HKSFA 25th Anniversary
香港財經分析師學會
THE HONG KONG SOCIETY OF FINANCIAL ANALYSTS

21st March 2018

Sent by Email and by Post

Corporate and Investor Communications Department
Hong Kong Exchanges and Clearing Limited
12/F, One International Finance Centre
1 Harbour View Street, Central
Hong Kong

Dear Sirs/Madams,

Re: Consultation Paper on a Listing Regime for Companies from Emerging and Innovative Sectors

The Hong Kong Society of Financial Analysts (HKSFA) is in strong agreement with CFA Institute that equal voting right is the best corporate governance structure to safeguard the interest of the general public.

If in any case the WVR structure be adopted, HKSFA is of the opinion that proper procedures and policies, such as limitation of maximum voting rights, time-based sunset clauses and enhanced corporate governance structures for WVR companies should be included.

Our specific response to this consultation paper is as enclosed in this letter.

Thank you for your attention.

Yours sincerely,
For and on behalf of
The Hong Kong Society of Financial Analysts

Charles Chui, CFA
Co-chair, Advocacy Committee

Claudius Tsang, CFA
Co-chair, Advocacy Committee

14/F, BOC Group Life Assurance Tower, 136 Des Voeux Road Central, Hong Kong.
Tel : (852) 2521 2543 Fax : (852) 2869 4800 E-mail : info@hksfa.org URL : http://www.hksfa.org A MEMBER SOCIETY OF CFA INSTITUTE

CFA Institute

23/F Man Yee Building
68 Des Voeux Road
Central, Hong Kong SAR

+852 2868 2700 tel
+852 2868 9912 fax
info@cfainstitute.org
www.cfainstitute.org

21 March 2018

Corporate and Investor Communications Department
Hong Kong Exchanges and Clearing Limited
12/F, One International Finance Centre
1 Harbour View Street
Central, Hong Kong

Re: Consultation Paper – A listing regime for companies from emerging and innovative sectors

Dear Sir,

We are responding to the above consultation conducted by the Hong Kong Stock Exchange (HKEx).

CFA Institute[1] appreciates the opportunity to offer comments to HKEx on its consultation paper entitled "A listing regime for companies from emerging and innovative sectors". In this response, we wish to focus on aspects related to the introduction of weighted voting rights (WVR) structures,[2] which is an area the CFA Institute has a particularly strong opinion on. CFA Institute represents the views of those investment professionals who are its members before standard setters, regulatory authorities, and legislative bodies worldwide about issues affecting the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues affecting the efficiency, integrity and accountability of global financial markets.

Before setting out our position on your consultation, we would like to highlight that CFA Institute remains steadfast in the belief that there **should not be any unequal voting rights.** Our views are in-line with what the Legislative Council suggested in 2015,

> *Voting is the* ***key right enjoyed by shareholders*** *and it is a tool for them to express views on important matters of the invested companies. In Hong Kong, listed companies must ensure that the voting power of their shares bears a reasonable relationship to the equity power of those shares. In other words,* ***the right of a shareholder to vote should be proportional to the size of his or her shareholdings, and this is reflected by the "one-share, one-vote" standard.***
>
> Legislative Council Secretariat, 2015[3]

Shareholders are entitled to voting right as a tool to express their views on important, and at times contestable, matters related to invested companies. The introduction of a structure

---

[1] CFA Institute is a global, not-for-profit professional association of more than 150,000 investment analysts, advisers, portfolio managers, and other investment professionals in 165+ countries and territories. The CFA Institute membership also includes 151 member societies in 70+ countries and territories.

[2] Also sometimes referred to as companies with dual-class shares structures

[3] Ng, T (January 2015) Understanding "weighted voting right structures". Legislative Council.

permitting disproportionate votes to one group of shareowners would allow a minority shareowner to override the desires of most owners for personal benefits, or other benefits not in the best interests of shareholders as a whole. Therefore, unequal voting rights would **weaken the checks and balances between shareholders and management, and immunize management against stakeholders' critics and accountability, leading to potential entrenchment issues**. In short, it remains our primary position that Hong Kong should retain the corporate governance gold standard of "one-share, one-vote".

In addition, while we understand the commercial imperative for HKEx to attract technology or "new economy" stocks, we remain unconvinced that allowing companies with WVR to list is the right strategy to compete in the global IPO business, as it is easily replicated and indeed being actively pursued by at least one other market in the region. If WVR becomes the lowest common denominator, what is Hong Kong's competitive advantage? Recently, there have also been reports that Chinese tech companies listed overseas may be allowed to list Chinese depositary receipts on mainland exchanges, giving them direct access to domestic investors. In that scenario, what is Hong Kong's unique selling proposition?

Nonetheless, it is observed that, in the emotive debate of introducing WVR structures to the Hong Kong market, the long-standing bedrock of high corporate governance standards appears to have been compromised, giving way to the battle for competitiveness and relevance. Therefore, **in the *probable* case where companies with WVR structures are introduced to the Hong Kong market, CFA Institute recommends that safeguards must be in place to protect shareholders from self-dealing and other misuses of corporate resources by company insiders for personal gain, or other actors not in the best interests of shareholders as a whole. Other safeguards should also be in place to mitigate risks of weakening corporate governance.**

Proper Safeguards Must be in Place amidst WVR Structures

In the event WVR structures are introduced, we agree in principle with certain safeguard provisions proposed in the consultation paper, including the permanent lapse of the WVRs attached to a beneficiary's shares when he or she i) dies, ii) stops being a director, iii) is deemed incapacitated, or iv) does not meet the requirements of a director (Paragraph 154). In addition, we also support the HKEx's demand for the establishment of a Corporate Governance Committee, a Nomination Committee that is made up of a majority of and chaired by independent non-executive directors (INEDs), and that INEDs should retire after three years of services (Paragraphs 137-140). Moreover, we also agree with the HKEx's proposal to prohibit companies from increasing the proportion of WVRs (Paragraphs 113-115).

At the same time, we believe the proposed measures do not go far enough and we urge HKEx to consider further safeguards as highlighted below:

I. Mandatory corporate governance provisions

The Hong Kong Listing Rules contain a Corporate Governance Code which sets out the principles of good corporate governance and contains code provisions that impose an obligation to "comply or explain". For companies with WVRs, we believe the code provisions highlighted below should be made **mandatory** to ensure investor protection:

- Separation of the roles of chairperson and chief executive
- Appointment of an independent chairperson
- Appointment of a majority of INEDs to the board

Having an independent chairperson and a majority of INEDs on the board are leading best practices and will enable the board to take a long-term view, maintain high corporate governance standards, and set a more accountable, pro-shareholder agenda.

II. ***Need for stronger sunset provisions***

II(A). Need for time-based sunset provisions

We urge the HKEx to consider mandating time-based sunset provisions, which will mean the automatic conversion of super voting rights to regular voting rights on a "one-share, one-vote" basis after an agreed period between management and investors.

As a safeguard against WVR structures, **time-based sunset provisions limit preferential voting rights to a defined period, and, in turn, relieve minority stakeholders of permanent exposure to moral hazard.** Our view is also in-line with Robert J. Jackson Jr., the new U.S. Securities and Exchange Commissioner (SEC) who proposed that companies and their management should not be given preferential voting rights in a perpetual manner in his recent address.[4] CFA Institute considers a mandatory sunset provision that automatically converts super voting rights to regular voting rights in three, or at most five years, to be appropriate.

Referring to a SEC preliminary study that covers some 157 stocks that had been listed with WVR structures since early 2000s, Commissioner Jackson suggested that firms with perpetual WVR structures had been traded at a significant discount to those with time-based sunset provisions. Whatever advantages a founder or an entrepreneur might bring to a company in its early years post-IPO would fade over time. He added that firms that had given up their WVR share structures saw a significant boost in company valuations. These findings illustrate the need for such time-based sunset provisions.

Noting that WVR structures do not provide equitable treatment of investors, such sunset clauses have been adopted by reputable technology-related companies when they went public in recent years, such as Mulesoft (2017), Fitbit (2015), Yelp (2012), Workday (2012) and Groupon (2011).[5] The silver lining in recent developments is that a small but growing number of dual-class companies are adopting time-based provisions.

We note that HKEx plans to undertake a separate consultation on *Corporate WVR Beneficiaries* (Paragraphs 156-159). The *potential* perpetuity of corporate super voting rights makes the need for time-based sunsets even more acute. In the event that Corporate WVR Beneficiaries became an option, we are of the view that time-based sunsets are a must.

[4] R. J., Jackson (Feb 2018) Perpetual Dual-Class Stock: The Case Against Corporate Royalty, U.S. Securities and Exchange Commission.
[5] Council of Institutional Investors (Feb 2018) Time-Based Sunset Approaches to Dual-Class Stock.

II(B). Need for look throughs / anti-avoidance measures

On a related note, while we agree in principle with the event-driven safeguards as proposed by HKEx, we question if and how such safeguards would apply for shareholders who vest their shares, say, in a trust or a foundation. Regardless of the outcome of the consultation on *Corporate WVR Beneficiaries*, anti-avoidance measures need to be established to prevent circumvention of sunset provisions.

III. Lower maximum voting differentials

We appreciate HKEx's attempt to set limitations on the maximum voting differentials, which could be considered as a measure to reduce entrenchment issues and is a common practice in some European markets.[6] However, **we strongly disagree with the proposed 10-to-1 maximum voting differential** (Paragraph 125).

According to the Global Governance Principles of International Corporate Governance Network (ICGN), the misalignment of economic interests and voting rights could result in managerial entrenchment.[7] Similarly, the Organisation for Economic Co-operation and Development also suggests that a higher degree of economic involvement by management could lead to lower transaction costs and discourage opportunistic behaviors.[8]

As requirements are currently laid out in the proposal, a shareholder with 9.1% economic stake in a company would possess over 50% of the voting rights.[9] In this setup, management would have more incentives and opportunity to act for personal benefits than on behalf of other stakeholders. Such a lax corporate governance structure may lead to or induce management entrenchment, and, therefore, **lowering the ratio – to 2:1, or, at most, 3:1 –[10] would be more effective in holding the company management properly accountable** for their actions (i.e. they would need to have higher economic stake in the companies), thereby mitigating expropriation and entrenchment risks.

In order to come up with an optimal level of maximum voting differential, it is of our view that a thorough regulatory impact assessment (RIA) should be conducted to rationalize the conclusions and decisions that will be made.[11] Ideally, such a RIA would provide a detailed analysis of the specific "positive and negative effects of proposed and existing regulations and non-regulatory alternatives," which will be conducive to balancing the costs and benefits of future actions.

IV. Higher minimum/maximum economic interest

If the limits of maximum voting differential are adjusted, we believe it will also be justifiable to amend the minimum and maximum economic interest requirements for WVR companies, which are currently proposed to be 10% and 50% respectively (Paragraph 116).

[6] Shearman & Sterling LLP (2007) Proportionality between Ownership and Control in EU Listed Companies: Comparative Legal Study.
[7] ICGN (Feb 2017) Differential share ownership structures.
[8] Maher, M., and Anderson, T. (1999) Corporate governance: Effects on firm performance and economic growth. OECD.
[9] We are aware of the fact that the consultation paper has explicitly demanded WVR beneficiaries own no less than 10% of economic stake on an aggregate basis (Paragraph 116).
[10] If the maximum voting differential is set at 3:1, owners of shares with higher voting rights would need 25.1% equity stake to have a majority vote; if it is set at 2:1, a 33.4% equity stake will be required.
[11] http://www.oecd.org/gov/regulatory-policy/ria.htm

In the case that a lower maximum voting differential is adopted, HKEx should set higher limits of minimum/maximum economic interest accordingly to reflect the adjustments made in (III).

Consistent with the reasoning underlying our position in (III) above, a RIA should be untaken in the process of setting up a threshold that can stand up to scrutiny.

V. *Key matters to be decided on a "one-share, one-vote" basis*

We acknowledge the fact that HKEx has proposed the requirement of certain matters to be decided on a "one-share, one-vote" basis (Paragraphs 128-129). While those conditions are suitable, **HKEx must add a coat-tail provision, requiring WVR companies' voting decisions to be made on a "one-share, one-vote" basis if and when a takeover offer is received.**

The purpose of the coat-tail provision is to ensure that every shareholder will be entitled to equal voting rights if the issuer (company) receives a takeover offer. This provision would mitigate the risk of exploitation of the WVRs by company executives who might act out of self-interest instead of in the interests of shareholders as a whole (e.g. rejecting an offer with huge premiums to maintain his/her managerial power in the company). In the absence of such a provision, owners of shares with inferior voting rights could be deprived of the rights to have their views counted for such important decisions.

In addition to the coat-tail provision, **we propose that the list under Paragraph 128 to be expanded to include (a) connected party transactions (CPTs), and (b) very substantial transactions (VSAs).** Under the current Listing Rules (Chapter 14), shareholders are required to approve individual CPTs and VSAs if such transactions exceed a certain threshold in terms of revenue, assets or consideration ratios (14.06). For companies with WVR structures, if shareholder approval is triggered, we believe the matter should be voted on a "one-share, one-vote" basis, where WVR beneficiaries will not be able to exercise super voting rights. This will prevent a full-fledged confiscation of non-WVR shareholders' rights to vote on issues which have a substantial effect on their interests.

VI. *Reduce reliance on subjectivity*

While the consultation document has a reasonably concrete framework regarding companies' eligibility to list with a WVR structure, it has come to our attention that the degree of subjectivity it has provided for the Exchange is rather high. For instance, in Paragraph 106, it was proposed that HKEx would become the sole gate-keeper in terms of the eligibility of the companies to list with WVRs.

We are, in fact, more troubled by Paragraph 117, which suggests that HKEx would be authorized to set a lower minimum shareholding percentage for companies with large market capitalization. As stated in (III), the level of economic stake in a company would have implications to corporate governance. The vagueness illustrated in Paragraph 117 may incentivize entrenchment and other risks, and could potentially lead to widespread negative impact given the size of relevant companies. To be clear, even if the amount of economic stake is high in absolute monetary term for a company with large market cap, permitting a lower minimum shareholding percentage will put other shareholders at higher risk of managerial entrenchment etc.

CFA Institute urges HKEx to avoid vagueness and subjectivity in the proposals, which could "give rise to regulatory uncertainty and could result in inconsistent and unfair decision-making."[12]

VII. *Explanation for proposed market capitalization requirements*

As the old maxim states, "If something sounds too good to be true, it probably is." While it may appear to be intuitive for HKEx to lure larger enterprises to list, the Securities and Futures Commission (SFC) has made a strong case by suggesting that "**size offers no assurance that a company would treat its shareholders fairly.**"[13] We also agree with the SFC's view that "any corporate misconduct by an issuer with a large market capitalization will likely affect more investors and have a greater impact on our markets," including, but not limited to, Hong Kong's reputation as a properly regulated securities market. Perhaps, HKEx should address such concerns.

From a commercial perspective, we acknowledge it may be appealing for HKEx to target at companies with large market capitalization. Not only will it be beneficial to the financial (e.g. banks and intermediaries) and professional services (e.g. accounting and legal) industries, but it may also bring about higher trading income for HKEx going forward. Nonetheless, **the HK$10 billion or HK$40 billion minimum market cap threshold appears to be somewhat arbitrary**, and we hope HKEx can shed more light on how it had come up with such thresholds.

At the same time, from a local entrepreneur standpoint, given the high (HK$10 billion) WVR listing threshold, would reasonably scalable local start-ups that have not reached such a valuation threshold be driven away from listing domestically? Indeed, according to CB Insights, GoGoVan has been the only home-grown unicorn – start-ups with valuations over US$1 billion (~HK$7.8 billion).[14] Therefore, **we are unsure if this listing structure will be beneficial to home-grown high-tech companies**, which the Hong Kong SAR Government targets to nurture.

These unanswered questions reinforce our belief that, **rather than allowing WVR structures, exchanges and regulators should explore alternative measures to make Hong Kong a more attractive financial center more attractive for local technology stock listings.**

VIII. *Secondary listings of qualifying issuers*

We note that the proposals in Chapter 4 of the consultation paper are largely designed to entice the return of Mainland companies already listed on an oversea Qualifying Exchange to Hong Kong, by way of a secondary listing initially and then by moving the primary listing venue to Hong Kong over time.

According to the proposal, if companies listed on an overseas Qualifying Exchange prior to 15 December 2017 apply for secondary listings in Hong Kong, they are deemed to be grandfathered and are not required to comply with the WVR safeguards required by HKEx. Furthermore, if, over time, they decide to move their primary listing to Hong Kong, they will still enjoy this exemption and not have to comply with the WVR safeguards required by HKEx.

[12] Securities and Futures Commission (June 2015) SFC statement on the SEHK's draft proposal on weighted voting rights.
[13] Ibid
[14] The number of unicorns from Hong Kong may double to **two** if we consider SenseTime as a Hong Kong home-grown unicorn, which is not in-line with CB Insight's definition.

CFA Institute strongly believes in the principles of market fairness and consistency, which are already put to test by the introduction of WVR structures. Any further relaxation of the rules and safeguards for a select group of companies will place additional strains on the market and confuse investors, who will in turn assign a discount, or, even worse, re-allocate their capital elsewhere. Rightly or wrongly, the proposal as it stands gives a perverse signal to the market that the revised Listing Rules are written with some very specific companies and outcomes in mind, rather than for the long-term, healthy development of the market. Hence, on this matter, our position is that all companies with primary listings on HKEx should be subject to the same WVR safeguards.

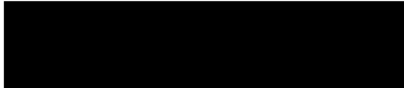
Concluding Remarks

Although enhancing competitiveness and profits may be compelling reasons for the proposals, compromising hard-earned credibility in corporate governance and weakening investor protection is not a sustainable growth strategy. The introduction of the WVR-structured companies will encourage short termism, and deter long-term capital and high-quality issuers from these markets.

Please do not hesitate to contact us should you have any questions concerning our comments.

Yours faithfully,

/s/ Mary Leung, CFA
Head, Advocacy, Asia Pacific
CFA Institute



/s/ Rocky Tung
Director, Capital Markets Policy
CFA Institute