



2020 Half Yearly Review and Foresight – Mergers and Acquisitions: Share Buy-Backs In Hong Kong

*Produced in partnership with
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This Review highlights notable developments relating to the structure and compliance issues of share buy-back transactions for listed issuers in Hong Kong in 2019 and the first half of 2020.

Background

Many Hong Kong listed issuers have seen a significant drop in share price since early 2020 due to the economic impact brought by the Covid-19 pandemic and rising U.S.-China tension, leading to the Hang Seng Index once losing over 20% from its peak in 2020. To reassure investors' confidence in their long-term development, some listed issuers have conducted share buy-backs, while the major or controlling shareholders of some listed issuers have acquired more stakes in the listed issuers. Notable cases include New World Development Company Limited (stock code: 0017, on-market share repurchase), CK Asset Holdings Ltd (stock code: 1113, on-market share purchase by controlling shareholder and chairman), and PCCW Limited (stock code: 0008, cash partial offer to acquire shares by substantial shareholder and chairman). Amongst these transactions, share buy-backs seem to be the most common and the compliance issues behind the same are plenty.

One of the typical reasons for share buy-backs is that the shares of the listed issuer have been trading at a substantial discount to the listed issuer's net asset value. By conducting a share buy-back, listed issuers will be able to utilise idle cash and at the same time convey a message to shareholders and potential investors that the listed issuer is being undervalued by the market. As the shares bought-back will be cancelled, this would result in an increase in the listed issuer's earnings per share and rate of return on capital, hence improving the financial ratios of the listed issuer.

This Review seeks to outline the different types of share buy-backs and their implications under the Code on Takeovers and Mergers (the "Takeovers Code") and the Code on Share Buy-backs (the "Share Buy-backs Code"), and setting out the views of the Securities and Futures Commission (the "SFC") on various compliance issues in relation to share buy-backs.

Methods of Share Buy-backs

Under Rule 1 of the Share Buy-backs Code, there are four methods to conduct a share buy-back:

- i. share buy-back by general offer;
- ii. on-market share buy-back;
- iii. off-market share buy-back; and
- iv. exempt share buy-back.

Share Buy-Back by General Offer

A share buy-back by general offer is effected by way of an offer made to all holders of a class of shares in the listed issuer. Usually, a maximum amount payable for the share buy-back will be set. For instance, the maximum total consideration payable in the share buy-back by general offer of Skyworth Group Limited (stock code: 0751) in July 2020 is over HK\$1 billion.

Amongst all types of share buy-backs, a share buy-back by general offer involves the most formalities and documents relating to the offer. Very often, both financial adviser (advising the listed issuer) and independent financial adviser (advising the independent shareholders as well as the independent board committee comprising the independent non-executive directors) are engaged in the exercise. An offer document containing the information required by Schedule III of the Takeovers Code, such as the terms of the offer and the change to the shareholding structure of the listed issuer before and after completion of the offer, will have to be issued.¹ Lastly, the share buy-back by general offer will have to be approved by the independent shareholders (namely, those without any material interest in the share buy-back that is different from the other shareholders) by ordinary resolution in a general meeting duly convened by a notice accompanied by the offer document.²

On-Market Share Buy-Back

An on-market share buy-back is made by a listed issuer through the facilities of the Stock Exchange of Hong Kong (the “Exchange”) in accordance with the Listing Rules. In essence, this means the listed issuer is repurchasing its own shares in the open market. The usual way to conduct an on-market share buy-back is for a listed issuer to exercise its power under a share repurchase general mandate obtained at its last annual general meeting to buy-back up to 10% of its total shares as at such annual general meeting. For the purpose of obtaining the share repurchase general mandate, an explanatory statement providing shareholders with the necessary information enabling them to make an informed decision as to voting for or against such general mandate must be published before the annual general meeting.³

A listed issuer shall not conduct an on-market share buy-back following the announcement of a share buy-back by general offer up to and including the date the share buy-back by general offer closes, lapses or is withdrawn, as the case may be.⁴

Exempt Share Buy-Back

An exempt share buy-back means any of the following:

- i. an employee share buy-back;
- ii. a share buy-back made in accordance with the terms and conditions attached to the shares being bought back which either permit or require such share buy-back without the prior agreement of the owners of the shares;
- iii. a share buy-back made by a listed issuer at the request of the owners of the shares bought back in accordance with the terms and conditions attached to the shares which provide the owners of the shares a right to require the listed issuer to effect such share buy-back; and
- iv. a share buy-back that is required by the law of the jurisdiction in which the offeror listed issuer is incorporated or otherwise established.

Off-Market Share Buy-Back

An off-market share buy-back is any share buy-back that does not fall within the aforesaid methods of share buy-backs (namely share buy-back by general offer, on-market share buy-back or exempt share buy-back). A common example would be a buy-back of shares from a targeted substantial shareholder through private agreements. Similar to the case

¹ Rule 4 of the Share Buy-backs Code.

² Rules 3.1 and 3.2 of the Share Buy-backs Code.

³ Main Board Rule 10.06(1).

⁴ Rule 5.4 of the Share Buy-backs Code.

of share buy-backs by general offer, the listed issuer is required to issue a circular with, inter alia, details of the agreement in relation to the share buy-back, the recommendations of the independent board committee and the advice of the independent financial adviser.

An off-market share buy-back needs to be approved by both the Executive Director of the Corporate Finance Division of the SFC (the “**Executive**”) and at least three-fourths of independent shareholders who are disinterested in the transaction,⁵ and the Executive’s approval is usually conditional upon such independent shareholders’ approval. In an Executive statement issued by the SFC in December 2019, the SFC publicly censured CLSA Limited (“**CLSA**”), CITIC Securities Brokerage (HK) Limited, Beijing Enterprises Holdings Limited (stock code: 0392, “**Beijing Enterprises**”) and their representatives for buy-back transactions in the shares of Beijing Enterprises in breach of the Share Buy-backs Code. In the relevant transaction, CLSA approached Beijing Enterprises and asked if it was interested in buying-back its own shares from CLSA’s institutional clients. Beijing Enterprises agreed and executed two on-market orders for the buy-back of its shares, which were matched with the sell orders of two institutional clients of CLSA respectively. Although these trades were executed on the Exchange, they were pre-arranged and were in substance off-market share buy-backs. As such, the SFC was of the view that approvals from the Executive and Beijing Enterprises’ independent shareholders should have been obtained under Rule 2 of the Share Buy-backs Code.

Whitewash Waivers

Share buy-backs may result in an increase of the major and controlling shareholders’ stake and control in the listed issuer. This will happen where the major and controlling shareholders do not accept the share buy-back offer, while the other minority shareholders (usually public shareholders) accept the share buy-back offer. As the shares bought-back will be cancelled,⁶ this would result in an increase in such major and controlling shareholders’ proportionate interest in the voting rights of the listed issuer. Under Rule 32.1 of the Takeovers Code and Rule 6 of the Share Buy-backs Code, such increase will be treated as an acquisition of voting rights for purposes of the Takeovers Code, and such major and controlling shareholders may thereby become obliged to make a mandatory offer in accordance with Rule 26 of the Takeovers Code (the “**Mandatory Offer**”).

A Mandatory Offer is required to be made to all shareholders of the listed issuer to purchase their shareholdings where:⁷

- i. any person (or two or more persons acting in concert) acquires, whether by a series of transactions over a period of time or not, 30% or more of the voting rights of a listed issuer; and
- ii. any person (or two or more persons acting in concert) holding between 30% and 50% of the voting rights of a listed issuer, acquires additional voting rights that increase his or their holding of voting rights by more than 2% from the lowest percentage holding by that person (or the concert group) in the preceding 12-month period (the “**Creeper Rule**”).

The obligation to make a Mandatory Offer may not be an intended result for the major and controlling shareholders. If the major and controlling shareholders become obliged but do not wish to make a Mandatory Offer, they may apply to the Executive for a whitewash waiver to dispense with the requirements of extending a Mandatory Offer. In such circumstances, a whitewash waiver will normally be granted by the Executive where:

- i. **The Takeovers Code implications of the share buy-back are disclosed in the listed issuer’s offer document**
- ii. **The share buy-back is approved in accordance with the Share Buy-backs Code**

For instance, in accordance with the shareholders’ approval procedures in Rule 2 (off-market share buy-back) and Rule 3 (share buy-back by general offer) in the Share Buy-backs Code.

⁵ Rule 2 of the Share Buy-backs Code.

⁶ Main Board Rule 10.06(5).

⁷ Rule 26.1 of the Takeovers Code.

iii. **The procedures set out in Note 1 to Rule 26 of the Takeovers Code is followed**

The whitewash waiver should be approved by at least 75% of the independent shareholders, and the share buy-back itself must be approved by at least 50% of the independent shareholders, in each case in a general meeting. An announcement must also be made by the listed issuer to inform shareholders of the results of the general meeting.

iv. **The procedures set out in the Whitewash Guidance Note (Schedule VI of the Takeovers Code) is followed**

For instance, Rule 2 of the Whitewash Guidance Note provides that a whitewash waiver is subject to there having been no disqualifying transactions by the person or group seeking the waiver in the period from the date six months prior to the announcement of the proposals and up to and including the date of the general meeting.

It should be noted that under Rule 32.1 of the Takeovers Code, a whitewash waiver is only available in the cases of off-market share buy-backs and share buy-backs by general offer, but not exempt share buy-backs and on-market share buy-backs. In 2003, the Kadoorie family sought to challenge against the unavailability of whitewash waiver for on-market share buy-backs but the application was refused by the Takeovers and Mergers Panel.⁸ In the 2005 consultation conclusion on the review of the Takeovers Code, this issue was taken up again, but the SFC refused to make whitewash waiver available for on-market share buy-backs, citing reasons such as the uncertainties as to the price, quantity and timing of on-market share buy-backs.⁹

Recent Proposal for Suspension of the Creeper Rule

In June 2020, the Chamber of Hong Kong Listed Companies (whose members comprise blue-chip listed issuers on the Exchange) proposed that in view of the economic impact to Hong Kong and China brought by the Covid-19 pandemic and rising U.S.-China tension, the SFC should consider a general or blanket suspension of the Creeper Rule for a period up to one year to incentivise major and controlling shareholders to buy more shares in the listed issuers, and to allow listed issuers to conduct share buy-backs without triggering an obligation for its major and controlling shareholders to extend a Mandatory Offer. This would allow listed issuers and their major or controlling shareholders to exhibit their confidence in the prospects of the listed issuers, and thus stabilising stock prices. Concerns over price manipulation can be addressed by requiring the major and controlling shareholders whose shareholdings crossed the 2% threshold under the Creeper Rule (whether by way of their own share purchase or by way of a share buy-back by the listed issuer) to be subject to lock-up periods after such increase in shareholding.

In response to media enquiries relating to this recent proposal, the SFC stated that the reasons behind the Takeovers Panel's rejection of a similar proposal made by market participants during the global financial crisis in 2008 remain valid. They include:

- i. the proposals ran counter to General Principle 1 of the Takeovers Code which requires equality of treatment for all shareholders, which is an "absolutely fundamental" principle underpinning the regulation of takeovers and mergers in Hong Kong;
- ii. while the stock market had experienced substantial declines in prices, there was no suggestion that it was not functioning properly; and
- iii. the proposals appeared to be motivated more by the interests of major or controlling shareholders than the market as a whole.

⁸ Ruling on the application of Rule 32.1 to an on-market share buy-back programme by CLP Holdings Limited, Takeovers and Mergers Panel, 17 December 2003.

⁹ Consultation Conclusions on a Review of the Codes on Takeovers and Mergers and Share Repurchases, Securities and Futures Commission, August 2005.

Foresight and the Way Forward

Share buy-backs have been given more consideration by Hong Kong listed issuers in 2020 in face of looming economic downturn and geo-political risks as a financial tool to stabilise slumping stock prices and improve declining price-earnings ratios. While they are commonly executed by listed issuers in Hong Kong, it is prudent for market participants and professional advisers to fully understand the recent developments in relation to the prohibition of pre-arranged on-market share buy-backs and the proposal to suspend the application of the Creeper Rule, in order to fully utilise this financial tool.

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As a Partner and the Head of Corporate and Commercial Department, Raymond is an experienced practitioner in the corporate & commercial field, including corporate finance, mergers & acquisitions, securities & futures, funds, notes & bonds, and banking & financing. He has over 20 years of solid and extensive experience in advising regulators, financial institutions and listed companies in handling mergers and acquisitions for multi-national corporations, and corporate finance practice such as venture capital financing, pre-IPO investments, IPO, post-listing fund raising, listed company compliance, and takeovers in Hong Kong, PRC, and some other countries with different jurisdiction systems.

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