RESPONSE TO HKEX CONCEPT PAPER ON WEIGHTED VOTING RIGHTS

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28 November 2014

Introduction

This is a joint response by the four investment banks listed on the cover. This response has been prepared principally by our respective Hong Kong equity capital markets and corporate finance teams advising issuer clients. Freshfields Bruckhaus Deringer have coordinated this response, and if you have any queries on it, you should contact their Teresa Ko and David Cotton in the first instance.

Question 1 - Should the Exchange in no circumstances allow companies to use Weighted Voting Right structures?

We do not consider that the Exchange should impose an absolute ban on companies using WVRs for the reasons set out below.

Global and regional competitiveness

In order for Hong Kong to remain an attractive financial centre for the listing and trading of Mainland Chinese enterprises, it is important for the Exchange to be competitive with other global exchanges and Mainland China exchanges. An absolute ban on WVRs would mean that Hong Kong would continue to be at a disadvantage to the United States, and therefore continue to be likely to lose a significant number of listings of Chinese corporations to the United States. In addition, looking to the future, an absolute ban risks Hong Kong being placed at a significant disadvantage to Mainland China exchanges if they change their rules to allow WVR structures - which we believe is a strong possibility given the large number of Chinese corporations that have chosen to list outside China.

Investor choice

The current absolute ban limits investor choice by preventing some investors from investing in companies that would otherwise choose to list in Hong Kong, while at the same time resulting in a situation where those investors who are able to invest in overseas listed securities are doing so without the benefit of the Hong Kong regulatory system or enforcement mechanisms, and generally at greater expense.

We believe that investors should be given the choice to be able to invest in companies with WVRs in Hong Kong, provided that (i) full disclosure is made of the relevant risks; (ii) conditions and restrictions apply to WVR structures (see out below); and (iii) the Hong Kong capital markets are efficiently priced so that the perceived risks associated with a company that has a WVR structure are adequately captured in the market price of its shares and investors therefore bear a price that fully reflects the risks and benefits of a company with a WVR structure.

In particular, we would like stress that while management entrenchment is often viewed as a potential concern with a WVR structure, in fact, some investors may wish to invest in a company in which management is entrenched through a WVR structure because they strongly believe in their ability to successfully run the business. They may want to insulate management from shareholder pressure to achieve short term financial returns and give them more freedom to focus on the long term interests of the company as well as protecting the company from opportunistic acquirers. As the Concept Paper notes, although empirical studies show that investors generally apply a discount to the share price of companies with WVRs to reflect the risks of management entrenchment, there is no consensus on whether the risks actually result in a negative impact on a company's performance. We believe that an absolute ban would deprive investors of opportunities to invest in companies where a WVR structure has a positive impact.

Effective enforcement regime

We believe that Hong Kong is well-equipped to protect investors from the risk of abuse through WVR structures. As discussed in more detail below, the Exchange, and particularly the SFC, possess a wide range of powers to protect investors who are prejudiced by issuers or their management and shareholders in violation of relevant laws and regulations. The SFC has actively used these powers on behalf of listed company shareholders and effectively obtained significant compensation from issuers and their management and advisers. In addition, there are number of statutory provisions through which investors can initiate private actions against listed companies directly.

Question 2 - Should the Exchange permit Weighted Voting Right structures:

(a) for all companies, including existing listed companies; or

(b) only for new applicants; or

(c) only for:

(i) companies from particular industries (e.g. "information technology" companies);

(ii) "innovative" companies;

(iii) companies with other specific pre-determined characteristics (e.g. size or history); or

(iv) only in "exceptional circumstances" as permitted by current Listing Rule 8.11?*

If respondents wish, they can choose more than one of the options (b), (c) and (d) above to indicate that they prefer a particular combination of options

New applicants vs. existing listed companies

We believe that WVRs should only be permitted for new applicants. As discussed further below, we believe that WVRs may be an appropriate structure for certain companies at an early stage in their development, but that the greater influence they give the founders of the business should reduce over time as the business becomes more mature. Accordingly, we do not believe that existing listed companies, which, by their nature, are generally more mature businesses, should be able to change their capital structures to a WVR structure.

Limiting WVR structures to new applicants would also mean that investors would never be in the position of having invested in a company with a one share one vote structure, but forced into holding inferior class shares following that company adopting a WVR structure without their consent (e.g. because it can be adopted by a majority vote). Permitting existing listed companies to convert to WVR structures, and the associated perception of potentially forcing some investors into holding inferior class shares, may also jeopardise the valuations of companies and have an adverse effect on their share prices, which would harm existing investors in those companies.

Size and sector based limitations and requirement for companies to be 'innovative'

We do not believe that companies eligible to have a WVR structure should be limited to companies in particular sectors or to companies which are 'innovative'. We consider that such a restriction would be arbitrary and hard to justify from a competitive position of Hong Kong point of view or an investor protection standpoint. For example, if WVRs were limited to businesses in the technology sector, this may limit Hong Kong's competitiveness by giving it a bias towards the technology sector when in the future WVRs could become commonly used in another sector. From an investor protection point of view, the risk profile of an issuer is not necessarily correlated with its sector. The Exchange may also experience difficulties in applying a sector based restriction because, as a practical matter, businesses with various features do not always fall neatly into one or other

sector classification. Likewise, there could be great difficulty in applying an 'innovative' company requirement, posing confusion to the market.

Similarly, we do not think that it would be appropriate to impose a size based limitation, since this would potentially discriminate against smaller companies, some of which may have equally or more effective corporate governance than larger companies.

Exceptional circumstances exception

The current "exceptional circumstances" exception is regarded by the market as effectively an absolute ban. In our view, the Listing Rules should be amended to permit WVR structures, with clear eligibility criteria so that companies and their advisers are able to easily understand what is permitted. We would however also suggest retaining the exceptional circumstances exception (i.e. in addition to new Listing Rules) so that the Exchange has the flexibility to list of companies falling outside the eligibility criteria, but which are nevertheless suitable for listing.

Question 3: If a company has a dual-class share structure with unequal voting rights at general meetings, should the Exchange require any or all of the restrictions on such structures in the US, or others in addition or in substitution?

If the Exchange were to permit dual class share structures, and WVR structures more generally, we would support the imposition of certain conditions and restrictions on companies with such structures to ensure sufficient investor protection.

When determining the types of conditions and restrictions to be imposed on companies with WVR structures, we suggest that the Exchange consider the matters listed below. However, to ensure that such conditions and restrictions are not unduly prohibitive taking into account an issuer's particular characteristics, we consider that a flexible and case-by-case approach should be adopted so that conditions and restrictions of varying degrees could be applied to each company on an assessment of its individual business, management and characteristics.

- Special voting rights generally to be limited to members of management of the company at the time of IPO ("founders"). One of the main reasons for a company to adopt a WVR structure is to give its management a degree of insulation from its ordinary shareholders. Although there are examples of successful long existing companies with a WVR structure, it is generally more appropriate for companies at an early stage in their development. This is because public investors will typically have less understanding of the business and its drivers than its founders at this stage, meaning that it may be in the company's and its investors' long term interests to give the founders insulation from ordinary shareholders, who may make short term decisions that are not in the company's interest due to a lack of understanding. WVRs are harder to justify for shareholders investing after the IPO or pre-IPO shareholders who are not involved in the management of the business, since they will generally not have this special knowledge, meaning that the potential benefits of a WVR structure may be outweighed by the risks associated with insulating management from ordinary shareholders. We believe that limiting holders of WVRs to founders involved in the management of a business would give investors an appropriate balance between the potential advantages of WVRs and the associated risks. We acknowledge that the Exchange may face practical differences in defining when a person is a founder. To address this issue, we would suggest that the definition is drafted broadly but that the Exchange has the ability to deem persons not to be founders if in substance it would not be appropriate to regard them as founders.

- Conversion to ordinary shares on certain trigger events. Once special voting shares are no longer owned by a founder[1], the shares should convert into ordinary shares. This is a natural consequence of the argument in the preceding bullet and such a rule would also mean that, over time, the power of the special voting founder block would be expected to decline, which is also consistent with the principle that WVRs should only be permitted for companies at an early stage of their development. It may also, or alternatively depending on the company, be appropriate for the special voting shares to convert into ordinary shares

[1] The Exchange would need to consider the extent to which a founder would be permitted to put its special voting shares into trust arrangements for the benefit of itself and associated persons.

when the company has achieved a pre-set strategic or growth milestone. In this case, the exact trigger event for termination for a WVR structure should be determined for each company individually based on the circumstances supporting the maintenance of such a structure. It may also be appropriate for such companies to conduct regular reviews and consider whether the reasons for maintaining a WVR structure remains valid. The Exchange may also consider setting a specific deadline for collapse of a WVR structure so as to prevent companies and their management from continually extending milestones.

- Minimum shareholding requirement for the founder group. We believe that in order to enjoy special voting rights, the founder group should have a minimum shareholding in the company at all times. This would ensure that their economic interests were aligned with those of ordinary shareholders and reduce the incentive for consumption of private benefits by the founders. We propose that the minimum shareholding percentage to be held by the founder group should be determined in accordance with the market capitalisation of each company. Companies with a larger market capitalisation should have a lower minimum shareholding percentage to ensure that the founder group is required only to hold an equity interest that is sufficient to align their economic interests with those of ordinary shareholders rather than an inordinately large equity interest in the company.

- Limitation on special voting rights ratio. A limitation on the special voting right ratio (i.e. the ratio by which the special voting shares have additional votes to ordinary shares e.g. 10:1) would have a similar effect as a minimum shareholding requirement – it would prevent the economic interests of the founder group being significantly different to ordinary shareholders and reduce the incentive for consumption of private benefits. The actual special voting shares ratio may be determined by the company upon due consideration of the degree of control that the founder management group desires to have on the company and the expected investor tolerance to a disproportionate voting ratio, although the Exchange may consider stipulating a ceiling to avoid abuse of this by the founder management group.

- Full disclosure. The listing document should clearly describe the WVR structure and the associated risks. It should also provide worked examples of how the WVR structure will affect the rights of ordinary shares (e.g. to pass resolutions at general meetings).

- Lock-up requirement. Since the key justification for WVRs is that they enable a company's management to manage the business with a long term view, and insulate them from ordinary shareholders' short term interests, it would seem appropriate for founder shareholders holding special voting rights to be locked up from selling their shares for a longer period of time than is required for controlling shareholders and to be locked up even if they hold less than 30% of the company's share capital.

- Different stock code. To ensure that investors are quickly and easily able to identify a company with WVRs without having to carry out further research, we would propose that companies with a WVR structure be required to have a stock code with a particular number prefix.

- Offering restricted to certain investors. Given that Hong Kong investors may not be familiar with WVR structures, the Exchange may consider limiting the offer of the offer shares at IPO for companies with WVRs to a placing only in the early stage of implementation. For example, limiting subscribers and purchasers to:
    - (a) persons falling under the definition of "professional investors" in Securities and Futures Ordinance; and
    - (b) other clients of an intermediary provided that the subscription price or purchase price payable by each client is subject to certain minimum amount (e.g. HK$1 million).

We note that the Concept Paper refers to the possibility of increasing independent non-executive directors' ("INEDs") powers. We do not believe that any increase in powers should extend to a requirement to appoint a greater number or percentage of INEDs. We are of this view because the shortage of quality INED candidates in Hong Kong and challenges in appointing INEDs with suitable experience for different businesses, would mean that companies would face substantial difficulties in satisfying any such requirement and it may well result in a further decline in the quality of INEDs of Hong Kong listed companies if companies satisfy the requirement by appointing low quality candidates merely to make up numbers.

Question 4: Should other Weighted Voting Right structures be permissible, and, if so, which ones and under what circumstances?

We do not believe that the Exchange should limit WVR structures to dual class shares. For example, the Alibaba Group partnership structure arguably provides investors with better protection than a simple dual class share structure since it enables investors to vote down directors nominated by the partnership or remove them from office at subsequent general meetings, whereas in a dual class share structure, investors holding the ordinary class shares are generally not able to block the holders of special class shares appointing a particular director, nor are they able to remove directors. The fact that Alibaba Group's shares commenced trading at more than a 30 per cent. premium at listing and as at 26 November 2014 traded at more than a 60 per cent. premium (in each case to the IPO offer price) shows that investors endorse and attribute a premium to the benefits of its partnership structure.

We would also support the concept of "loyalty shares". Under this structure, shareholders receive additional voting rights after holding shares for an extended period of time. This structure is popular in France where fully paid up shares registered in the shareholder's name accumulate a maximum of two votes per share over time, usually after at least two years of ownership. These loyalty shares do not form a separate class of shares and the double voting rights are lost upon transfer (subject to limited exceptions for transfers between relatives). Such a WVR structure encourages long term share ownership in companies without compromising investor protection.

Question 5: Do you believe changes to the corporate governance and regulatory framework in Hong Kong are necessary to allow companies to use Weighted Voting Right structures?

Changes in corporate governance and the Listing Rules

In order to minimize the risk of abuse of WVRs, we propose that shareholders of special voting rights should be required to adhere to a code of conduct setting out the general principles to taken into account when exercising special voting rights, which may include, among other things, paying due consideration to the company and shareholders as a whole and using voting powers only for the particular purpose(s) for which they were conferred.

In addition, depending on the specific restrictions and conditions imposed on WVR structures, it may be necessary to review whether the current connected transaction rules need to be amended to cater for special cases of connected transactions with members of management who hold special voting rights – for example a higher independent shareholder majority or absolute prohibitions in certain cases.

Other than what we have proposed above, we do not believe that any changes would be required to be made to the existing corporate governance and regulatory framework in Hong Kong to allow companies to use WVRs, taking into account that the existing Listing Rules already provide investors with protection against abuse of position by major shareholders and management (i.e. through the connected transaction rules), and the Exchange and SFC have extensive experience in applying and enforcing these rules. In addition, the Listing Committee approval process provides investors with the safeguard of needing the approval of a group of leading market practitioners in order to be listed.

We would also note that the Exchange, and particularly the SFC, have broad powers to seek remedies on behalf of investors who are harmed by issuers or their management and shareholders in breach of applicable laws and regulations. The SFC has used these powers in a number of recent high profile cases involving listed companies and obtained significant sums in compensation for investors. Investors are also able to take action in their own name under various statutory provisions.

Class action regime

We do not think that it is necessary for Hong Kong to have a class action regime before it can allow WVRs. The principal benefit of a class action regime is to enable smaller investors to claim compensation without incurring significant legal fees upfront or in the event that they are not successful. In Hong Kong, the SFC has the power to obtain compensation for investors and has done so on several recent occasions, as discussed in the next paragraph below. A class action system is therefore not needed in Hong Kong. Moreover, the SFC is arguably the best person to pursue securities litigation on behalf of investors given its statutory powers and responsibilities. A class action regime would also act as a significant disincentive to companies listing in Hong Kong – it would be hard to justify when balanced against the limited potential benefit that it would provide investors.

It is also worth noting the nature of the class action lawsuits associated with listed companies in the United States, the jurisdiction best known for class actions. The majority of class

action lawsuits are initiated on grounds of misrepresentation or misstatements in the registration statement or other regulatory filings as opposed to concerns of abuse of management or majority shareholder powers, which may be more efficiently dealt with by regulators.

Question 6: Do you have any comments or suggestions regarding the additional matters:

(a) using GEM, a separate board, or a professional board to list companies with Weighted Voting Right structures; and

We do not believe that companies with WVRs should be required to list on a separate board – companies with WVRs should be able to list on the Main Board or GEM, depending on eligibility. We believe that requiring companies with WVRs to use a specific stock code prefix would provide investors with sufficient, and quick and easy notice of a company having WVRs.

However, if the Exchange concludes that allowing companies with WVRs to list on the Main Board is not supported by the market, we believe that consideration should be given to allowing companies with WVRs to list on the Exchange's Growth Enterprise Market (*GEM*). Given that GEM is a specialist market, catering for smaller, typically more risky issuers, this would reduce the investor protection concern by ensuring clear awareness of the additional risks associated with WVRs among investors.

(b) the prospect of overseas companies seeking to list for the first time on the Exchange with a Weighted Voting Right structure or seeking a further primary or secondary listing here?

We believe that overseas companies with WVRs wishing to list in Hong Kong should generally obtain a primary listing (including a dual primary listing if already listed overseas) so that they are subject to the full requirements of the Listing Rules, ensuring that investors obtain the maximum level of protection available under the Listing Rules.

However, we would not wish to exclude companies with WVRs from obtaining a secondary listing in Hong Kong, particularly those with a global business that may not choose to list in Hong Kong if they can only do so a primary basis. It may be appropriate to impose a higher entry requirement for such companies – for example based on the test for the automatic waiver regime under the Revised Joint Policy Statement regarding the listing of overseas companies which requires an issuer to have been primary listed on a recognised stock exchange for a minimum period of time, well established and with a good compliance history, to ensure that investors are adequately protected notwithstanding the lighter touch rules afforded by the secondary listing regime. In addition, it may be necessary to make certain provisions of the Listing Rules that would ordinarily be waived for such companies mandatory, in light of the greater power of the founder shareholder group, such as the connected transaction rules.

Question 7: Do you have any other comments or suggestions regarding Weighted Voting Right structures?

Risk of Mainland China exchanges permitting WVRs

We believe that there is a significant risk that in the coming years one or more Mainland China exchanges, or markets within those exchanges, will modify its rules to permit companies with WVR structures to list. This would be an obvious move to ensure that large Chinese companies that come to market in the future choose to list in China rather than the United States. Moreover, with the China market gradually opening to international investors (including notably through the recently launched Shanghai-Hong Kong Stock Connect Program), it may soon become a real alternative to Hong Kong and the United States for international equity trading and investment. It is accordingly critical that Hong Kong acts now to ensure that it is able to retain and protect its position as the natural listing destination for Chinese businesses.

Allowing WVR structures is an incremental rather than fundamental change

It has now been 20 years since the introduction of H shares to the Exchange. This was a highly significant change in the type and risk profile of issuers eligible to list in Hong Kong and it would arguably be considerably less of a significant change to allow WVR structures – which are already accepted by investors and other major regulators. Since the introduction of H shares, the Hong Kong market has matured considerably, and we believe that it is now mature enough for investors to be given the choice to invest in companies with WVRs structures, provided that they do not come to market with considerably less protection than would normally be expected of them if they were listed in other worldwide recognised jurisdictions. Moreover, Hong Kong's highly developed and prescriptive listing regime and strong enforcement track record will ensure that by opening the door to WVR structures, we are not potentially exposing investors to unacceptable risks. We believe that Hong Kong is now sufficiently mature to allow WVR structures.

Flexible restrictions for shareholder protection

Concerns about investor protection feature significantly in the discussion about whether companies with WVRs should be permitted to list in Hong Kong. However, it is important that any investor protection measures imposed on companies with WVRs interfere to a minimum with the running of an issuer's business and do not adversely affect Hong Kong's global competitiveness. Accordingly, we believe that the Exchange should impose restrictions and conditions in a flexible way that ensures sufficient investor protection while ensuring that companies are not unduly inhibited in the operation of their business or dissuaded from coming to Hong Kong in the first place. At a practical level, this would mean that some or all restrictions and conditions would be imposed on a case by case basis and/or there is a clear route to obtaining waivers where particular restrictions and conditions are not appropriate for an issuer.