper on Capital Raisings by Listed Issuers. In a controlled-company market like HK, few things are more important than pre-emptive rights and proper capital discipline. This is the submission of Webb-site.com. Readers, we need your support - see the bottom of this page to submit your views.

Highly dilutive rights issues, open offers and specific mandate placings

HKEX proposes to disallow rights issues, open offers and specific mandate placings that would in aggregate amount to a cumulative value dilution of 25% or more in any rolling 12-month period to those shareholders who do not take up the rights issue or open offer, or are not offered shares in the placement. This would, for example, allow a 1 for 1 rights issue at a 50% discount to market, or a 5 for 1 rights issue at a 30% discount.

We support this proposal, but it does not go far enough, because it pays no regard to the amount of liquid assets that a company already has or that may arise from such issues. A company with substantial amounts of net cash relative to its net tangible assets should not have any real need to raise equity capital and dilute the rate of return on equity. In our 3-Mar-2016 article, "Preventing cash shells" (hereby included in this submission), we proposed that any company with net cash (broadly being cash plus financial assets minus debt) which exceeds a very generous 50% of net tangible assets (the "**Cash Shell Limit**") should not be permitted to issue equity for cash, and any notifiable transaction which would result in breaching the Cash Shell Limit (such as a major disposal) should be made conditional upon a distribution of the surplus. Further, any company which exceeds the Cash Shell Limit in its annual accounts should be required to propose a distribution of the surplus for minority shareholders' approval at the AGM (if not distributed by the board declaring a special dividend).

So, in addition to its proposed restriction, HKEX should also implement the Cash Shell Limit, subject to the normal market consultation. We are confident that you would receive widespread support for the Cash Shell Limit from investors large and small. No investor with whom we have discussed this proposal has opposed it. Indeed, with the Cash Shell Limit, highly dilutive issues would become rare anyway, because the cash raised by say a 5:1 issue at a 30% discount would be 350% of market capitalisation and, unless the company is highly indebted or trading at a deep discount to net asset value, it would swamp the balance sheet and breach the Cash Shell Limit, so such issues would naturally be confined to situations of financial distress.

Specific and General Mandate Placings

Specific Mandate Placings (**SMP**) and general mandate placings (**GMP**) should be regarded as a distinct problem, because they are non-pre-emptive - that is, the shares are not offered to existing shareholders, so there is no way to avoid the dilution. It is not just a question of limiting the dilution to inactive shareholders, but preventing involuntary dilution of *all* independent shareholders.

Currently an SMP can be approved in a general meeting and a controlling shareholder is allowed to vote. The SMP is widely abused by issuers who seek to avoid the Listing Rules requiring independent shareholders' approval for a refreshment of the 20% annual general mandate (which is too large anyway). So if an SMP is allowed at all (see below), then controlling shareholders and executive directors should be prohibited from voting on SMPs.

SMPs and GMPs allow boards to choose shareholders, rather than shareholders choosing boards, so it corrupts the chain of corporate governance. That is particularly problematic when a board can park blocks of votes in friendly hands before making egregious proposals for "independent" shareholders' approval. This consultation does nothing to address the widespread opposition from investors to non-pre-emptive issues, and HKEX has done nothing about GMPs since abandoning a consultation in 2009. When controlling shareholders are excluded from voting figures on general mandates, it is clear that independent shareholders (which includes employees and management-friendly votes) vote more than 2 to 1 against the 20% mandate, but HKEX and its Listing

Committee prefer to ignore that. For more on this issue, click here.

The UK Pre-Emption Group, with principles in effect since 1987, imposes an issue limit of 5% for cash placings in any 12 months and 7.5% in any 3-year period, with a maximum discount of 5%. UK companies need a special resolution with 75% of votes cast to approve that. UK-HK dual-listed companies such as HSBC Holdings plc (0005) and Standard Chartered plc (2888) comply with those rules. There is no evidence that this has in any way impeded UK corporate finance, but it does protect ownership rights.

In HK, the general mandate only needs a 50% approval and allows 20% in 12 months or 72.8% (with compounding) in 3 years, and the discount is up to 20%. All of these parameters should be adjusted to UK levels, including the requirement of a 75% approval for the general mandate (a special resolution). Intra-year "refreshments" of general mandates after they are exhausted should be prohibited. A company can make a rights issue instead. Special mandates for placings should not be permitted by the Listing Rules unless a general mandate was not obtained at the previous annual meeting.

Option scheme abuse

We incidentally note that while share options for full-time employees with appropriate long-term vesting schedules can have a legitimate purpose, the Listing Rules on option schemes are far too wide and have become a conduit for back-door placings, with companies issuing options to exhaust the 10% limit and the options being exercised very soon afterwards. The rules should be amended to restrict board grants to full-time employees or directors of the issuer and its subsidiaries and set a minimum vesting period of at least 1 year. Any grants beyond this should be subject to specific shareholder approval, excluding controlling shareholders from the vote. The establishment or renewal of option schemes should also be subject to independent shareholders' approval, with anyone who may receive options from the scheme (including directors) prohibited from voting, as was the case before HKEX relaxed the rules in the early 2000s.

Open offers

HKEX proposes to require minority shareholders' approval for all open offers except for those that are made under the general mandate. In other words, those which are larger than 1 new share for every 5 share held, given that the general mandate is currently up to 20% of the existing issued shares.

We support this, but again, it does not go far enough. An open offer is an entitlement that is not transferable, so the holder cannot sell her entitlements in the market if she is unwilling or unable to subscribe for the new shares. Her only option is to sell the shares in the often-brief window before the shares go "ex-entitlement". For that reason, any substantial discount forces dilution upon the shareholder. We propose that the discount on open offers should be limited to 10%. If a company wishes to offer a larger discount, then it should make a fully transferable (renouncable) rights issue.

Abolishing the underwriting requirement

HKEX proposes to remove the mandatory requirement for all rights issues and open offers to be underwritten. We support this. It will save costs for companies and encourage them to use rights issues in preference to placings. In any event, underwriting is often not of real value as the exclusions for force majeure are often very wide. Let boards make a commercial decision on whether they really need to obtain underwriting or are willing to take a lower amount of cash if the issue is only partially successful.

Requiring independence of underwriters

HKEX proposes to require underwriters (if any) for rights issues and open offers to be SFC-licensed and independent from issuers and their connected persons, except that controlling shareholders may act as underwriters, provided that compensatory arrangements are made available for the unsubscribed offer shares and the connected transaction Rules are complied with.

Note: a "**compensatory arrangement**" is one which requires that any rights holders who do not subscribe are compensated by the issuer selling the related shares in the market (if a premium is obtainable) and sending the cash premium to the rights holders, to compensate them for the dilution.

HKEX also proposes to remove the connected transaction exemption currently available to connected persons acting as underwriters.

We support these two proposals, but as submitted below, the compensatory arrangement should apply in all circumstances. However, if you are going to permit controlling shareholders (with compensatory arrangement and independent shareholders' approval) to act as underwriters, then we see no reason why substantial shareholders (i.e. holding between 10% and 30%) should not also be permitted to do so on the same terms. The Takeovers Code contains requirements (the Whitewash procedure) for independent shareholders' approval if the underwriter may as a consequence increase its holding through the 30% threshold or by more than 2% between 30% and 50%.

This reminds us once again that HKEX shouldn't be making or administering the Listing Rules when the SFC already makes and administers the Takeovers Code. HK needs a Listing Authority under the SFC. For more on this issue, click here.

Requiring compensatory arrangement

HKEX proposes to require issuers to adopt either the "excess application arrangement" (**EAA**) or the compensatory arrangement for unsubscribed shares in rights issues or open offers. This does not go far enough. There is no circumstance when it is right to penalise inactive shareholders by diluting their economic value. That is theft by any other measure, whether it benefits the "underwriters" (when no system is used) or other shareholders (when the EAA is used). The EAA merely provides the opportunity for active shareholders to steal the value of rights belonging to the inactive shareholders, simply by applying for them, not at the market price, but at the subscription price.

For readers who may not understand this point clearly, let's give an example. A company with a share price of $5 proposes a 1 for 1 rights issue (1 new share for each share held) at $2.50 per share. The expected ex-rights price is then the simple average, $3.75 per share. The right to subscribe is therefore worth $1.25 per share. If the holder does not exercise or sell that right, then in an EAA he loses that value and his shares have lost 25% in value from $5 to $3.75. With a compensatory arrangement, he receives a payment of about $1.25 (less expenses).

The HK approach has been "you snooze, you lose". This is fundamentally wrong. Some shareholders are simply unaware of a rights issue, suffering from illness or on holiday or simply not informed by their bank or broker, or they have died leaving the shares in limbo (particularly if they did not leave a will). So the EAA amounts to theft from the absent, the ignorant, the sick and the dead, amongst others. It must end if HK is to be a world-class market, and the compensatory arrangement must be used in all circumstances, protecting the absent, the ignorant, the sick and the dead.

In paragraph 85 of the paper, HKEX suggests that the sale of unsubscribed shares in the market "may be disruptive to the share price, whereas an [EAA]...may allow long-term shareholders to take up the unsubscribed shares with less price disruption and benefit all shareholders". That is utter nonsense. Long-term shareholders are just as capable of buying the shares in the market as they are buying shares in an EAA. In any event it is well-known that EAAs attract short-term traders looking to benefit from the loss suffered by inactive shareholders, like vultures to a carcass. Having obtained shares in the EAA (often with only a nominal prior shareholding to qualify), they will then turn around and sell the shares in the market anyway, with the same market impact that the compulsory arrangement would have had.

The UK has for decades required the compensatory arrangement in all rights issues, without such difficulties. If the size of the unsubscribed rights is substantial, then it is usually because the market price has fallen below the issue price, in which case no premium can be obtained, and the underwriter (if any) is requried to take them up. On the other hand, if the market price remains above the issue price, then most of the rights will be subscribed, leaving only a small "rump" to be sold in the market, so the impact is minimal.

Disallow the use of general mandate for placing warrants and options

We support this. There is really no good reason for placing warrants for cash or issuing "bonus warrants" anyway. A company either needs fresh equity or it doesn't, and it should not leave its capital structure to the vagaries of the market price, receiving equity only if the market rises above the subscription price before the warrants expire.

Restrict general mandate placings of convertibles to a conversion price at or above market

We support this. If an issuer puts a discount in the initial conversion price then it increases the likelihood of eventual conversion anyway and begs the question of why they didn't just issue equity. However, we are disappointed to note that even in this consultation paper, HKEX is already walking back from its proposal by contemplating a limit of 20% discount to market "in the event that this proposal is not implemented".

Convertible bonds in any event are a somewhat stupid form of corporate financing, because like warrants, they generally only get converted if the market price rises above a level that makes the bond more valuable if converted than redeemed, at which point the market price is often at a substantial premium to the conversion price and the issuer will wish it had issued just issued straight debt and later issued equity at that higher price. A convertible leaves the debt:equity capital structure of the company to be determined by the market price, rather than determined by the board. If the share price falls, then they may have to issue shares anyway in order to finance the redemption of the convertible bond at maturity.

Generally, if a company needs capital then it should choose between debt and/or equity based on what adds the most to shareholder value, rather than deferring the decision to later market conditions. Some issuers who have been pitched the idea that a convertible bond "avoids impacting the market price" are perhaps unaware that a large chunk of convertible bonds are taken by funds which simply strip out the equity component (the embedded call option) by borrowing a (delta-neutral) amount of shares and short-selling them, or by selling a corresponding call option to someone else.

There may be exceptions though, such a banks which issue "bail-in" bonds for capital adequacy reasons, which only convert in a crisis.

Other amendments proposed by HKEX

Use of equity proceeds

HKEX proposes to require greater disclosure of the use of proceeds from equity fundraisings in interim and annual reports. Such requirements (including disclosing the subsequent use of proceeds from an IPO) are artificial, because there is no distinction between dollars in the bank, whether raised from equity, from borrowing or received from sales of goods, services or assets. Imposing such specific requirements could have the unintended adverse consequence of compelling issuers to ring-fence proceeds in segregated accounts while at the same time raising other funds to execute plans not covered by the intended purpose of an equity issue. This leads to inefficient balance sheet management.

So it would be better to simply require issuers (whether or not they have recently issued equity) to clearly state (at least annually) their expected capital expenditure, both in quantum and description, and then to report back on the execution or variation of those plans in subsequent reports. At the same time, they should explain why they regard their current capital structure to be optimal for their business plans, both in terms of equity and debt, and if they do not consider it to be optimal, then what they intend to do about it.

Disallow subdivisions or bonus issues if the price would be below a threshold

HKEX proposes to disallow stock splits or bonus issues if the theoretical resulting share price would be below HK$1 or $0.50. Why not just prohibit them, unless the share price is close to the maximum allowed by the trading system of $9,995? They are of absolutely no value to shareholders and cause costs to their company which they ultimately bear. See our article Truly pointless bonus issues and splits, 27-Dec-2010.

The purported reason for splits and bonuses is often to "improve liquidity" but in reality it tends to do the opposite, pushing stocks down into a wider part of the spread table or increasing transaction costs by causing smaller board lot values where none is needed.

HKEX states in para 112 that "low price securities are likely to be more volatile, and their pricing is less efficient as each price tick represents a wider percentage price spread". Well, looking at the second half of that statement, the problem of the minimum trading spread is entirely one of HKEX's making - it sets the rules on prices, and currently requires a tick size of $0.01 from $0.50 to $10.00, resulting in a ridiculous 2% bid-offer spread for a share at $0.50. It only looks vaguely

sensible above $5 when it becomes 0.2% or less. So we submit that if splits and bonus issues are allowed at all then the expected adjusted price should be at or above HK$5.

Readers with long memories will recall that when our editor, David Webb, was an elected INED of HKEX, he campaigned to cut the spread table, but was only partially successful, as vested interests who enjoy the race to be on the front of a wide bid-offer spread caused a U-turn in 2007, leaving spreads below $5 much less efficient. This impedes turnover by causing buyers and sellers to queue up either side of a price at which they would be happy to trade if the rules would let them.

Board lots

But, you might be thinking, what about the problem of "expensive" board lots as prices rise? For the uninitiated, a board lot is the minimum multiple of shares in which investors can trade on the exchange. If it is too large in value, then it might deter smaller investors from buying the stock. Well, the inconvenient truth is that the average board lot is far too small. At 23-Nov-2017, the median board lot size for 2099 listed stocks was HK$3020, with 711 companies at or below $2000 per lot, and 319 of those at or below $1000 (about US$128, daily data here). The typical minimum brokerage charge of say HK$50 at 0.1% means that any trade below $50k is going to cost more than 0.1% in brokerage and more than 0.5% below $10k.

These small board lot values not only increase costs but make it cheaper for manipulators to fix the closing price by making a single-lot order just before the market closes.

Yet for decades and despite inflation, HKEX has left the minimum board lot value at IPO at just HK$2k (about US$256). Why? Because HKEX makes more profit that way. HKEX charges a "scrip fee" of HK$1.50 per board lot for the net increase in any balance in a clearing account between successive book closure dates (just before payment of dividends). So if you have purchased a board lot worth HK$2k, then the first time you get a dividend, HKEX will charge $1.50, or 0.075% - which is more than some brokers charge to buy the stock in the first place. Also, HKEX gets a fee of HK$0.50 on each trade on the exchange (on top of the 0.005% trading fee), so if your buy order gets hit by a series of small sales (for example, 50,000 shares in 50 sales of 1 lot at $1000 per lot) then your broker will pay HKEX HK$25 or 0.05%. These scrip and trading fees go almost straight to the HKEX bottom-line profit before tax, and all of these costs ultimately get passed on to customers, either directly (sometimes marked up) or embedded in brokerage fees.

So, excessive board lot size, to the point of impeding trade, is rare. There are only 114 companies with board lots over $20k, and only 20 companies above $50k, if that is your measure. If a company wishes to reduce its board lot value, then it can do that simply by reducing the number of shares per board lot, without a stock split or a bonus issue. If the old board lot is an integral multiple of the new one, then it won't even create any "odd lots" as bonus issues often do. There isn't even any need to adopt the archaic "parallel trading" system that HKEX perpetuates as if we were still moving bits of paper around the city, as we did in the years BC (Before CCASS, 1993). Parallel trading was supposed to be abolished but was delayed indefinitely in 2008.

That's what you get with a monopoly - wide trading spreads, excessive fees, protection of vested interests and a failure to reform or innovate.

Have your say

This submission is made on what may be the last day of the formal consultation (right after Thanksgiving), but even if the window is not extended, please drop an email to response@hkex.com.hk with subject "Re: Consultation Paper on Capital Raisings by Liisted Issuers", agreeing with this submission or stating your alternative views. Just click the email address to generate a prepared email. Your voice should count.

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Organisations in this story

- HONG KONG EXCHANGES AND CLEARING LIMITED

Topics in this story

- Bonus issues and stock splits
- Financial regulatory structure
- Pre-emption rights/ general mandate

Webb-site proposes a new Listing Rule to prevent cash shells. The Cash Shell Test introduces equity discipline for existing companies and provides clarity for those proposing transactions and fund-raising. It should be welcomed by investors, regulators, issuers and their advisers. HKEx needs to build a proper sanitation system for this village rather than dig a new cesspit.

Preventing cash shells

3 March 2016

There were, once again, a number of abusive transactions in HK last year, including wholesale disposals by listed companies of their core businesses without distributing the proceeds, and cases in which companies take the proceeds and deploy them into a completely new line of business without minority shareholders having any say in the matter. This is a huge deviation from the founding principles of the joint-stock company, in which investors pooled their capital in "association", usually with limited liability and with a particular set of "objects" to pursue a joint enterprise.

There are also some companies that squat on vast amounts of surplus capital not needed in their core business, often accumulated from retained earnings (having paid no dividends or insufficient dividends), asset disposals, or from raising excessive amounts of cash in placements, open offers or rights issues for vague purposes such as "general working capital" when the real purpose is to position votes or discounted shares in friendly hands or to dilute other shareholders who have started to exercise their ownership rights. In HK, boards choose shareholders, not the other way around.

Unfortunately, there is nothing in the Listing Rules which will prevent a company from behaving this way. The risk that they will do so, particularly after management changes, results in even good companies being discounted for the risk of going bad, increasing the cost of capital for the economy, because their share prices are lower than they would be in a more trustworthy market.

Rather than address these problems, which occur on both the Main Board and GEM and at all size levels, the for-profit regulator, Hong Kong Exchanges and Clearing Ltd (**HKEx**, 0388), is now proposing a "Third Board". HKEx is rather like a village that refuses to build a proper sewerage system and instead digs another cesspit to accommodate a larger population, ignoring the fact that eventually nobody wants to live in a disease-ridden village. We'd rather build a proper sanitation system.

In a market where the vast majority of companies have a controlling shareholder, investors invest in a company in order to participate in its stated business. They accept that they will not have much influence over *how* that business is pursued, but they do at least expect that the company *will* pursue it, and will distribute any profits or excess capital that it does not need for that business rather than launch into something else, speculate in the markets, or simply hoard it in the bank.

So here's what we propose, to build the sanitation system:

1. At each Annual General Meeting, any company whose net cash exceeds 50% of its net tangible assets (the "**Cash Shell Limit**"), must propose an ordinary resolution to distribute at least the excess amount, and controlling shareholders, directors and their associates shall be prohibited from voting on that resolution.
2. "net cash" means cash, deposits, bonds and financial assets (including listed investments) minus interest-bearing obligations after deducting net cash attributable to minority interests in subsidiaries.
3. "net tangible assets" are those attributable to shareholders after deducting minority interests in subsidiaries.
4. Any Notifiable Transaction or Share Transaction which would result in a company breaching the Cash Shell Limit must be made conditional on shareholders' approval of a distribution to bring it below the limit. All shareholders would be permitted to vote on that distribution, so that controlling shareholders can still direct strategy if they approve the distribution.
5. In each case, the distribution must be paid in cash within 60 days after the AGM/EGM or completion of the transaction which triggers the breach, whichever is later.
6. No issue of equity for cash will be permitted if it will result in a company breaching the Cash

Shell Limit. To prevent avoidance, this prohibition will also apply to convertible bonds, subscription warrants, options or other instruments carrying equity rights, whether or not they are listed.

7. Banks, licensed deposit-taking companies, insurers and securities and futures brokers (and their holding companies) would have a qualified exemption if they can show that a statutory regulation requires them to keep or achieve a level of capital that exceeds the Cash Shell Limit.
8. Chapter 21 "investment companies" would be exempt from the AGM vote until the first AGM that falls at least 12 months after listing, to give them time to invest their initial fund-raising.

Now, before anyone cries that this will make their shell-peddling business harder, let's be clear that it won't cure all ills. It will still allow creative acquisitions that do not trigger the reverse takeover rules because they don't produce a new controlling shareholder. However, the Cash Shell Limit will at least fix one major problem, and introduce a new level of equity discipline to the market. The Cash Shell Limit is expressed in terms of attributable net cash and attributable net tangible assets, not gross assets, because it aligns with the equity owned by shareholders.

The Cash Shell Limit is a bright-line test that everyone, including listed companies and their advisers, can understand. It removes some of the fog from the Listing Rules and reduces the need for subjective judgment by the Stock Exchange and Listing Committee which opens it to allegations of favouritism or negative bias when reviewing proposed transactions. It should also accelerate the transaction process. We would expect regulators, the Listing Committee, issuers and their advisers to be in favour of that.

The AGM vote will allow companies and boards with good reasons for cash retention to make their case to minority shareholders that they should leave the cash in the company by voting against the distribution.

There is ample precedent in our Listing Rules for giving minority shareholders a say over equity structure. Under existing rules, no company can conduct a rights issue or open offer larger than 1 for 2 without minority shareholders' approval. Refreshments of the 20% general mandate to issue new shares, other than the AGM approval, also require minority shareholders' approval.

This generous limit will also not impede the healthy development of businesses, some of which need to retain all their profits in order to expand, building new factories, investing in research and development, or making acquisitions. It will simply stop mature companies from hoarding cash that could be more usefully deployed by investors elsewhere in the economy.

To have any substantive impact, the Cash Shell Limit must apply to the whole market, not just to new companies or on a new board. You cannot fix the sewerage problem that way.

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