

Frequently asked questions on adjustments of the exercise price of share options

Release Date	Main Board Rules	GEM Rules	Series No.	FAQ No.	Query	Response
6/11/2020	17.03(13)	23.03(13)	N/A	072-2020	<p>Main Board Rule 17.03(13)/ GEM Rule 23.03(13) permits adjustments to be made to the exercise price of share options in the event of certain corporate activities. The note to the relevant Rule requires that any adjustments must give a participant the same proportion of the equity capital as that to which that person was previously entitled, but no such adjustments may be made to the extent that a share would be issued at less than its nominal value (if any).</p> <p>How should an issuer calculate the adjustments in the event of (i) a capitalisation or bonus issue, (ii) rights issue or open offer, or (iii) subdivision or consolidation of shares?</p>	<p>The overriding principle is that no adjustments to the exercise price or number of shares should be made to the advantage of scheme participants without specific prior shareholders' approval.</p> <p>Please see Attachment for further guidance and examples on how adjustments are calculated in the event of the corporate activities.</p> <p>(Note: This FAQ reflects guidance set out in the Exchange's letter to issuers of 5 September 2005 (withdrawn).)</p>

Attachment

SUPPLEMENTARY GUIDANCE ON MAIN BOARD LISTING RULE 17.03(13)/GEM LISTING RULE 23.03(13) AND THE NOTE IMMEDIATELY AFTER THE RULE

Main Board Listing Rule 17.03(13)/GEM Listing Rule 23.03(13) and the Note

“17.03 The scheme document must include the following provisions and/or provisions as to the following (as the case may be):
/23.03

- (13) a provision for adjustment of the exercise price or the number of securities subject to options already granted and to the scheme in the event of a capitalisation issue, rights issue, sub-division or consolidation of shares or reduction of capital.

Note: Any adjustments required under rule 17.03(13)/[rule 23.03(13)] must give a participant the same proportion of the equity capital as that person was previously entitled, but no such adjustment may be made to the extent that a share would be issued at less than its nominal value (if any). The issue of securities as consideration in a transaction may not be regarded as a circumstance requiring adjustment.....”.

Issue

Concerns have been raised that the wording of the Note appears to be ambiguous. We are also aware of a small number of cases where adjustments have been made that are to the advantage of scheme participants contravening the Listing Rule requirements. The following example illustrates how adjustments have typically been made for a rights issue:

Existing shares in issue: 100m
Shares under option: 10m (10% of the existing share capital)
Existing market price: \$1.00
Existing exercise price of options: \$1.00 per share
Existing market capitalisation: \$100m
Total exercise price of options: \$10m
Rights issue price: \$0.50
Issue ratio: 4 new shares for each share held

Results:
Enlarged market capitalisation: \$300m
Enlarged shares in issue: 500m
Theoretical ex-rights price: \$0.60 (being $(1 \times \$1 + 4 \times \$0.50) / 5$)

Literal interpretation of the Note:

If the Note is taken literally, then the option holders would be entitled to the same proportion of the enlarged equity capital, that is, 50m shares. Since the aggregate money payable on subscription (\$10m) should be unchanged, this implies that the exercise price will be cut to \$0.20 per share. As such, each of the 50m options has an Intrinsic Value¹ of \$0.40, being the theoretical ex-rights price less the revised exercise price of the option, and is instantly worth \$20m in total. Before the rights issue, the options did not have any Intrinsic Value as the market price was the same as the exercise price. Therefore the adjustment is not correct.

Please see below for the correct adjustment.

Interpretation

The overriding principle is that no adjustments to the exercise price or number of shares should be made to the advantage of scheme participants without specific prior shareholders' approval. The adjustment should have a neutral impact or worse from the perspective of the scheme participants. Another way of looking at this is that no adjustments should be made that would increase the aggregate Intrinsic Value¹ of the outstanding options.

The Scheme Rules adopted by issuers and approved by shareholders, and the circular that is sent to shareholders, describe how any adjustment mechanism will work. In practice issuers seldom describe in detail in any circular how any adjustment mechanism would work. The circular normally simply includes the provision for adjustment and states the circumstances for adjustment as required under MB Rule 17.03(13) / GEM Rule 23.03(13).

Correct adjustment

A straightforward proportionate adjustment should be made for a capitalisation issue, sub-division, consolidation or reduction in share capital. Generally, adjustments should also be made for transactions where there is a price-dilutive element eg a rights issue or open offer. (Although MB Rule 17.03(13) / GEM Rule 23.03(13) does not cover an open offer, the Exchange considers that an open offer should be subject to the requirement of such rule if there is a price-dilutive element). That adjustment should be based on a scrip factor similar to the one used in accounting standards in adjusting the earnings per share figures, to account for the bonus or price-dilutive element embedded in a rights issue (see Hong Kong Accounting Standards 33, Appendix A). No adjustment should be made for an issue made at full consideration unless it also involves a capitalisation issue.

The correct formula for an issue of securities with a price-dilutive element, such as a rights issue, open offer or capitalisation issue, would be to multiply the number of shares subject to options by the scrip factor (F), and divide the exercise price by the scrip factor, where:

¹ . The Intrinsic Value is the difference between the market price (or theoretical ex-entitlement price) of shares under option and the exercise price (or revised exercise price) of the option.

$$F = \text{CUM} / \text{TEEP}$$

CUM = closing price as shown in Daily Quotation Sheet of the Exchange on the last trading day before going ex-entitlement to the offer (the cum-rights price)

TEEP = Theoretical Ex-Entitlement Price (based on offer ratio, offer price, and CUM)

In the above example, F is 1.667 (being $\$1 / \0.60). Therefore the adjusted number of options is 16.667m (10m multiplied by 1.667). The adjusted exercise price is $\$0.60$ ($\$1$ divided by 1.667). The total exercise monies would still be the same as before, $\$10\text{m}$, and the Intrinsic Value would also be the same as before (nil).

Set out in the appendix are examples for calculating the permitted adjustment to the exercise price of outstanding options for a capitalisation or bonus issue, rights issue or open offer and sub-division or consolidation of shares.

APPENDIX TO SUPPLEMENTARY GUIDANCE ON MAIN BOARD LISTING RULE 17.03(13)/GEM LISTING RULE 23.03(13) AND THE NOTE IMMEDIATELY AFTER THE RULE

Adjustments for Capitalisation or Bonus issue, Rights issue or Open offer, and Sub-Division or Consolidation of shares:

A Capitalisation or Bonus Issue and Rights Issue or Open Offer of Shares

Adjustments follow the formula:

New number of Options = Existing Options x F

$$\text{New Exercise Price} = \text{Existing Exercise Price} \times \frac{1}{F}$$

Where

$$F = \frac{\text{CUM}}{\text{TEEP}}$$

CUM = Closing price as shown in the Daily Quotation Sheet of the Exchange on the last day of trading before going Ex-Entitlement

$$\text{TEEP (Theoretical Ex Entitlement Price)} = \frac{\text{CUM} + [M \times R]}{1 + M}$$

M = Entitlement per existing Share

R = Subscription Price

(a) *Capitalisation or Bonus Issues*

Example:

Existing shares in issue : 100m
Shares under Option : 10m (10% of the existing share capital)
Existing market price of the Shares : \$1.00
Existing Exercise Price of the Option : \$1.00 per Share
Bonus issue ratio: 1 new Share for every ten Shares held

ie. CUM = \$1.00, R = \$0 and M = 0.1

Therefore,

$$\begin{aligned} \text{TEEP (Theoretical Ex Entitlement Price)} &= \frac{\text{CUM} + [M \times R]}{1 + M} \\ &= \frac{1 + [0.1 \times 0]}{1 + 0.1} = \frac{1}{1.1} \end{aligned}$$

$$F = \frac{\text{CUM}}{\text{TEEP}} = \frac{1}{1/1.1} = 1.1$$

Adjusted number of Options = Existing number of Options x F = 10m x 1.1 = 11m

(Additional 1m Options will be allocated to the existing holder of Options in the proportion of 1 new Option for every 10 Options held by an Optionholder.)

$$\begin{aligned} \text{New Exercise Price} &= \text{Existing Exercise Price} \times \frac{1}{F} \\ &= \$1.00 \times \frac{1}{1/1.1} \\ &= \$0.909 \end{aligned}$$

Intrinsic Value of Options immediately before the Bonus Issue = 10m x (\$1.00 - \$1.00) = Zero

Intrinsic Value of Options immediately after the Bonus Issue = 11m x (\$0.909 - \$0.909) = Zero

The purpose of these adjustments is to ensure that, as far as possible, the intrinsic value of the Options remains unchanged before and after the corporate action.

(b) Rights Issue or Open Offer

Example:

Existing shares in issue : 100m

Shares under Option : 10m (10% of the existing share capital)

Existing market price of the Shares : \$1.00

Existing Exercise Price of the Option : \$1.00 per Share

Rights issue (or open offer) price : \$0.50

Rights issue (or open offer) ratio : 4 new Shares for each Share held

ie. CUM = \$1.00, R = \$0.50 and M = 4

Therefore,

$$\text{TEEP (Theoretical Ex Entitlement Price)} = \frac{\text{CUM} + [M \times R]}{1 + M}$$

$$= \frac{1 + [4 \times 0.5]}{1 + 4} = \frac{3}{5}$$

$$F = \frac{\text{CUM}}{\text{TEEP}} = \frac{1}{3/5} = \frac{5}{3}$$

Adjusted number of Options = Existing number of Options x F = 10m x 5/3 = 16.67m

(Additional 6.67m Options will be allocated to the existing holders of Options in the proportion of 2 new Options for every 3 Options held by an Optionholder.)

$$\begin{aligned} \text{New Exercise Price} &= \text{Existing Exercise Price} \times \frac{1}{F} \\ &= \$1.00 \times \frac{1}{5/3} \\ &= \$0.60 \end{aligned}$$

Intrinsic Value of Options immediately before the Rights Issue (or open offer) = 10m x (\$1.00 - \$1.00) = Zero
 Intrinsic Value of Options immediately after the Rights Issue (or open offer) = 16.67m x (\$0.60 - \$0.60) = Zero

B Subdivision or Consolidation of Shares

Adjustments follow the formula:

New number of Options = Existing Options x F

$$\text{New Exercise Price} = \text{Existing Exercise Price} \times \frac{1}{F}$$

Where F = Subdivision or Consolidation Factor

(a) Share Sub-division

Example:

Existing shares in issue : 100m
 Shares under Option : 10m (10% of the existing share capital)
 Existing market price of the Shares : \$1.00
 Existing Exercise Price of the Option : \$1.00 per Share
 Share Subdivision: subdivide 1 old Share into 5 new Shares

ie. SF = 5

Therefore,

$$\text{Adjusted number of Options} = \text{Existing number of Options} \times F = 10\text{m} \times 5 = 50\text{m}$$

(Additional 40m Options will be allocated to the existing holder of Options in the proportion of 4 new Options for each Option held by an Optionholder.)

$$\begin{aligned} \text{New Exercise Price} &= \text{Existing Exercise Price} \times \frac{1}{5} \\ &= \$1.00 \times \frac{1}{5} \\ &= \$0.20 \end{aligned}$$

Intrinsic Value of the Option immediately before the Share Subdivision = $10\text{m} \times (\$1.00 - \$1.00) = \text{Zero}$

Intrinsic Value of the Option immediately after the Share Subdivision = $50\text{m} \times (\$0.20 - \$0.20) = \text{Zero}$

(b) Share Consolidation

Example:

Existing shares in issue : 100m

Shares under Option : 10m (10% of the existing share capital)

Existing market price of the Shares : \$1.00

Existing Exercise Price of the Option : \$1.00 per Share

Share Consolidation: consolidate 5 old Shares into 1 new Share

ie. SF = 1/5

Therefore,

$$\text{Adjusted number of Options} = \text{Existing number of Options} \times F = 10\text{m} \times 1/5 = 2\text{m}$$

(The new 2m Options will be allocated to the existing holder of Options in the proportion of 1 new Option for every 5 old Options held by an Optionholder.)

$$\begin{aligned} \text{New Exercise Price} &= \text{Existing Exercise Price} \times \frac{1}{1/5} \\ &= \$1.00 \times 5 \\ &= \$5 \end{aligned}$$

Intrinsic Value of the Option immediately before the Share Consolidation = $10\text{m} \times (\$1.00 - \$1.00) = \text{Zero}$

Intrinsic Value of the Option immediately after the Share Consolidation = $2\text{m} \times (\$5 - \$5) = \text{Zero}$