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RESEARCH REPORT

LISTING REGIME REFORMS FOR DUAL-CLASS SHARE STRUCTURE AND BIOTECH INDUSTRY — SUMMARY

Chief China Economist's Office
Hong Kong Exchanges and Clearing Limited

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SUMMARY

In the light of the current global economic restructuring and an expanding number of growth companies in Internet, high-tech and biomedical research and development (R&D) industries, a listing regime for weighted voting rights (WVR) has been introduced or is being considered by major international financial markets, like the US, the UK and Singapore, to facilitate the listing and financing of such companies.

The primary concern about adopting a listing regime for WVR is the separation of management control and cash-flow rights ownership, which is expected to aggravate the corporation's agency problem[1] and undermine the management's accountability to shareholders. However, a dual-class share structure is conducive to a start-up's long-term development, especially if it is an innovative technology company with substantial initial investment, high uncertainties and high growth potential. To be specific, a dual-class share structure helps an innovative company build its long-term value, incentivises the founders to instill the company with greater innovation and more human capital, and forestalls hostile takeover attempts. To a certain extent, it is also seen as a self-protective measure taken by start-ups to avoid market short-term behaviour when there is an over-concentration of institutional investors in the financial market. Moreover, according to some empirical studies, corporate values were improved and agency costs were reduced after a dual-class share structure had been adopted.

Certainly, there is still much debate in theoretical and empirical studies as to whether a dual-class share structure incurs higher agency costs than a single-class share structure and is therefore less conducive to the protection of shareholders' rights. So how can a company with a dual-class share structure enhance internal supervision to ensure effective monitoring of its controlling shareholders? Several options have been suggested: (1) imposing suitable restrictions over the use of super voting rights, including the cap of voting rights ratio of WVR shares relative to other ordinary shares, and a clear delineation of the applicable scope of super voting rights; (2) establishing clear exit and transfer mechanisms for super voting rights, including the commonly known "sunset clauses" and restrictions on the transfer of super voting rights; (3) enhancing corporate governance and the parallel use of internal and external control mechanisms.

In April 2018, HKEX put forward in its related consultation conclusions[2] new measures for allowing dual-class share structures while imposing control and restrictions as appropriate. Under the new measures, applicants are required to possess certain characteristics before they can list with WVR. HKEX will reserve the right to reject an application on grounds of unsuitability to list if the applicant's WVR structure extremely deviates from governance norms (e.g. ordinary shares carry no voting right at all). HKEX also put forward detailed investor protection measures that are applied to WVR companies after their listing. These include measures that restrict the power of WVR, protect the voting rights of non-WVR shareholders, and strengthen corporate governance and disclosure. Issuers with WVR structures will be differentiated from others through a unique stock marker "W" after their stock name. In addition, WVR beneficiaries must be directors of the issuers to ensure they operate the companies with a director's obligations as set out under laws and regulations. The WVR attached to a WVR beneficiary's shares will lapse once the WVR beneficiary transfers the WVR shares to another person, or dies or is incapacitated, or ceases to be a director. WVR are therefore subject to natural sunset clauses and will not exist indefinitely.

[1] In corporate finance, the "principal-agency problem" (or "agency problem") usually refers to the conflict of interest between a company's management and the company's shareholders. The managers, acting as the "agents" for the shareholders, or the "principals", are supposed to make business decisions that will maximize shareholders' wealth but the managers may be motivated to act in their own best interest, which may be contrary to those of their principals.

[2] See *Consultation Conclusions to the Consultation Paper on a Listing Regime for Companies from Emerging and Innovative Sectors*, published by HKEX on 24 April 2018 (http://www.hkex.com.hk/News/Market-Consultations/2016-to-Present/February-2018-Emerging-and-Innovative-Sectors?sc_lang=en).

Meanwhile, HKEX would introduce a new chapter in the Listing Rules to open a route to listing for early-stage companies that do not meet the financial eligibility tests, including biotech companies with no revenue or profits. The biomedical sector differs from other sectors mainly in that it is characterised by having substantial investment, high-value outputs and high risks, and being technology-intensive. As a result, biomedical enterprises usually adopt equity financing rather than debt financing during their growth period. Investing in early-stage biotech companies that do not have any prior record of generating revenue would be something new to Main Board investors. However, the regulation by internationally recognised bodies such as the U.S. Food and Drug Administration (FDA) and the stages involved in their approval processes provide investors with an indication as to the nature of the biotech companies and a frame of reference with which to judge the stage of development of the regulated products to be produced by these companies. Today, many major securities markets in the world have in place securities rules for biotech companies.

Based on the unique characteristics of biomedical start-ups (no profit or revenue for a long time before and after listing) and their risk profile, HKEX would introduce a new chapter in the Listing Rules to make the rules better satisfy the needs of biomedical and other new-economy companies, so as to attract more capital to the high-risk and high-return biotech sector and promote the long-term development of the biomedical industry. Investors in the Hong Kong stock market are believed to be more familiar with relevant Mainland laws and market conditions than Nasdaq investors, and would be more experienced in evaluating the risks of investing in Mainland biomedical companies. Mainland investors can also buy biotech stocks listed in Hong Kong via Stock Connect. Both factors contribute to the formation of a sound investor base and a financing and investment environment that favours vibrant biotech companies of good potential.

Moreover, the new Listing Rules recognise China Food and Drug Administration (CFDA) as a regulator qualified to assess biotech products, putting it on par with the US' FDA and the European Medicine Agency (EMA). The recognition of Mainland drug standards would facilitate the use and promotion of the Mainland standards in the international market.

No doubt, the availability of a new financing platform in Hong Kong for biomedical companies will provide an exit channel for venture capital funds that have invested in such enterprises at pre-IPO stage. This will encourage more venture capital and private equity funds to invest in the biomedical field, and facilitate public offerings by biomedical enterprises to raise new funds based on the progress of their clinical experiments and their latest corporate plans.

To sum up, appropriate reforms in the listing regime with suitable listing rules will encourage the emergence of giant innovative biotech companies, contribute to the development of new-economy industries within the region, help upgrade the regional economy and expand its horizon. This is the kind of long-term positive impact that capital market reforms could have on the Hong Kong economy.