23 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
response@hkex.com.hk

Dear Sirs:

Re: Emerging and Innovative Companies CP

On behalf of its equity capital markets committee and other investment-banking members, the Asia Securities Industry & Financial Markets Association[1] is setting out in this letter its response to the Hong Kong Stock Exchange's (the "Exchange") Consultation Paper ("Consultation Paper") on a Listing Regime for Companies from Emerging and Innovative Sectors. The views expressed in this letter are those of the aforementioned members of ASIFMA (the "sell side"), and "we," "our" and other references to the authors of this letter should be construed accordingly. Davis Polk & Wardwell has kindly assisted us in preparing and coordinating this response.

Unless otherwise indicated, the terms used in this letter shall have the same meanings as in the Consultation Paper.

General

We welcome the introduction of new Listing Rules to implement the proposals set out in the December 2017 consultation conclusions to the New Board Concept Paper ("New Board Conclusions"). We believe it is important for our regulators to act promptly and decisively to bring more variety and flexibility to the market. In our view, the proposed Listing Rule amendments do not deviate materially from the plans set forth in the New Board Conclusions, and are a step in the right direction. However, there are a number of practical issues and suggestions we would like to bring to the Exchange's attention.

WVR and biotech: Detailed guidance on listing qualifications

A number of key qualifications for listing weighted voting rights ("WVR") and pre-revenue biotech companies are not set out in the draft Listing Rules but will be incorporated in accompany guidance letter(s). In the absence of an exposure draft of such guidance, uncertainty remains over a number of key issues, for example:

- The parameters of "innovation," "new technologies," "research and development," etc. – the Exchange has helpfully given an example that a convention retail business with an online sales platform may not qualify for listing under the WVR regime. It has also stated its willingness to review cases on their individual merits to provide for flexibility. However, purely on the basis of the Consultation Paper, market practitioners are having some difficulty advising prospective issuers on their eligibility status under the new regime.

[1] ASIFMA is an independent, regional trade association with over 100 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive and efficient Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

- The approach to "sophisticated investors" appears heavily subjective (please see the section "WVR and biotech: Sophisticated investors as disclosure / entry requirement" below our main comment on the subject of sophisticated investors).

We would urge the Exchange to release the relevant guidance (or an exposure draft) as soon as possible, to give the market a better idea of the nature of business that are likely to be suitable for the new regime.

WVR and biotech: Sophisticated investors as disclosure / entry requirement

The Exchange has specified investment by sophisticated investor(s) for a certain period before IPO as an entry requirement for both WVR and biotech listings, on the basis that third party investment would be a mode of external validation for the business.

Some members have observations about this approach. In reality, in today's market third party investment even by reputable investors does not necessarily provide assurance on the viability of the business. Our concern is that having this as part of the eligibility requirements would probably not give any realistic "quality assurance" but will very likely add another layer of uncertainty into the process, and worse still, may give a false sense of comfort to retail investors. The cons may well outweigh the pros. A better way forward may be to have such investment as a disclosure rather than eligibility issue. This would be closer to the current approach to cornerstone, strategic and other investments where details about such investments would be considered as relevant information for public investors' investment decisions, but without any connotation that the quality of a business can or should be imputed purely by the pre-existence of third party investment.

That said, other members see merit in retaining the requirement, subject to better clarity on the concept of sophisticated investor. If the Exchange is minded to retain this as an entry rather than disclosure requirement, we would suggest more guidance to remove the subjective elements – e.g. specifying the amount of investment required.

WVR: Corporate vs. individual beneficiaries

We note that specific rules on WVR beneficiaries and attendant safeguards will be the subject of a forthcoming consultation.

We are generally in support of allowing WVR beneficiaries to be corporations. In principle, we do not find any compelling reasons for limiting WVR holding to individuals. On the one hand we understand the concerns expressed by the Exchange in the Consultation Paper that at this stage WVR should be limited to persons who have made an active personal contribution to the success of the company. On the other hand, there are no similar restrictions in the major markets with which Hong Kong competes, and as a matter of international market experience, the investing public may be assumed to be familiar with corporate WVR beneficiaries.

An observation we would like to make at this stage is that the proposed 50% cap on equity holding by a WVR beneficiary appears problematic to us. With such a cap, even a moderately sizeable issue of new shares by the company will lead to a loss of control by the WVR beneficiary. The logic behind the 50% is not apparent to us, as there is no reason why a shareholder holding more than 50% would not have the same reasons for holding WVR as opposed to another shareholder holding less than 50%. We are also concerned that in practice, companies whose founders hold more than that level will simply choose other markets with no similar restrictions, for there appears little incentive for the controllers to dilute themselves to fit the Hong Kong requirement. As we see it, this will be distinctively unfavorable to Hong Kong in terms of the attractiveness of our market.

We would urge the Exchange to proceed with the corporate WVR beneficiary consultation as soon as possible to gather market views as to the advantages and disadvantages of each approach. As it is difficult to formulate views in the absence of concrete proposals on how the corporate WVR rules will be crafted, we shall offer our detailed comments in that consultation.

WVR: Permitted transfers

The Exchange has worked into the draft rules a degree of flexibility for group transfers of WVR to non-individuals such as trust, limited partnership, private companies, etc. provided there is no circumvention of the general transfer restriction.

We note the experience in foreign markets that allow transfers to controlled companies or other "affiliates" ("affiliates" being contractually defined but mostly following commonly accepted market practice). We are concerned that the proposed permitted transfer provision for Hong Kong may be significantly more restrictive than other markets. In our view, the Exchange may consider introducing more flexibility in order to maintain the competitiveness of our market.

One issue for clarification by the Exchange is that if – as a result of a transfer – a third party is potentially given an interest in the WVR share (e.g. a family member is named as beneficiary under a trust, or minority shareholders are present in a private company), whether this always fall on the wrong side of "circumvention." What does the issuer have to do to prove there is no circumvention? We note that this would not be an issue in overseas markets, where one needs simply apply the definition of the word "affiliate" to come to a much more clear-cut answer.

In terms of ongoing compliance, it may also be helpful for the SFC to provide guidance on the ways in which the listed company (as well as public investors) may monitor their WVR shares, for example by way of the Part XV Securities and Futures Ordinance disclosure of interest provisions. This should be a useful compliance aid for all concerned.

WVR: Reserved one-share-one-vote matters

Since the release of the Consultation Paper, there has been some market confusion as to the amendment of the issuer's constitutional documents being a matter reserved for determination by one-share-one-vote. Some issuers take this to mean that minority shareholders can remove the WVR structure by voting through changes to the articles. Having consulted legal counsel, we believe this is unlikely to be the true position, given this would involve an alteration of class rights.

We would like to bring this to the Exchange's attention so that, if considered appropriate, the Exchange will state in one of the notes or guidance letters that the reserved matters list will not affect the application of law and regulations.

Biotech: Definitions

The pharmaceutical / biotech is a new and very wide industry and it is often uncertain which category or sub-category an issuer may fall within. We note that "biotech" is defined very broadly in the draft rules and believe that the market will need further guidance in this respect.

Another area of uncertainty is the definition of "product", especially for pharmaceutical and biologics. It is not uncommon for the same drug to apply to multiple indications. As the application of a drug which is already commercialized to each additional indication requires the same clinical trial process, we suggest that the new Chapter 18A listing framework should be designed so that appropriate cases of new indications are not excluded.

Biotech: Entry requirements

We note that under the draft rules, a product that has completed Phase I clinical trial will generally be considered as eligible for listing.

Some members observe that there is a huge number of biotech companies that have completed Phase I trials, but the likelihood of their commercial success remains relatively low. This problem could be aggravated in the case of single-product companies. To improve the quality of potential listing candidates, these members suggest raising the entry bar to completion of Phase II instead of Phase I clinical trial. They observe further that, given investors in Hong Kong (as compared to the US) are less experienced with biotech companies, it would be helpful to introduce companies in a more advanced development stage to start with. Members who are in favour of raising the entry bar point out that this is likely to provide a more realistic protection to the market, as compared to relying on third party investment as a form of validation.

On the other hand, some members are of the view that although Phase I trial is a lower bar, the reception of these companies should be determined by market forces. They point to the fact that there is no coercion for investors to invest in companies that in their view are premature, nor for securities firms to underwrite or sponsor deals for such companies. These members caution that, since some companies with novel compounds products need a significant amount of funding between Phase I and Phase II trials, they may look to overseas markets for a listing if Hong Kong is not amenable to them. Hence the overall attractiveness of our market may suffer.

As a possible alternative, other members have put forward for the Exchange's consideration the possibility of accepting other measurable milestones along a typical clinical trial process, for example, commencement of Phase II trial and specifically after confirmation from the proof of concept stage or Phase IIa trial. This could be a feasible middle ground for companies that have gone past Phase I but have not yet entered into the larger-scale and potentially much more costly Phase IIb.

Ultimately, despite a multitude of limits and safeguards installed in advance by regulators and diligent investigations by professional intermediaries during the listing process, the comparatively high risk of business failure for a pre-revenue biotech business cannot be completely eradicated. This is an inherent risk which the regulators as well as investors must accept, particularly when the market as a whole is entering new uncharted territory.

Biotech: "Bundled" clinical trials

In paragraph 75 of the Consultation Paper, the Exchange states that it would consider a number of factors as possible proof that a product has developed beyond the concept stage. This includes (in sub-paragraph (a)(i)) a product that has completed Phase I clinical trials with no objection from the competent authority against the commencement of Phase II. This raises the question whether, in a case where a product is to go through Phases I – III in a "bundle," whether this product would not be considered eligible until all phases are complete. As these types of issues may be prevalent in the biotech and pharmaceutical industries, the market will benefit greatly from more detailed guidance given in advance, rather than being left to making pre-IPO submissions which inevitably causes much uncertainty and loss of time.

Biotech: Sophisticated investment exemption

In paragraph 8(g) of the Consultation Paper, the Exchange states that a spin-off IPO may be exempt from the "sophisticated investment" requirement if the listing applicant is otherwise able to demonstrate a reasonable degree of market acceptance, e.g. in the form of collaboration with other established R&D companies. We have the following observations:

- The concept of "reasonable degree of market acceptance" is undefined and very vague. Without sufficient clarification, the market will in practice have to seek pre-A1 consultation in every spin-off transaction.

- There are many large pharmaceutical conglomerates potentially seeking to spin off their biotech subsidiaries through a Hong Kong listing. This may be for various reasons, including the search for continuous financing to support the R&D activities of the company, or to

unlock shareholders' value for the parent. The "blockbuster" products of these conglomerates are often developed without cooperating with external R&D companies. For these issuers, the requirement for collaboration will not be appropriate at all. As a replacement or alternative test, we suggest that the Exchange may review the background and R&D track record of the parent company, the market acceptance of the existing products (including one of the indications of a drug) that have been commercialized and/or views and comments from key opinion leaders of relevant therapeutic areas, instead of relying simply on external collaboration as validation of the business.

Biotech: Cornerstone investment

It would be useful for the market if the Exchange were to confirm and/or clarify the following issues in one of the guidances:

- One question raised by paragraph 13 of the Consultation Paper is where a cornerstone investor who is not a connected person proposes to acquire IPO shares in circumstances allowed under one of the guidances (e.g. pursuant to a pre-existing anti-dilution right under LD44-2 or where relevant conditions are fulfilled under GL85-16), whether such shares would count towards the public float. Based on the policy rationale stated in paragraph 13 (i.e. to reduce the influence of pre-arranged deals on the book-building process and to help ensure that the pricing process is market-driven), we believe that, in the circumstances mentioned above, the cornerstone shares should count toward the public float, as in these cases there should be no threat to the fairness and orderliness of the book-building and price discovery process.

- We welcome the proposal to allow any existing shareholder (including anyone holding a 5% voting right or above before listing) to participate in a biotech IPO as a cornerstone investor. Our reading of the draft Rule 18A.06 suggests that (i) such shareholders to be subject to a six-month lock-up and that (ii) the shares subscribed for by such investors at the IPO will not be counted towards the IPO public float. But other shares acquired pre-IPO or post-IPO by such shareholders will be counted towards the public float.

- Regarding the application of GL85-16 in the context of a group of professional investors investing in biotech listings, we understand from paragraph 86 of the Consultation Paper that where an existing shareholder does not meet the conditions of GL85-16, under the new regime it may nevertheless participate in the cornerstone tranche. Some sophisticated "cross-over" funds investing in biotech companies may be affiliated to large public or retail fund managers. Where an investment fund that already holds a stake in the listing applicant takes advantage of the new policy in paragraph 86, will the dispensation apply likewise to its affiliated funds?

More generally, we welcome the recent relaxation of the double-dipping rule by way of GL85-16 and now in the proposed biotech context, but believe there may be scope for further relaxation. In practice, the double-dipping rule (which does not exist in other markets) is often a significant concern for issuers already listed overseas that are considering Hong Kong for a follow-on listing. For these companies, the restriction on their existing shareholders and affiliates subscribing for additional shares is often a major deterrent. Please see the section "Biotech: Post-IPO funding" below for further discussion.

In view of this, we encourage the Exchange to conduct a holistic review of the placing regime as soon as possible and start a public dialogue as to how the problems currently hampering market development may be resolved.

Biotech: Post-IPO funding

Biotech companies often require continued funding support to advance through different stages of development. A substantial shareholder that has invested in the biotech at the early stages has taken on substantial risks and, in international market experience, they would be reluctant to come to a market where they are severely hampered from taking steps against dilution either at the IPO stage and even beyond IPO.

We therefore support the Exchange's move to allow companies more flexibility to raise additional funding from existing shareholders at IPO. Going forward, we believe that the regulators may consider extending the flexibility to post-IPO follow-on offerings. In this connection, two alternative proposals have been put forward:

- A member has suggested that existing shareholders holding less than 30% of the total shares outstanding should be allowed to participate in follow-on offerings post-IPO conducted by a biotech company pursuant to a general mandate (while controlling shareholders holding 30% or more will have to obtain shareholders' approval to acquire additional shares). We believe this would allow financial investors to continue their much-needed support of the listed company as it continues to develop.

- Another member suggests allowing existing shareholders and connected persons to participate in post-IPO follow-on offerings, but only up to their percentage holdings in the company, so as to allow the significant shareholders to prevent dilution. This member notes that this will contribute significantly to the attractiveness of Hong Kong as compared to other international markets.

Secondary listing: Grandfathering

Under the draft rules, the grandfathering provision for concessional secondary listing is based on a specific date: 15 December 2017. While this has the advantage of certainty, it is also highly inflexible and does not appear to be supported by sound policy. Any company listed after that date would not be inherently less suitable for the new secondary regime. We would therefore suggest that the Exchange consider taking a more flexible approach in this regard.

That said, we agree with the underlying concern to prevent regulatory arbitrage. Therefore it would be understandable for any flexibility given to be accompanied by safeguards, such as a more lengthy period for which the company must have been listed overseas with a clean compliance record before it can be eligible for a secondary listing in Hong Kong.

Secondary listing: Amendment of constitutional documents

It is not a straightforward matter – even under existing rules – to determine when a company needs to amend its articles to meet HK-equivalent shareholders' protection standards. This would be a function of Rule 19.30(1)(b), Appendix 3 and Appendix 13 of the Listing Rules and the 2013 Joint Policy Statement. There are multiple variations that depend on whether the company is from a "recognized," as opposed to an "acceptable," jurisdiction, and whether the company is proposing a primary or secondary listing in Hong Kong. Unfortunately, the proposed rules do not clear this matter up, and instead introduced an additional layer of requirements by way of the proposed Rule 19C.07.

We support the Exchange's original statement in section 279 of the Concept Paper Conclusions that "the practical requirements for secondary listing applicant (who is already listed elsewhere) to vary its constitutional documents to meet this equivalent requirement can be arduous". It is potentially a significant consideration for issuers as to whether the expenses, efforts and uncertainties involved will outweigh the benefits of a HK secondary listing. We urge the Exchange to adopt as flexible an approach as possible, and require technical changes to the constitutional documents only in exceptional cases where there would otherwise be absolute failure to meet the equivalence requirements.

More generally, the Exchange may want to take this opportunity to reconsider the various requirements in Rule 19.30(1)(b), Appendix 3 and Appendix 13 of the Listing Rules and the 2013 Joint Policy Statement. In our view, regardless of the place of incorporation of the issuer and whether the listing being sought is primary or secondary, the regulatory spirit would in all cases appear to be "compliance with shareholders' protection standards equivalent to Hong Kong".

At the moment, the myriad of rules affecting a listing applicant's articles are potentially making this an unnecessarily difficult area of practice in our IPO market. It would be very helpful for the Exchange to review holistically the existing and proposed rules in this area, with a view to removing some of the uncertainties and inconsistencies.

Secondary listing: VIE

Regarding the Exchange's proposal to allow grandfathered Greater China companies to conduct secondary listings in Hong Kong with their existing VIE structure subject to certain conditions. While we have no objections to this in principle, we invite the Exchange to review and, if appropriate, update the practice for VIE listings.

The current LD43-3 was revised in 2015 following the publication of the exposure draft PRC Foreign Investment Law by the Ministry of Commerce. By way of (largely unwritten) practice, the Exchange has since required controllers of VIEs that are subject to foreign investment restrictions to provide various certifications and undertakings as to their controlling interest in the listing applicant.

It appears that this practice was put in place largely in anticipation of the Foreign Investment Law. However, three years later the law has yet to be finalised. Before the rollout of the final version of the law, this additional layer of documentation for the Hong Kong market does not add much real value. We propose that the Exchange review and simplify the current practice.

Secondary listing: Migration of trading volume to Hong Kong

Note 1 to the draft Rule 19C.13 provides that, where 55% or more of the total trading volume of the shares in a listed issuer over the most recent fiscal year take places on the Exchange's markets, the issuer's trading volume be deemed to have migrated to Hong Kong, with attendant consequences as to the withdrawal of certain waivers.

We invite the Exchange to clarify how it chose 55% as the threshold, as well as whether this would be a rebuttable or conclusive assumption.

Secondary listing: Confidential filing

GL57-13 provides a confidential application proof filing regime for companies that have been listed in one of the specified overseas markets for not less than five years and have not less than US$400m in market capitalisation. This regime is relatively restrictive and we understand that it has very rarely been invoked.

By contrast, the US regulators have been moving towards further opening up rather than narrowing down confidential filing. Recently, under the U.S. Securities Act of 1933, as amended, the confidential submission regime for US registration statement has been further extended to IPOs of non-emerging growth companies, certain filings in connection with spin-offs or filed prior to 12 months after IPOs, and amendments to publicly-filed registration statements that are not yet effective.

In our view, this would be a good time for the Hong Kong market to reconsider our confidential filing regime with a view to maintaining our competitiveness. For example, it seems sensible to align the GL57-13 five-year listing requirement with the proposed two-year requirement for concessional secondary listings where a qualifying WVR / biotech issuer is concerned.

Secondary listing: Liquidity

While the introduction of the concessional secondary listings is a positive development for the market, its success cannot be assured without some powerful measures being taken to enhance and maintain liquidity in the secondary market. Key to this would be the involvement of the Stock Connect project. We trust the Exchange will continue to work with the relevant PRC authorities to obtain an optimum result.

Conclusions

We are encouraged by the speed with which the Exchange has pursued the current project. With the above observations in mind, we are in agreement with the general direction of the draft Listing Rules. We believe this will be a positive development for the market and look forward to the successful launch of the new regime.

Contacts

Please do not hesitate to contact me [redacted] or Bonnie Chan, partner at Davis Polk & Wardwell ([redacted] if you wish to discuss any of the above. We have no objections to disclosing the name of the Association (noting that this represents the views of ASIFMA's sell-side members) in the version of this response published by the Exchange on its website.

Sincerely,

Wayne Arnold
Executive Director, Head of Policy and Regulatory Affairs
Asia Securities Industry & Financial Markets Association