

HKEx Concept Paper on Weighted Voting Rights
Response from Slaughter and May

We set out below some general comments and observations in relation to the issues raised in Hong Kong Exchanges and Clearing Limited (“**HKEx**”)’s Concept Paper on Weighted Voting Rights. We also briefly respond below to the specific questions raised in the Concept Paper. As a general comment at the outset, we commend the Concept Paper on being balanced and well-researched.

Introduction

1. In summary, we believe there are circumstances in which the “one-share, one-vote” concept should not be rigidly applied. It should be measured against the goal of achieving the right level of investor protection while accommodating the wishes of the owners of a new applicant who wish to maintain a higher level of control, albeit with less than a majority of the equity shares.
2. Hong Kong benefits from a highly developed legal and regulatory system in which investors are protected against directors and majority shareholders favouring themselves or their connected persons at the expense of other shareholders (who would generally be a minority). We believe that new applicants with an A/B (weighted voting rights) structure would generally fit within the existing legal and regulatory framework in Hong Kong with the result that Hong Kong investors would be afforded the same degree of protection while also being allowed to choose for themselves whether they wish to invest in a company with such a structure.
3. We also believe the Listing Committee should be encouraged or empowered to exercise its discretion under Listing Rule 8.11 to approve the listing of companies with other minority control structures, as long as the applicant proposing the structure voluntarily (through its statutes of incorporation or otherwise) binds itself to the relevant Hong Kong investor protection provisions which are not otherwise readily applicable to it (see further below).

Proportionality

4. With regard to the issue of proportionality discussed in paragraph 57 of the Concept Paper, we observe that while investors in Hong Kong listed companies currently do have a degree of proportionate risk and reward, ultimately in practice there are very few circumstances in which (to give just two examples) the level of dividend or the composition of the board is actively influenced by public investors. This is because those investors are generally in the minority.

Value shifting

5. Regarding the risk of value shifting (paragraph 59), this is a risk that is equally common to both existing listed family or SOE controlled companies with large non-listed private groups, as well as companies with weighted voting rights structures. This risk can be

mitigated for companies with weighted voting right structures in the same way as it is now for listed companies i.e. under the connected transaction rules and other rules requiring an independent shareholders' vote, as well as the import of Hong Kong law principles on directors' duties through Listing Rule 3.08.

Moral hazard

6. A key discussion point in relation to proportionality is the moral hazard of having a small minority being able to manage a company and make decisions which ultimately turn out to be poor but they suffer the economic consequences much less than the other shareholders. Poor management by a family-controlled board in a large family-controlled company will have equal proportionality consequences for the family shareholders as for the minority public shareholders. While this is a factor against weighted voting rights structures, one could also point to a number of companies over the years where directors' poor decision-making has caused ruin for shareholders, sometimes resulting in new legislation or regulation, sometimes in claims for breach of directors' duties, and other times where there has been no legal redress since there has been no culpability other than poor judgement. However, in general, these directors have not been entrenched by weighted voting rights. Therefore, this is where the arguments of full and clear disclosure and the free decision-making of the investing public versus not allowing weighted voting rights are particularly acute.

Class actions

7. We query whether investors would necessarily be prejudiced by the lack of a class action legal system in Hong Kong if they were provided with the ability to invest in companies with a weighted voting rights structure. The combination of Hong Kong rules of law regarding the fair treatment of shareholders (as also adhered to in many other jurisdictions) as well as the Hong Kong investor protection regime (principally under the Securities and Futures Ordinance ("SFO")) are a counter-weight to the risk of the minority controllers acting in their own self-interest to the prejudice of the other shareholders.
8. While it is accepted that the cost of going to Court can be prohibitive, a US-style class action system (and the potential cost savings it might bring for individual litigants) would not be a necessary addition to the Hong Kong investor protection regime if companies with weighted voting rights were to be allowed to list in Hong Kong. However, we note the Department of Justice has established a cross-sector Working Group to consider the Law Reform Commission's proposal that a mechanism for class actions should be adopted in Hong Kong.
9. Until then, the current combination of regulatory enforcement and the Hong Kong legal system should be sufficient with respect to companies with weighted voting rights structures. The situation for Hong Kong shareholders is not materially altered whether they invest in a company with a family/SOE controlling block of shares or a minority controlling stake in a company with weighted voting rights or other control structures. While bad behaviour will take place from time to time, it is hard to judge whether the deterrent effect of the US-style class action lawsuits would have a greater effect than the threat of censure and fines by the regulator and/or shareholders bringing proceedings in the Hong Kong court.

Takeover Code

10. As mentioned in the Introduction, the simplest form of A/B weighted voting rights structure would generally fit within the existing securities regulatory regime in Hong Kong, including the application of the Takeover Code 'control' test. This is because the basis of the Takeover Code is control over voting rights in a public company. However, other structures under which a higher degree of control is maintained by a minority over, say, the appointment of directors or veto rights through the company's constitution will not fit so readily within certain aspects of the current investor protection regime. For example, the control test in the Takeover Code may be harder to apply where control is maintained through means other than the exercise of voting rights.

Connected transactions

11. The weighted voting rights proposal by way of A/B class shares should not require a change to the connected transaction rules under Chapter 14A of the Listing Rules. The connected transactions regime regulates transactions between a listed issuer and its connected persons, including its substantial shareholders. A "substantial shareholder" is any person who is entitled to exercise, or controls the exercise of, 10% or more of the voting rights at any general meeting of the company. The Exchange also has the power to deem any person to be a connected person (Rule 14A.07(6)). If a shareholder or group of shareholders has weighted voting rights giving the power to exercise, or control the exercise of, 10% or more of the voting rights - e.g. in respect of the power to appoint directors to the board of the listed issuer at a shareholders' meeting – they would fall within the definition of "substantial shareholder" under the Listing Rules and would therefore be a connected person.
12. If a new applicant came forward with a structure that would appear to circumvent the connected transaction rules - e.g. through a superior board control structure - the Exchange could still make sure the relevant person(s) holding that power fall within the ambit of Chapter 14A through its deeming power referred to above.

Disclosure of interests under Part XV SFO

13. Subject to one point highlighted below, the Hong Kong disclosure of interests regime appears to be set up to accommodate weighted voting rights – in the sense that:
- (a) disclosures are made in respect of voting shares in a listed corporation;
 - (b) those voting shares may be listed or unlisted; and
 - (c) the 5% threshold for what constitutes a "substantial shareholder" under the SFO applies in respect of each class of voting shares.
14. In the case of Swire Pacific Limited – the only company listed in Hong Kong with a dual class structure – separate disclosure is made under Part XV of the SFO in respect of notifiable interests in the 'A' and 'B' shares.

15. “Voting shares” are shares of a class which carry rights to vote in all circumstances at general meetings. However, if a weighted voting structure did not satisfy this definition of “voting shares” – e.g. the ‘B’ shares carry a right to vote only in certain circumstances, such as in relation to appointment of directors – the ongoing disclosure obligations under Part XV of the SFO would appear not to apply to those shares. This would require an amendment to the SFO.

Listing Rule 8.11

16. It may be hard to change the regulatory framework to cater for a whole variety of minority control structures. For alternative structures which are not simply based upon A/B class shares, flexibility needs to be afforded to the Listing Committee to consider such structures. Where there are potential deficiencies in the investor protection regime - for example, there is no clear application of the Takeover Code “control” test – the new applicant should provide a detailed analysis of the compatibility of the proposed structure with the then current investor protector regime and could be obliged to provide remedies e.g. through voluntary additions to the new applicant’s statutes of incorporation. For example, there are companies that have changed domicile and ceased to be subject to parts of the UK Takeover Panel’s jurisdiction but, to reassure shareholders, these companies have written parts of the UK Takeover Code into their statutes so as to adhere to the UK Takeover Code rules voluntarily.

Consultation Questions

In answer to your specific questions:

1. We believe weighted voting rights structures should in principle be permitted.
2. (a)(b) The Exchange should permit weighted voting rights structures only for new applicants. We believe that as a first step companies listing with a weighted voting rights structure should have a large market capitalisation. We do not believe existing listed companies should be able to change their structures as otherwise shareholders which have subscribed for shares on the basis of equal voting rights may be prejudiced. Existing issuers wishing to adopt a weighted voting rights structure should provide shareholders with a reasonable exit through delisting, and reapply for a new listing with the weighted voting rights structure.
- (c) We do not believe the weighted voting rights proposal should be limited to any particular type of company or industry. It would not be fair for this only to be made available to certain industries.
- (d) We believe the “exceptional circumstances” provision under Listing Rule 8.11 should be available for companies that seek to list with control provisions other than A/B class shares and the Listing Committee should be empowered or encouraged to exercise its discretion accordingly.
3. We do not see in paragraph 153 of the Concept Paper a set of restrictions that is applied to all companies universally. We believe there is merit in requiring the extra control

elements to lapse if the shares are transferred outside of the immediate controlling group or the control proportion becomes too low compared to the number of non-control shares in issue (for example a 15% ratio).

4. Yes, please see above our view that it should be for those advocating a new structure to establish how the existing investor protections can be maintained.
5. We believe that very few changes would be necessary if only A/B weighted voting rights shares were to be allowed.
6. (a)(b) We believe that flexibility is required to attract overseas companies with alternative structures but which agree to be bound by Hong Kong's investor protection regime. We do not believe companies with weighted voting rights structures should be listed only on a particular board or on GEM. What matters is the quality of the company, a high level of disclosure and maintenance of high investor protection standards. Both primary and secondary listings should be encouraged.
7. We have no further comments at this stage.

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