A STUDY ON
HOW TO SOLVE THE PROBLEM OF STOCK DILUTION

By
Vahe Danielyan

THESIS

Submitted to
School of Public Policy and Management, KDI
in partial fulfillment of the requirements
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Committee in charge:

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ABSTRACT

Equity market represents a significant source of funding companies' new development projects. However this investment process is not costless as minority shareholders bear a risk of dilution of their ownership stake in each financing round. Currently, there are some solutions how to reduce stock dilution risks and many studies about this issue but there is no study to offer an alternative solution to completely solve the problem without any further dilution possibility. We outline the existing mechanisms to fight dilution and draw conclusion evaluating the effectiveness of existing methods. It shows that current remedies of stock dilution are not met the requirements of the principles of property rights and anti-dilution provisions merely alleviate the dilution problem. We highlight advantages and drawbacks of current mechanisms and offer new solution that, to our assessment, outweighs current means to combat the dilution problem. It leads to designing a new model as an alternative to current anti-dilution provisions.
To My Late Father
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CHAPTER 1
INTRODUCTION

The main function of capital market is to provide capital to companies. Companies benefit from this market through investments by the market participants who buy and sell equity and debt instruments. We divide the capital market into two various markets: primary capital market and secondary capital market. The primary capital market deals with the new securities, traded in this market. The secondary capital market is a market where securities are traded among investors not buying securities from directly the issuing company but from other owners of the market. As a rule, issuing companies get no revenue from trading process and benefits. Institutional and retail traders take part in these kinds of markets such as NASDAQ, New York Stock Exchange (NYSE) and other major exchanges around the world.

At the other hand, companies use the primary capital market to generate funds for new investment programs at first through IPO (Initial Public Offering), then through secondary offering. While in secondary capital market traders trade among themselves, when it comes to Secondary offerings investors purchase securities directly from the company that issues new stocks after IPO.

Equity offerings benefit the issuing company by attracting additional financial resources for its future development. Generally, equity capital is the main source of finance for small or young companies since this kind of companies are usually lack of capital (assets) for using collateral to borrow money from banks. Investors invest in companies through buying stocks in equity market. Thus, they become owners of the company sharing the ownership among other shareholders in proportion to the number of shares they hold.

After IPO when companies need more funds to invest in new projects, they issue new stocks and sell them through secondary offering. The latter creates stock dilution, which decrease the economic value of the investor's investment in the entity.

The secondary market is that part of the capital market that deals with the securities that are already issued in the primary market. In the secondary market, the money earned from selling a security does not go to the company. The money earned goes to the investor who sells the security. As a result, investors do business for profit by selling-buying stocks in
Stock Exchange Market and pay Capital gain taxes.

As mentioned above, the stock dilution is a decrease in the stock’s value. Regarding to the nature of above mentioned value, we deal with 2 types of dilution:

Percentage dilution;

Economic dilution.

Percentage dilution decreases the voting power of old shareholders. In other words, percentage dilution is a situation when stock owners voting power decreases as the percentage of the ownership decreases because of more outstanding shares. For instance, let’s assume a company that has 5 shares and 5 people own one share each (each owns 20 percent equally as 5 shares compound 100 percent of the company’s share) decides to issue additional 5 shares and sell it an outside single investor. Now the company has 10 shares outstanding and new investor owns 50 percent of shares (5 shares out of 10) or in other words 50 percent of the company. In this new situation, an initial owner of the company holds only 10 percent of the company, in other words 10 percent of shares outstanding (1 share out of 10). Therefore, initial owners loose the percentage of ownership in the company by 50 percent since their ownership in the company drops from 20 percent to 10 percent. Voting power (often called voting interest) is one form of economic interest. In the above mentioned case, 3 initial shareholders (together comprising 60 percent of all votes, 3×20 percent) could select the board of directors that nominates CEO and thus, influence on the decisions of the company. After issuing new stocks, even 5 initial shareholders (comprising 50 percent of all votes, 5× 10 percent) could not independently exercise the right to select the board and have the same influence on making decisions of the company as before.

Economic dilution is the reduction of the economic value of a company’s share. Economic dilution is subdivided into 2 types of dilution:

1. Earnings dilution;

2. Stock value dilution.

Earnings dilution occurs when we have reduction of the earnings per share. Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.
which indicates the profitability of the company. The newly issued stocks increase the net in shares but the net income stays stable. Earnings per share are calculated by dividing net income by common shares outstanding during the period. Thus, a shareholder receives less amount of dividends per share than before, since now we have more total outstanding shares that means bigger denominator in EPS calculation formula and as a result, small earnings per share.

Stock value dilution is the reduction of the stocks’ price. New equity offerings create greater supply that leads smaller demand for bigger quantity. Thus, the reduction in stock prices is inevitable according to the Law of Supply and Demand (the price adjustment mechanism). The economic value of any company’s stock is determined by the price of a stock plus Earnings per share (EPS).

1.2. Structure of the paper

The remainder of the thesis is structured as follows. In the first Chapter of the paper, we present general overview of stock dilution problem. We also set the research question here. Second Chapter of the thesis describes the methodology of the research of the paper. In Chapter III, we survey the prior literature, current legal regulations and courts’ decisions noting how they do not address the question we are looking forward to answer. We also examine current anti-dilution provisions in various legal systems showing their impotence to protect minority shareholders from dilution. We discuss ways in which dilution damages shareholders property rights. In section IV we draw your attention to the findings of the analysis we have done. In Chapter V, we represent the study’s limitations. In the last, Chapter VI we draw conclusion answering the research question. In this chapter we also design theoretical new model as an alternative to current anti-dilution provisions.

1.3. Research questions

Are current stock issuance mechanism and anti-dilution provisions capable to solve stock dilution problem being compatible with the principles of the right to the property?
CHAPTER 2

METHODOLOGY

The present study is mainly based on a review of existing literature and prestigious courts’ decisions. The method used to reach of the aims of this paper would be mainly qualitative. In addition secondary data will be used to advocate the arguments or reject them to come out a concrete conclusion. This study is aiming to evaluate current legal regulations and economic activities along with surveys, studies and the author’s knowledge and experience as a lawyer and policy maker in his government. This approach allowed not relying on any single methodology while providing an interrelated analysis of various aspects of companies’ issuance process.
CHAPTER 3: LITERATURE REVIEW

3.1 Stock dilution as an economic problem

The decision to issue new equity requires either the agreement of all shareholders or the board of directors (also known as the executive board) makes such decisions. In both cases each shareholder’s relative power of the ownership matters since the percentage of ownership in the company is directly proportional to each shareholder’s influence in the decision making process. In the first case, when shareholders’ agreement is needed for the decision to issue share capital each shareholder’s influence in the decision making process is direct but in the second case, when the executive board makes the decisions the influence is indirect as now the decision is made by members (board of directors) who have been elected by shareholders. Shareholders, that can’t afford to buy new shares find new stock issue process and following dilution bad news as they lose relative power in company’s decisions.

Naturally, large investors whose stake is more than 50 percent in the company are concerned more as they may lose the control of selecting board of directors or making other major decisions and may dilute their ability to control stocks successive issues that require shareholder approval. Besides, existing shareholders lose investment when dilution occurs and the company’s stock prices go down.

Atanasov, et al (2007) point out that equity dilution problem arises only when all of the following three conditions are met. Condition 1: A significant amount of equity is issued. If the size of the equity issue is small, shareholder wealth loss is negligible.

Condition 2: Some shareholders receive a disproportionately lower (higher) stake in the new issue. If all existing shareholders receive a proportionate amount of the newly issued shares, then there will be no dilution effects and the equity issue will resemble a stock split or a stock dividend.

Condition 3: Equity is issued at a lower price than the fair value of the stock. If the new stock is issued a fair value or even above fair value, regardless of participation or issue size, existing shareholders will not suffer a wealth loss.

Although we agree that equity dilution may happen when above mentioned conditions are met, we are sure that equity dilutions is limited by the narrow definition of these conditions.
The difference of our views may be determined by the concept of the problem we take into account. In contrast to these researchers that neglect shareholders’ minor wealth loss excluding them from the notion problem, we, as a principle, highlight the importance of any economic loss regardless of the size. The dilution will get noticed when company issues comparably big number of new shares but it doesn’t mean if the economic loss is discernible to the naked eye it does not exist. In our opinion, any economic loss arising from legal regulations and not determined by purely economic natural rules is a situation regarded as unwelcome in terms of being harmful and needing to be dealt with to overcome. Thus, we consider even small wealth loss problem in the equity issuing process.

Regarding to the second condition, we should bear in mind that equity dilution is a reduction either in relative ownership (percentage dilution) or in economic value (stock price dilution and earnings per share (EPS) dilution). That means a shareholder has to purchase as many newly issued shares as his ownership percentage in the company, in order not to suffer percentage dilution. For instance, if a shareholder owns 20 percent of the company, he has to purchase at least 20 percent of newly issued shares to remain 20 percent owner of the company after the stocks issue. This actual requirement for avoiding the dilution is practically impossible for all shareholders as they have to invest more and more every time the company decides to issue new shares. Besides, the existing shareholders suffer economic loss too as economic dilution also happens and shareholders are deprived of a part of their initial investment.

Finally, third condition is purely concerned with theoretical approach of the subject rather than its practical application. It’s true that if a company issues new equity in a fair value or more than this fair value, it won’t be any economic loss for existing shareholders. Here everything is depend on that if because it’s not possible in practice for a company to issue new shares and sell them in the market price or higher. This view is advocated by one of the basic concepts in economics, the Law of Supply and Demand (The price adjustment mechanism). New shares create more supply, thus, it reduces the price of stocks. Therefore, the reduction of a company’s stock price after issuing new shares is inevitable. Financial practitioners also alert about stock price fall after successive issue of new shares.

In summary, equity dilution happens not only when above discussed three conditions
Almost all financial practitioners agree that issuing new stocks reduces the price of the stocks. In theory, this view is coined by Scholes (1972) that is called price-pressure hypothesis. According to this hypothesis, the decline in stock prices is determined by economic relationship between supply and demand, especially because the demand curve for stocks is downward sloping. The advocates of this hypothesis note that each company’s share is unique in stock market and there is no close substitution for stocks. Some researchers agree with the stock price reduction fact after new issue but they find different reason behind this phenomenon. For example, Myers and Majluf (1984) see stock price reduction as a result of inner information about the company’s performance. Management is assumed to know more about the company's real value than potential investors. Investors take the information of new issue as a bad news (potential bad performance) as they are afraid that company needs money to cover expenses, pay debts but not investing in new profitable projects. There is also opposite view that claims that new offerings by companies can be viewed as expanding of the company and therefore good news for the company’s performance. Martin and Thomas (2002) drew a conclusion from such studies that compensation plans that align management's interests with those of stockholders, including stock option plans, raise the company's stock price and benefit stockholders. Although this case is about option plans not about general seasoned equity, we should take into consideration that stock option plans are a form of compensation that can be done through issuing new shares.

In contrast, the opponents of price-pressure hypothesis argue that the curve of stock demand is horizontal rather than downward sloping because stocks of different companies are close substitutes taking into account the fact that stocks can't be unique because the price of all stock are determined by the risk and expected return that is common for all types of stocks. However, we agree with the second group of researchers as the stock market is under the general rule of economics, especially supply-demand rule: more stocks means more supply that will lead to price reduction in free economic market. This view has been asserted by a quantitative research done by Paul Asquith and David W. Mullins, Jr. (1983). The latter above discussed theories grouped into three categories:

No price effect - consistent with the close substitutes - efficient markets hypotheses.
Negative price effect - consistent with (1) a downward sloping demand for firms’ shares leading to a permanent price reduction, (2) capital structure hypotheses based upon redistribution of firm value among classes of security holders, tax effects, and/or leverage-related information effects, (3) information effects associated with the sale of equity by informed sellers, both firms and investors, and (4) large transaction costs associated with equity issues.

Positive price effect - consistent with (1) a favorable information effect associated with investment, and (2) a value enhancing reduction in financial leverage due, for example, to a reduction in the expected costs of financial distress and/or agency costs.

This study, examining the announcement day and issue day price effects of both primary and secondary issues of new equity, analyzed 531 registered common stock offerings by utilities and industrial firms (data has been taken from Wall Street Journal) and came to the conclusion that equity issues reduce stock prices. The regression results demonstrate that the announcement day price reduction is significantly related to the size of the equity offering. As bigger the size of new issued equity is, as big is the reduction of stock price. This conclusion is consistent with the price-pressure hypothesis that discussed above. It means that the demand for a company’s share is a downward sloping and new issued shares create dilution by pushing stock prices down.

The results of this study also showed that new are security issues are generally viewed by knowledgeable investors as unfavorable signals about a company’s performance and future prospects. This phenomenon can also describe the widespread situation when the most shareholders are reluctant to issue new shares.

To explain why investors negatively react to seasoned equity Offerings, Kim, E. Han and Amiyatosh Purnanandam (2006) have done an empirical assessment of the relative importance of three theoretical explanations for the negative investor reaction and have concluded that of the three possible explanations, pure signaling effects and agency problems exhibit significant explanatory power. We notice the same tendency when it comes to stock option plans. Stock options are granted by companies to their employees as part of the employees’ compensation package. A company that issues Employee option plans (EPO) to its employees also set a particular price (generally company’s current stock price) at which
EPO can be exercised. Until recently, EPOs have been widely used by companies as a part of employee remuneration package, especially by start-up technology firms. Generally such companies are lack of asset and EPOs are the best option to save some financial resources when paying workers’ salaries. In these companies, workers hope to get more benefits from EPOs compensation when the company goes public. Nevertheless, the tendency in this sphere shows shareholders’ reluctance to EPOs as adverse form of compensation. Lublin and Scism (1999) notes that institutional shareholders are now concerned about the drawbacks of widely used stock option plans, particularly the potential dilution in earnings that would be caused if the outstanding shares are exercised. This means EPOs are assumed to be detrimental for shareholders. That is why Thomas and Martin (2000) report that “shareholder unfriendly” features in option plans cause shareholders to vote at significantly higher levels against option proposals. In our opinion this so called “shareholder unfriendly” features includes potential dilution.

It is much more important to clarify who the stock dilution can be problem for. A seasoned issue is beneficial for the issuing company as it is source of funding regardless of potential dilution effect because the company as a legal entity can be indifferent to the fact that existing shareholders loose while new investors get benefits. It can be also beneficial for new investors who buy newly issued stocks in a lower price than before issuing equity by the company. The only victim target in this process is existing, in other words, old investors, as their ownership reduces. The financial history of the world is full of examples when financial instruments helped to despoil big company owners of their ownership. One of the most outstanding cases is the Erie War in 19th century. Erie war was a conflict between American financiers in the late 1860s to control the Erie Railway Company. The main characters in this conflict were Cornelius Vanderbilt, Jay Gould and Jim Fisk. Cornelius Vanderbilt (known as “The Commodore”) was a transportation magnate and the richest man in the US at that time. Jay Gould and Jim Fisk were Wall Street traders.

As Geiss (2006) mentions Daniel Drew that became the best known and most feared stock trader of his era, by 1857, had become the director of Erie railroad and engaged in the infamous “Erie Wars” with Jay Gould and Jim Fisk against Cornelius Vanderbilt to gain control of the railroad between 1866 and 1868. Jay Gould and Jim Fisk brought to Daniel Drew on the board and conspiring with the help of the director “watered down” the stocks of
the company by issuing new shares. Cornelius Vanderbilt got manipulated by purchasing a large quantity of these watered stocks. Watered stock is a highly overvalued asset. The origin of the term is credited to Daniel Drew. Daniel Drew, a cattle driver turned financier in New York, had a reputation for shady behavior in business, and he was a major participant in many Wall Street manipulations of the 1850s and 1860s. Daniel Drew as a cattle drover and horse trader used to feed his animals excessive amount of water to make them look fat right before selling them. In this way he could sell them in insubstantial higher prices. Thus, Daniel Drew carried over the term watered stocks to stock markets meaning stocks that have been tremendously dilated.

Using a quirk in the law, Drew, Gould, and Fisk began issuing additional shares of Erie stock for several rounds. The Commodore kept purchasing the watered shares. Vanderbilt was outraged, but kept trying to buy up the Erie stock as he believed his own economic might could outgun Drew and his cronies. Eventually, the Commodore lost more than $7 million in the process of attempting to gain control over Erie Railway Company.

Another illustrative example, this time from modern financial era, is the case of billionaire Eduardo Saverin who is one of the co-founders of Facebook Inc. Eduardo Luiz Saverin, an alumni of famous Harvard University, is a Brazilian investor and Internet entrepreneur. In 2004, Mark Zuckerberg, along with other fellow Harvard College students Eduardo Saverin, Dustin Moskovitz, Andrew McCollum, and Chris Hughes established Facebook that later became Social networking giant corporation. Mark Zuckerberg first time met Eduardo Saverinhis junior year at Harvard asked him to deposit $15,000 in a bank account for business purposes. The money was anticipated to go toward the servers needed to host a website that Zuckerberg wanted to develop. The small start-up team divided the work among its members. Eduardo Saverin was in charge of setting up the company, get extra funding, and make a business model. All of a sudden Zuckerberg decided to cut Saverin out of the company as he thought Saverin had failed to do his duties properly.

To bring the decision into reality, Zuckerberg established a new company, a Delaware corporation, to purchase the old company (Florida LLC) that ownership was shared by Saverin too. Delaware Corporation acquired Florida LLC and Zuckerberg distributed new shares to everyone excluding Eduardo. Now, in Facebook ownership the stake of Zuckerberg
was 65%, 30% for Saverin, and 5% for Moskovitz. After an investor, named Peter Thiel, invested $500,000 in the company getting 9% of the company, the portion of Zuckerberg, Saverin, and Moskovitz became accordingly 40%, 24% and 16%. Zuckerberg offered 3 million shares to Saverin (shareholder agreement) to give up claim on all Facebook intellectual property rights and turn over his voting rights to Mark Zuckerberg. It made Saverin a passive investor. Right after that Zuckerberg printed 9 million more shares and distributed to everyone but Saverin. He took 3.3 million new stocks and distributed 4 million shares to Sean Parker and Dustin Moskovitz equally. The stock issuance process instantly diluted Saverin's stake in the disputed company from ~24% to 10%. Therefore, several rounds of seasoned equity offerings diluted Saverin’s ownership stake in the company.

Zuckerberg’s plan succeeded through using his position in the company to print new shares and reduce Saverin's stake in Facebook diluted its stocks. As of 2015, Saverin owned approximately 0.4% of all outstanding shares of the company.

A famous movie named Social Network portrays the relationship between Saverin and the Company’s CEO Zuckerberg from their creation of Facebook to Saverin's legal action against Zuckerberg. The movie is based on the book of Ben Mezrich called The Accidental Billionaires.

As seen, selling seasoned issued equity shifts the wealth from ‘existing’ shareholders to the favour of ‘new’ shareholders. The recent studies also show expropriation of the wealth of minority shareholders when issuing new shares for investment. For instance Atanesov, et al (2006) and Baek, Kang and Lee (2005) in their studies shows evidences of controlling shareholders respectively in Bulgaria and in Korea often avoids equity offerings to raise new capital and also shows the regression results as an evidence of expropriate the wealth of minority shareholders by the companies through diluting their ownership stake.
3.2. Existing methods for solving dilution problem, their capability of completely solving it

As seen, stock dilution is inevitable when companies go for seasoned issues to raise extra capital for programs needing investment. Investors seek protection of possible dilution as they may lose a part of their ownership stake in the company.

Anti-dilution provisions are anticipated to satisfy such needs maintaining shareholders' voting power, influence on the Board of Directors and minority shareholders' property rights.

We divide anti-dilutions mechanisms into two groups:
Anti-dilutions methods that are directly prescribed by law (we will call these methods legal solutions) and anti-dilutions methods that are not directly prescribed by law but have been widely used throughout time on a basis of freedom of contracts and free will (on which terms to contract) which plays central role in the contractual relationships (we will call second group's methods practical solutions).

3.2.1. Legal Solutions

Someone may think that modern legal systems provide solid guarantees for existing investors not to suffer economic loses using their voting power when company decides whether or not there is a need to issue new securities. However, the reality is so much different than our expectations.

Constituting one third of the world's stock market, United States stock market is the largest in the world. The USA has got rich traditions and valuable experience in this sphere which is indispensable asset for other countries’ stock markets in general and for emerging markets in particular. In 1940, after stock market crash of 1929 in the USA, the US Congress passed Investment Company Act that regulates companies’ responsibilities and duties in
investment relationships with potential and existing investors. Investment Company Act of 1940 followed two other important acts: the Securities Act of 1933 and the Securities Exchange Act of 1934. According to Section 23 (Distribution and repurchase of securities: closed-end companies) of this act:

(a) No registered closed-end company shall issue any of its securities (1) for services; or (2) for property other than cash or securities (including securities of which such registered company is the issuer), except as a dividend or distribution to its security holders or in connection with a reorganization.

(b) No registered closed-end company shall sell any common stock of which it is the issuer at a price below the current net asset value of such stock, exclusive of any distributing commission or discount (which net asset value shall be determined as of a time within forty-eight hours, excluding Sundays and holidays, next preceding the time of such determination), except (1) in connection Sec. 24 INVESTMENT COMPANY ACT OF 1940 68 with an offering to the holders of one or more classes of its capital stock; (2) with the consent of a majority of its common stockholders; (3) upon conversion of a convertible security in accordance with its terms; (4) upon the exercise of any warrant outstanding on the date of enactment of this Act or issued in accordance with the provisions of section 18(d); or (5) under such other circumstances as the Commission may permit by rules and regulations or orders for the protection of investors.

(c) No registered closed-end company shall purchase any securities of any class of which it is the issuer except— (1) on a securities exchange or such other open market as the Commission may designate by rules and regulations or orders: Provided, That if such securities are stock, such registered company shall, within the preceding six months, have informed stockholders of its intention to purchase stock of such class by letter or report addressed to stockholders of such class; or (2) pursuant to tenders, after reasonable opportunity to submit tenders given to all holders of securities of the class to be purchased; or (3) under such other circumstances as the Commission may permit by rules and regulations or orders for the protection of investors in order to insure that such purchases are made in a manner or on a basis which does not unfairly discriminate against any holders of the class or classes of securities to be purchased. (Aug. 22, 1940, ch. 686, title I, Sec. 23, 54 Stat. 825.)
As seen, above mentioned Section is related to merely closed-end companies. A closed-end fund is a publicly traded investment legal entity. In contrast to closed-end companies, open-end funds are excluded from this Section. It is worth to mention that most of mutual funds are open-end funds that do not have restrictions on the number of issuing new shares. Neither other provisions of the Investment Company Act of 1940 nor the Securities Act of 1933 and the Securities Exchange Act of 1934 contain similar restrictions indicated in Section 23 for open-end funds. Anyway, in summary Section 23 four major means of protection for existing shareholders to avoid stock dilution: prevention of issuance of shares to pay for services, preemptive rights, minimum issue price and approval rights.

Prevention of Issuence of Shares to Pay for Services

Part a) of the Section 23 of the Investment Company Act of 1940 clearly states that no registered closed-end company shall issue any of its securities (1) for services; or (2) for property other than cash or securities. Here is a strong method of protection from complete dilution of stocks.

Preemptive Rights

Preemptive rights (often called preemption rights, "first option to buy", subscription privilege or subscription rights) give existing shareholders the right to purchase new issued shares by the company. A preemptive right is a privilege granted to existing shareholders to buy newly issued shares prior to those shares being available for outside investors. Moreover, it is a right for existing shareholders to purchase new shares on not less favorable terms (including the price) or at least, on the same terms as outside investors. This right is limited to the number of equity securities required to maintain existing shareholders' respective percentage ownership positions in the issuer. In other words, as a rule, a limit is put on the number of newly issued shares a shareholder can buy depending the exact proportion the shareholder holds in the company in order to prevent dilution but not to strengthen his position in the company. In this sense, preemptive rights are more common in Venture capital deals where after each round of financing the company's some existing shareholders want to preserve their ownership stake and take part in new investment. To maintain its power in the company's decision making process an existing shareholder must purchase new shares on a pro-rata basis. This means if a shareholder has got let's assume 30 percent of
outstanding shares of the company before the issuance, he/she needs to buy at least 30 percent of newly issued shares not to suffer from dilution and to maintain the same power in the company after issuance he/she had before it. A preemption right guarantees purchasing of not more than 30 percent of new shares in the above mentioned hypothetical case since 30 percent of new shares is enough for the shareholder not to be deluted.

Besides being an useful protection tool from dilution, this right can be immensely valuable for existing shareholders especially when the company does well and there is a high expectation from its future prospects.

One of the important feature for preemptive rights is transferibility of the right. Preemptive rights are securitised and shared between shareholders who can easily sell those rights to third parties. Smith (1997) notes that only 50 percent of existing shareholders exercise their preemptive rights in the USA, while 40 percent of shareholders sell them. It means the other 10 percent suffer dilution.

Although most legal system contains preemptive rights in their anti-dilution protection arsenal, these rights are given only to closed-end funds' shareholders in the USA by law but for other corporations it is neither default, nor mandatory. Anyway, preemptive rights are enforceable when such privilege is written into the contract regardless whether or not the concrete states grant this right as a matter of law. Discussing contract is an agreement between existing shareholders and the company upon shareholders such right and specific details of exercising that right.

Despite above mentioned advantages, preemptive right has also weaknesses. In particular, not all aspects are regulated by laws or by the contracts giving shareholders preemptive rights. For instance, in most legal systems it is not clarified if the payment for new shares will be in cash or in other ways: such as future services, other companies shares. Non-cash payments might create dilution as well. Another drawback of preemptive rights is waivability. Preemptive rights can be waived by majority shareholders vote. It means controlling shareholders can easily use their influence on decision making process and dilute minority shareholders stake of ownership in the company. Besides, preemptive rights are shareholders' rights to be capable by law to act to prevent dilution, not the rights to never
suffer from it since if a shareholder can't make new investment to buy new shares, his
ownership stake will be diluted.

Minimum Issue Price

Minimum issue price is a pricing rule that forbids the issuing company to issue new
shares below certain price. As such price usually serves Net Asset Value (also called Book
Value). Net Asset Value (NAV) is the value of an entity's per share: assets including market
value of all the securities held by the fund plus cash and equivalent holdings, minus the funds
expenses/liabilities, divided by the total number of outstanding shares. In some countries the
pricing rule is fair value or market price of shares instead of NAV. In all cases manipulation
of the calculation is a big threat in practice. First of all, it is difficult to determine fair value.
In case of market price, controlling shareholders often use wash sales or maneuvers to press
minority shareholders to sell their shares (Freeze-out). Finally, when NAV is related to
pricing rule, accounting various manipulations (for example, showing excessive liabilities)
come to help controlling shareholders. However, regardless of the fact that pricing rule is
based on whether NAV or fair value per share, minimum price is able to reduce dilution or
minimize its adverse consequences but is not able to eradicate it. Another important thing is
that Investment Company Act of 1940 enforces minimum issue price rule above NAV price
to only closed-end funds and although it is also theoretically possible for other companies to
have such agreements, it doesn’t happen in real life. Khorana, et al (2002) shows that only
few companies were able to issue new equity above NAV price in the last 30 years. Basically,
we see companies that come to agreement upon pricing rule based on certain price and
number of shares rather than NAV. For instance, Metallurgical Corporation of China Ltd.’s
Announcement in 2016 on adjustments to minimum issue price and maximum number of
shares to be issued under the non-public issuance of a shares. According to this
Announcement, pursuant to the Issuance Plan, the issue price of the non-public issuance of A
shares of the Company (the “Non-Public Issuance”) shall be not less than RMB3.85 per share,
and the number of shares to be issued shall not exceed 2,548,716,883 shares (find full text
attached in Appendix).

Like preemptive rights, minimum issue price also has disadvantage in the form of
waivability of the right. Preemptive rights can be waived by majority shareholders vote. It
means controlling shareholders can easily use their influence on decision making process and dilute minority shareholders stake of ownership in the company.

Approval rights

An approval right is a right given to shareholders to control new equity issuance process. If the majority of shareholders approve, the company can issue new shares to anyone at any price. A company's power to issue new shares is regulated by the Companies Act of 1993. Aspects that are not subject to the Companies Act of 1993 are determined by the contents of the company's constitution (or often called charter document). Issuing new equity at a certain number and price is most of time at the board of directors' discretion according to companies' constitutions. But if there are some restrictions in the company's constitution for the board of directors to issue new equity, such restrictions can be overcomed by shareholders' approval. This is done by a special resolution of shareholders, which usually requires a 75 percent majority. Although Investment Company Act of 1940 requires less votes, simple majority but a majority for all shareholders and not for existing shareholders present in the voting process. Even this requirement is difficult too satisfy as most of small investors are passive, inexperienced and as usual reluctant to take part in voting processes.

Approval rights are able to overcome other restrictions too. For instance, companies listed on the New York Stock Exchange are required to submit approval of their shareholders when number of new equity issue shares exceeds 20 percent of outstanding shares.

Atanasov, et al (2007) examining preemptive rights, minimum issue pricing rule and approval rights come up with a conclusion that these rights are not able to protect all investors equally and their effectiveness will depend on the distribution of investors in a particular firm.

3.2.2. Practical Solutions

Most common anti-dilution practical solutions are the weighted average and permanent, full-ratchet, anti-dilution protection.

Weighted Average

Weighted average is a common price anti-dilution protection method. Naturally investors’ concern that in every round of financing new shares can be at a lower price than
the price they paid per share when acquiring their shares. Therefore, the investor will insist upon anti-dilution protection not to suffer from potential dilution. Weighted average is a mechanism that adjusts existing investors’ number of shares to the price of new shares. For example, an investor wants to purchase 40% of the company by investing $400,000 to get 400,000 shares. It means he pays $1 for a share. The company had 600,000 shares before the investment. Now the company has 1,000,000 shares (600,000+400,000) and costs $1,000,000 ($1×1,000,000 shares). In the next financial round another investor offers $500,000 for getting 50% of the company. As the company has 1,000,000 shares it needs to issue additional 1,000,000 shares to give the new investor to satisfy that 50% request. It means new investor purchases 1,000,000 shares paying $500,000 or $0.5 for each share while first investor paid $1 for each share. First investor paid $400,000 but his shares now worth $200,000 (400,000 shares × $0.5) and his ownership drops from 40 percent to 20 percent. Therefore, first investor ownership stake is diluted. In order to compensate first investor’s loses the company reprice the shares using the following formula:

$$CP_2 = CP_1 \times \frac{(A+B)}{(A+C)}$$

where:

- $CP_2$ = New Series A Conversion Price
- $CP_1$ = Series A Conversion Price in effect immediately prior to new issue
- $A$ = Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding common stock, all shares of outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)
- $B$ = Aggregate consideration received by the Corporation with respect to the new issue divided by $CP_1$
- $C$ = Number of shares of stock issued in the subject transaction

If we put our values to above mentioned formula we get $CP_2=\$0.75$

As a share has been reduced from $1.00 to $0.75, initial 400,000 shares of preferred stocks should convert into 533,333 shares of common stock. Therefore the company has to give the first investor additional 133,333 shares of common stock.
The biggest problem with this kind of anti-dilution protection is the imperfection of the formula. Particularly, it does not work properly with big numbers in subsequent financial rounds.

Financial practitioners also alert about this problem. For instance, Destin (2009) (Fred Destin joined Accel in 2014 and focuses on consumer and software investments. He is the lead investor and board member at Deliveroo, Pillpack and KNC. Prior to Accel, he was a partner at Atlas Ventures for 10 years) explains this problem on an example: "Imagine the following happens: the pre-money valuation on your next round is less than the cash you raised previously. Say your company is in difficulty and raises $10M at $10M pre-money, having raised $10M previously. Because the anti-dilution calculation is iterative, guess what, the share price mathematically converges to… zero. Legally it will be set at the par value, say €0.0001.

Your ownership just evaporated. You are now relying on people’s ethics, sense of fairness, or belief that long-term you don’t build venture firms by screwing entrepreneurs.”

In our opinion, the protection of investors’ rights can’t merely relied upon people’s business ethics when there is a serious risk of losing ownership. All these relationships should be regulated in a legal state.

Full-ratchet anti-dilution

A “full ratchet” provision is the simplest type of anti-dilution provision. Full ratchet works by simply reducing the conversion price of the existing preferred to the price at which new shares are issued in a later round. So if an investor purchased 1,000 shares of preferred stock with full-ratchet anti-dilution protection for $10,000, or $10 per share, and in a future down round the company sells shares for $5 per share, and in a future down round the company sells shares for $5 per share, the investor’s preferred stock would be convertible into 2,000 shares of common stock ($10,000 ÷ $5), and each share of preferred stock would be convertible into two shares of common stock. In essence, the existing investor gets the benefit of the new, lower per share price for her prior investment. As a result, the common shareholders are significantly diluted just because they issued a single new share. As a rule next round investors don’t like full ratchet given to previous investors and they usually offer only two possible solutions to overcome the problem either original investors waive their full ratchet protection provisions or new investor walks away from the deal.
Full ratchet is easy and it’s the most advantageous way to handle dilution from the preferred investor’s standpoint but it is the most risky for the holders of any common stock. Thus, full-ratchet is the most burdensome on the common stockholders and it can have significant negative effects on later stock issuances. With this approach, the common stockholders bear all of the downside risk.

Full ratchet also makes later investment rounds more difficult. It is similar to give an investor a power of veto to control the company's next issuance as new investors have to get previous investor’s permission to raise any capital.

Fenwick & West LLP (2009) analyzed the terms of venture financings for 89 companies headquartered in the Silicon Valley showed that 97% of down rounds had a weighted-average, only 3% are full ratchet (0% have no anti-dilution provision). Therefore, the practice considers weighted-average more effective anti-dilution provision than full ratchet and besides, always seeks anti-dilution protection, otherwise shareholders know they will suffer dilution.

In summary, neither current legal nor practical solutions are effective enough to overcome dilution problem and protect minority shareholders from suffering losing their ownership. Current anti-dilution methods are merely capable to alleviate the dilution problem but are not completely solve it.

3.3 Right to property

It is of key importance to understand the difference of possession both in economic and legal sense. Historically, possession of goods has preceded the right to possess of goods. As Antony M. Honoré (1961, p. 115) says: ‘To have worked out the notion of ‘having a right to’ as distinct from merely ‘having’ … was a major intellectual achievement. Without it society would have been impossible. … It is not enough for a legal system to recognize the possibility of people owning things. There must be rules laying down how ownership is acquired and lost and how claims to a thing are to rank inter se.’

Atanasov, et al (2007) state that in order for an equity market to flourish, it has to develop mechanism that limits the dilutive consequences of equity issues, thus, the law is an
important mechanism that serves such preventive role in many markets and a variety of legal statutes have been designed to address dilution.

Researchers, as a rule, have examined either ownership in the light of economics or jurisprudence but not the notion of possession as a compound phenomenon. This existing reality is somehow natural, as those researchers were either economists or lawyers and their main objective was to satisfy their professional needs and interests. It rarely happens when a researcher is both economist and lawyer to examine an issue in comprehensive manner. Geoffrey M. Hodgson (2004) mentions “legal theorists and other commentators have long established a distinction between property and possession. According to this usage adopted here, possession refers to control of a resource, but property involves legally sanctioned rights. Strikingly, much of the ‘the economics of property rights’ literature concentrates on possession, ignoring or downplaying the issue of legitimate legal rights”.

Possession is a relationship between a legal person and a thing. It is physical control of the things, in other words, actual ownership while de jure ownership is a right to control the things including the formal title of ownership recognized by the authority. Therefore, if a de facto possession is a relationship between a legal person and a thing, legal ownership is a relationship between the owner, the state and third parties. Third parties are people who are obliged to regard the owners’ property rights, stay abstained from breaching their property rights, while the state has the obligation to regulate parties’ duties and rights in this process not to leave a room where legitimate expectations of owners or other parties can suffer a loss.

We differentiate two types of property: personal property and real property. Personal property (often called movable property) is anything other than land, such as money, stocks, patents, copyrights, intangible property. Real property (also referred to as immovable property) is land and anything attached directly to land including buildings, mines, ponds, dams. Personal property is itself subdivided into two categories: tangible and intangible. Tangible property includes all goods that can be touched, such as jewelry, buildings. Intangible property refers to all goods that can’t be touched as they don’t have any physical substance, for example patents, copyrights, stocks, bonds and other securities. Stocks held in companies are considered as personal properties throughout the whole world. We can’t touch, hear, taste or see a stock. A share of stock is a certificated paper representing someone’s
ownership in the corporation.

The right to property is guaranteed in many international legal acts. For instance, Article 17 of Universal declaration of human rights of 1948 states:

1. Everyone has the right to own property alone as well as in association with others.
2. No one shall be arbitrarily deprived of his property.

Another important document is the European Convention for the Protection of Human Rights and Fundamental Freedoms (“European Convention”). European convention is an international agreement between European countries to protect human rights and fundamental freedoms. Countries who want to become member of European Council have to ratify this agreement. European convention’s provisions operate in 47 European countries, thus making European convention as the main legal source in Europe. According to Article 1 of the first Protocol of the European Convention:

1. Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.

2. The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.

Article 1 of the first Protocol of the European Convention contains 3 rules:

1. The principle of peaceful enjoyment of possessions that is set out in the first sentence of the Article
2. Deprivation of property
3. Control of the property rights

The principle of peaceful enjoyment is an opportunity given to an owner to enjoy his ownership without any interference by the state or other people. Interference of the state to the first rule is permissible when there is a solid public interest (deprivation of property) or when it pursues general interest (Control of the property rights). States should aspire to set
fair balance between public interests and people’s fundamental rights, thus, the limitations of certain rights should not only pursue legitimate aim but also the measures to achieve such an aim should be proportionate to the pursued aim. The states have the margin of appreciation to deal with this proportionality but it is still binding with the principles of the European Convention. A court should always take into consideration if there were alternative solutions with less negative effects for owners when evaluating the proportionality of the means of interference in relation to the pursued aim.

Not only tangible goods but also assets including claims can be qualified as possessions when it is established properly. The claim is established properly when it is prescribed by law which make it enforceable. U.S. Supreme Court (1945) states “not all economic interests are "property rights;" only those economic advantages are "rights" which have the law back of them, and only when they are so recognized may courts compel others to forbear from interfering with them or to compensate for their invasion. ... Such economic uses are rights only when they are legally protected interests”.

In case of stock dilution we have economic legitimate expectations that are not protected in legal level. Any investor, regardless of the amount of money he invests and his relative power in the company expects his property to be protected by law. In other words, although minority shareholders suffer actual economic loses, there is no effective legal remedy to be protected from losing their property.

Generally, shareholders are not considered “victims” under European Convention, legal persons whose personal interests have been directly affected could have that status. ECHR in the case of Agotexim v. Greece (In this case as the company's business continued to decline, the shareholders' general meeting decided on 30 August 1983 to wind up the company and appointed two liquidators) states that shareholders, as a general rule, have no claim based on economic losses sustained by the company unless they show they have nor been able to use the remedies given in domestic level. ECHR notices that their complaint was based exclusively on the proposition that the alleged violation of the company's right to the peaceful enjoyment of its possessions had adversely affected their own financial interests because of the resulting fall in the value of their shares. They considered that the financial losses sustained by the company and the latter's rights were to be regarded as their own, and
that they were therefore victims, albeit indirectly, of the alleged violation. In sum, they sought to have the company's corporate veil pierced in their favour. ECHR further points out it is a perfectly normal occurrence in the life of a limited company for there to be differences of opinion among its shareholders or between its shareholders and its board of directors as to the reality of an infringement of the right to the peaceful enjoyment of the company's possessions or concerning the most appropriate way of reacting to such an infringement, such differences of opinion may, however, be more serious where the company is in the process of liquidation but anyway the applicant didn’t show that the liquidators failed to do their duties properly.

Actually, the ECHR said that the company should have applied to the Court as a legal entity but not their shareholders. It means Court examined not the current mechanisms correspondence to the Convention especially to the right to property guaranteed by the Convention but procedural correspondence of the case to current mechanisms operating in most countries. That is why one of judges, Mr. B. Walsh expressed his dissenting opinion;

“1. Joint stock companies are simply commercial devices for raising capital, particularly when large sums are required which would normally be beyond the private means of individuals. Nevertheless if such a company fails the ultimate losers are the individual shareholders. They have the power to liquidate the company even when it is doing well. They are the beneficial owners of the assets even though the legal ownership rests in the legal entity of the body corporate.

2. While it is true to say that such a body corporate has neither a soul to be damned nor a body to be beaten, nonetheless, the shareholders have and the existence of the corporate entity gives no protection to the shareholders as individuals against the loss in value of their shares or against criminal or civil liability for their individual activities in the commercial advancement of the companies.

3. It appears to me to be anomalous that the defense of human rights in the field of property, or otherwise, should yield to the
commercially sacred impenetrability of the "corporate veil".

4. In the present case the fact that the applicants are themselves bodies corporate does not affect the principle because such bodies are composed of individuals each of whom has property rights. Shareholders may complain of the violation of their own rights and insofar as they complain of injustice to their corporate image they are in fact seeking to protect their individual property rights to the extent thereof.

5. Ordinary joint stock companies are to be distinguished from special bodies created by statute or by royal grant which may not in fact have any shareholders.

6. In my opinion the applicant bodies may be treated as the collective face of the individual victims.”

We do agree with the judge, Mr. Walsh that institutions are means to serve the people not the contrary: as legal entities the existence of companies is justified as a form of cumulative power, skills, and investment of people that serves their economic interests. Barzel (1997), distinguishing “economic property rights” which is the ability to enjoy the property and “legal (property) rights” that the state assigns to a person, notes that economic rights are the end whereas legal rights are the means to achieve the end. Legal rights play a primarily supporting role. Therefore, we believe that a state should regulate such relationships in a way that not only majority shareholders’ but everyone’s property in the company is protected by law.

European Court of Human Rights (ECHR) recalls in his cases that European Convention is a “living instrument” which, must be interpreted in the light of present-day conditions (Judgment: Tyrer v. the United Kingdom, 1978). ECHR in the case of Henaf v. France (Judgment: Henaf v. France, 2003) points out: “... certain acts which were classified in the past as ‘inhuman and degrading treatment’ as opposed to ‘torture’ could be classified differently in future. It takes the view that the increasingly high standard being required in the area of the protection of human rights and fundamental liberties correspondingly and
inevitably requires greater firmness in assessing breaches of the fundamental values of democratic societies ...

This means that the European Convention develops the content of concrete human rights. Thus, human rights and freedoms guaranteed by the Convention are in dynamic development and not in a condition of static stagnation. In other words, a mechanism that is in conformity with certain human rights at an exact point of time may contradict to them in future.

States have negative binding obligations under the European Convention not to interfere enjoyment of a person’s possessions. But the authority also has positive obligations to provide effective means of ownership protection taking account owners’ legitimate expectations. A state is not only obliged to stay abstained from breaching someone’s rights to property but to regulate the relationship between owners in the process of exchanging property, doing businesses together, investing through funds that accumulates many people’s wealth, thus protecting everyone’s and every single owner’s rights to property. Grgic, et al (2007) mention that in determining the effects of legal relations between individuals on property, the Conventions organs check that the law did not create such inequality that one person could arbitrarily and unjustly deprived of property in favour of another.

As seen, states mostly left the regulation of fighting stock dilution to contractual relationships (practical anti-dilution solutions) which doesn’t include under the scope of Article 1 of 1st protocol of the Convention. Therefore, investors are not capable of having effective remedies to protect their legitimate interests. However, first sprouts of the need to take into account above mentioned concerns have already been seen in dissenting opinions of ECHR decisions.
Chapter IV

Findings

Stock dilution is a big problem especially in emerging markets where in one hand, lack of institutional traditions peculiar to financial markets, in the other hand, low legal awareness and underdeveloped legislation in financial services industry, create devastating threat on losing investors’ ownership. Dilution is practical problem rather than a pure theoretical one since it causes unacceptable wealth transfer from minority shareholders to the firm controlling ones.

Although a state’s legitimate interests lay in the need to protect everyone’s wealth regardless of the extent of their ownership in the company, minority shareholders in fact are not protected properly from adverse effects of stock dilution.

Neither current legal nor practical solutions are effective enough to overcome dilution problem and protect minority shareholders from suffering economic losses. Current anti-dilution methods are merely capable to alleviate the dilution problem but are not completely solve it.

Current situation of weak and therefore discriminatory wealth protection of minority shareholders contradicts to the principles of the right to property.
Chapter V

Limitations of the study

The main limitation of this study is the lack of existing literature (almost no literature) combining economic and legal aspects of the problem and overreliance on economic literature. Empirical research could not be done due to spatial and time constraints. This paper is thus based solely on courts decisions and a review of the findings of existing relevant studies. Besides, although suggested model solves the problem of dilution for shareholders, the study does not pay attention to economic possible impacts of suggested model on the activity of corporations regarding to the amount of investment they get according to current mechanism and also the influence of this model on state’s overall economy. These are questions of further examination.
Conclusion

Modern anti-dilution provisions are not able to completely solve stock dilution problem to protect minority shareholders’ wealth in the corporation. Current stock issuance mechanism might not directly contradict to the present perceptions of the right to property, but it doesn’t correspondent to the nature of above mentioned right having problems with the principles of it. We predict with full of hope, that both new researches on this topic and lawmaking process with the support of practical improvements and developments of human rights especially through activities of prestigious courts will lead to a big challenge to change traditionally accepted mechanism of stock issuance as soon as possible to bring it into conformity with the principles of the rights to property.
Alternative model

First of all we want to draw your attention that the main objective of this paper is not to design a new model with comprehensive research. We just want to give an idea rather than ready model about one of possible alternatives to present situation.

To our knowledge, we are the first to model a concept that completely solves the problem of dilution. It does not merely solve the problem but maintains the benefits that provided the old system: such as attracting funds and keeping investment opportunities for companies. In this new model it is forbidden for companies to issue new stocks. At a first glimpse, our suggestion banning new equity issues may seem cutting of our heads to cure a headache but if we take a closely look to the alternatives we offer in that situation we will have a complete picture of the model. The keystone of this model is that firms are only allowed to split existing shares rather than issue new ones. For instance, if in current model a company has let’s suppose 1000 shares of outstanding and issues extra 1000 shares and sell them, in our new model the firm can split each share let’s say to 2 shares and 1000 shares of the company will become 2000 shares without changing the owners of shares. If a shareholder had 50 shares, now he would have 100 shares. In contrast to present model that the company sells new issued shares, in this new model, only owners can sell their shares in the secondary market. And all secondary market will be kind of “taxed” by companies. We know that there is a capital gain tax in many countries for shareholders who sell their shares in the secondary market. Shareholders contribute certain percent of the profit they get from selling shares in the same logic. Every day people make billions of dollars through trading in stock markets. If shareholders don’t mind pay capital gain taxes to the state who doesn’t have direct impact on getting the profit for shareholders, they should not mind giving away a part of the profit to a company that actually makes the whole profit for its shareholders. These contributions can accumulate in an investment fund inside the company to serve its future development projects. To show the model in the imaginary way, we had better depict it a in a form of cake. If current model adds pieces from outside the cake (company), suggested model cuts the cake further into new pieces instead of adding new pieces. This approach can be first accepted by companies that are concerned of their shareholders rights to property, thus boosting their reputation of protecting their investors’ interests regardless of the size of investment. In the second level, when we see such model works in practice, it could be done
in legal level imposing all companies as an anti-dilution effective mechanism of protection. Although this model is yet in raw condition, we believe that the model can prove its effectiveness in action when it gets successful examination of time.
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APPENDIX

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METALLURGICAL CORPORATION OF CHINA LTD.*

(A joint stock limited company incorporated in the People’s Republic of China with limited liability)

(Stock Code: 1618)

ANNOUNCEMENT

ADJUSTMENTS TO MINIMUM ISSUE PRICE AND MAXIMUM NUMBER OF SHARES TO BE ISSUED UNDER THE NON-PUBLIC ISSUANCE OF A SHARES

References are made to (i) the announcements of Metallurgical Corporation of China Ltd.* (the “Company”) dated 19 February 2016 and 20 April 2016 and the circular of the Company dated 4 March 2016, in relation to, among others, the adjusted plan on the non-public issuance of A shares of the Company (the “Issuance Plan”), and (ii) the supplemental circular of the Company dated 5 April 2016 and the announcements of the Company dated 20 April 2016 and 28 April 2016, in relation to, among others, the profit distribution plan of the Company for the year 2015 and its implementation.

Pursuant to the Issuance Plan, the issue price of the non-public issuance of A shares of the Company (the “Non-Public Issuance”) shall be not less than RMB3.85 per share, and the number of shares to be issued shall not exceed 2,548,716,883 shares. In the event that there is any ex-rights or ex-dividends event of A shares of the Company such as distribution of dividends, issuance of bonus shares or capitalisation from capital reserve, etc. during the period from the price benchmark date to the date of the issuance under the Non-Public Issuance, the minimum issue price and the maximum number of shares to be issued under the Non-Public Issuance will be adjusted correspondingly.
So far, the profit distribution in respect of the A shares of the Company for the year 2015 has been completed. Adjustments are now made to the minimum issue price and the maximum number of shares to be issued under the Non-Public Issuance as follows:

1. The price benchmark date of the Non-Public Issuance is the date of the announcement in relation to the resolutions passed at the eighteenth meeting of the second session of the board of directors of the Company (namely, 20 February 2016), and the minimum issue price before adjustment was RMB3.85 per share. Pursuant to the profit distribution plan of the Company for the year 2015, the Company proposed to distribute a cash dividend of RMB0.055 per share (tax inclusive). Upon completion of the distribution, the minimum issue price of the Non-Public Issuance will be adjusted to RMB3.80 per share. The detailed calculation is as follows: Post-adjustment minimum issue price = Pre-adjustment minimum issue price – Cash dividend per share = RMB3.85 per share – RMB0.055 per share = RMB3.795 per share, which is rounded up to RMB3.80 per share.

2. The number of shares to be issued: The number of shares to be issued under the Non-Public Issuance before adjustment was not more than 2,548,716,883 shares. Upon completion of the implementation of the profit distribution plan of the Company for the year 2015, the maximum number of shares to be issued under the Non-Public Issuance will be adjusted to 2,582,252,631 shares. The detailed calculation is as follows: Post-adjustment maximum number of shares to be issued = Pre-adjustment maximum number of shares to be issued × Pre-adjustment minimum issue price ÷ Post-adjustment minimum issue price = 2,548,716,883 shares × RMB3.85 per share ÷ RMB3.80 per share = 2,582,252,631 shares (rounded down to a whole number).

Save for the above adjustments, other relevant matters in relation to the Non-Public Issuance remain unchanged.

By order of the Board
Metallurgical Corporation of China Ltd.*

Lin Xiaohui
Company Secretary

Beijing, the PRC
6 May 2016

As at the date of the announcement, the Board of the Company comprises two executive directors: Mr. Guo Wenqing and Mr. Zhang Zhaoxiang; two non-executive directors: Mr. Jing Tianliang and Mr. Lin Jinzhen; and three independent non-executive directors: Mr. Yu Hailong, Mr. Ren Xudong and Mr. Chan Ka Keung Peter.