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23 March 2018
Attachment(s)
One

Subject
Re: Emerging and Innovative Companies CP
Handled by
Mr. Gerard W.R. Fehrenbach

E-mail
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[redacted]

Hong Kong Exchanges and Clearing Limited
Corporate and Investor Communications Department
12th Floor, One International Financial Centre
1 Harbour View Street
Central, Hong Kong
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SENT by E-MAIL

Re: Emerging and Innovative Companies CP

Dear Madam/Sir,

We welcome the opportunity to respond to the HKEx Consultation Paper on "A Listing Regime for Companies from Emerging and Innovative Sectors" of February 2018 (cp201802).

PGGM Investments (hereinafter: "PGGM") is a Dutch asset manager acting on behalf of - amongst others - *Pensioenfonds Zorg en Welzijn*, the Dutch pension fund for the healthcare and welfare sector and one of the largest pension funds in Europe. PGGM currently has approximately € 210 billion assets under management. A considerable amount thereof is invested in Hong Kong and HKEX listed companies. Please be informed that we are a long term shareholder in these companies and that we incorporate Environmental, Social and Governance (ESG) considerations into our investments decision making.

PGGM is an active member of the Hong Kong based Asian Corporate Governance Association (ACGA) and we contributed to many of their responses to consultations in the past. Please be informed that we fully support the comments and strong standpoints provided by ACGA in their letter today on the Consultation Paper. For your convenience, I attached it also to our letter.

Please be informed that we strongly belief in one of the core pillars of modern corporate governance: the one-share-one-vote principle. Our position on weighted voting rights (WVR), more commonly called "dual-class-shares", has always been clear and consistent: we are not in favour of WVR and we strongly oppose to the introduction thereof in markets that do are still upholding the one-share-one-vote principle for its listed companies.

We are fully aware that our home market, the Netherlands, *de facto* allows for multiple shares classes for listed companies and other capital markets - unfortunately - also allow for forms of dual-class-shares. We are not in favour of this and do engage to have this revoked as market practice. However, please be informed that the view Dutch listed companies that have introduced multiple share classes in the past, generally have done so in the early or mid of the last century (1900-2000). Hence, way before the current global best practices on corporate governance emerged. In addition and of great importance, the Dutch laws (e.g. the Civil Code on Company Law) does provide for very strong safeguards that are backed up by a very efficient and effective jurisdictional system (e.g. the Enterprise Division of the Amsterdam Court of Appeal and joint compensation action proceedings).

We strongly belief that the safeguards to limit the governance and investment risk posed by WVR currently proposed the Exchange are insufficient and inadequate. Although we remain a strong opponent, we encourage you to strengthen the safeguards for all investors, in particular the minority shareholders that invest long term, before even considering introducing WVR. In particular – as a last resource – an efficient and effective jurisdictional system. Please bear in mind that without a proper time-based sunset clause, the introduction of WVR will impact Hong Kong capital market for an indefinite time.

Please do not hesitate contacting me should you have any queries.

Yours sincerely,

Gerard W.R. Fehrenbach
Attorney at Law
Senior Advisor Responsible Investment
PGGM Investments

Attachment:
The Asian Corporate Governance Association (ACGA) response letter with comments on the consultation paper titled, “A Listing Regime for Companies from Emerging and Innovative Sectors”, dated 23 March 2018.

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

By email to: response@hkex.com.hk

Re: Emerging and Innovative Companies CP

Dear Sir,

The Asian Corporate Governance Association (ACGA) is a not-for-profit membership association chartered under the laws of Hong Kong and founded in 1999. The Association is dedicated to working in a constructive manner with listed companies, investors, auditors and regulators across Asia to improve corporate governance standards and practices, which we believe are a foundation for long-term economic development. We are guided by a practical, long-term approach that is relevant to each individual market. Our operations are supported by a membership base of institutional investors, Asian listed companies, insurance and accounting firms, and universities. ACGA has more than 110 corporate members, two thirds of which are institutional investors with more than US$30 trillion in assets under management globally. They are also significant investors in the Hong Kong market.

Our comments on the consultation paper titled, "A Listing Regime for Companies from Emerging and Innovative Sectors", follow.

Higher Systemic Risk

ACGA fully appreciates the competitive risks facing the Hong Kong capital market and the need to foster market development. As an organisation working with numerous stakeholders to implement more effective corporate governance practices throughout the region, we assess any new policy initiatives from the perspective of long-term market impacts. As a result, we are obligated to express a formal statement of concern regarding the Hong Kong government's analysis of the issues related to the adoption of weighted voting rights (WVR) and the ways in which they discriminate against the interests of long-term minority shareholders.

We believe that the consequences of ill-structured competition amongst global market operators is resulting in a regulatory "race to the bottom" that will damage the Hong Kong market's resilience, reputation and the quality of its corporate governance. We also believe that

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long-term returns for investors could suffer. While we recognize the current political imperative in Hong Kong, we firmly believe that leading global market operators have failed to demonstrate a holistic understanding of the impact of these changes on investors and their beneficiaries. Too often the debate is cast in a short-term context with little consideration of unintended consequences or systemic governance risks.

Two examples can be used to highlight our concerns. First, it is worth noting recent statements from the China Securities Regulatory Commission (CSRC) concerning new incentives for overseas-listed China issuers such as Alibaba, Baidu and Tencent to seek secondary listings on the Shanghai Stock Exchange to realise that Hong Kong risks worsening the competitive landscape rather than "winning" a stream of beneficial IPOs.

Second, the rushed consultation process—at four weeks one of the shortest in recent memory—has opened a Pandora's Box of unresolved issues that will now be addressed out of sequence. The original WVR proposal was firmly justified by a need to 'reward the unique and value-enhancing leadership of WVR founder-shareholders'. In other words, only individuals will be eligible. As the current paper states, each WVR beneficiary "must have been materially responsible for the growth of the business, by way of his skills, knowledge and/or strategic direction in circumstances where the value of the company is largely attributable or attached to intangible human skill."

Yet the consultation document already opens the door to a later consultation on whether to extend such benefits to corporate shareholders. The precise beneficiaries of any subsequent consultation on corporate WVR remain unclear, but we are deeply concerned about a scenario in which acquisitive WVR companies would then spawn additional WVR companies with a cascading loss of governance rights for investors. This is precisely the type of unintended design flaw that we had been led to believe HKEX would not encourage.

Specific Comments

Our other points fall into three categories: ad hoc processes; enforcement; and safeguards.

1. Ad Hoc Processes—Suitability and Guidance Letters

One of the under-appreciated contradictions in the new regime is the extent to which the new biotech and WVR regimes mark a meaningful deviation from HKEX's traditional clarity and reliance on rules. In general, this commitment to rule-based decision-making on IPOs has benefitted the Hong Kong market by eliminating uncertainty for potential issuers and encouraging careful consideration of the potential impact of any changes to the Listing Rules.

Yet throughout Chapters 2 and 3 of the consultation document there is a repeated reliance on references to "case by case" considerations of listing applicant suitability. With reference to the WVR tests, the proposal explicitly states that approval of one WVR issuer should not be taken to mean that "another applicant with similar technology, innovation or business model will also qualify for listing with a WVR structure." This will almost certainly lead to

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appeals and will lay HKEX open to criticism for being unfair and arbitrary. In addition, the decision to rely on new Guidance Letters to supplement the selection criteria for WVR suitability (Section 106) is fraught with implementation risk, and will create uncertainty concerning the actual listing rules and their governance impacts.

We also believe that the reliance on suitability judgements for both pre-revenue biotech issuers and WVR applicants is at odds with the behavioural norms of the Listing Committee and its governance. This is an intermediary-driven committee working under extreme time pressure and dominated by pro-cyclical professional interests. It seems unlikely that the Listing Committee, as currently configured, possesses the capacity for careful analysis of business models, patent trends, and R&D programs that will be required for selecting new biotech issuers. Or that it will have the energy and interest in debating whether one applicant is truly innovative and another is not. Such a case-by-case approach is inconsistent with the rules-based framework within which the Committee functions.

Indeed, in June 2015, the Securities and Futures Commission (SFC) highlighted precisely this issue when it posed a series of questions to HKEX following publication of the latter's conclusions to its earlier WVR concept paper of 2014. The SFC stated that one of its concerns was that HKEX expected eligible applicants to have certain unique features "relating to their businesses and the contribution of their founders". As the regulator stated unequivocally at the time:

> "The SFC has significant concerns about these proposals that require regulators to assess compliance with the criteria for companies to be eligible for WVR (for example, whether the applicant has some unique features that cannot be easily replicated and are likely to provide a sustainable competitive advantage, as well as the contribution of the founder or founders). Such criteria can only be applied subjectively and are therefore inherently vague. A regime that relies on the subjective judgement of regulators to determine which listing applicants are eligible for WVR would give rise to regulatory uncertainty and could result in inconsistent and unfair decision-making. The SFC is opposed to proceeding on this basis."[1]

Outsourced Standards

Another unwelcome trend evident in the design of the biotech and WVR proposals relates to the reliance on a so-called "Sophisticated Investor" as a proxy for suitability. The presence of a "meaningful" investment made by a Sophisticated Investor at least six months prior to the proposed listing is taken to "demonstrate that a reasonable degree of market acceptance exists for the applicant's R&D and Biotech Product." This correlation rests on a false premise. The presence of an investor can only be taken to mean that one specific investor hoped to

[1] Securities and Futures Commission, "SFC statement on the SEHK's draft proposal on weighted voting rights", 25 Jun 2015. See www.sfc.hk (news and announcements section)

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make money on their investment, not that the R&D or product is a suitable investment for others. In addition, we note that a similar concept of "external validation" is applied to potential WVR issuers with an added requirement that such investors retain an "aggregate 50% of their investment at the time of listing for a period of at least six months post-IPO." Without extensive ongoing disclosure by a Sophisticated Investor of their direct and indirect portfolio holdings and the presence of any contractual or derivative structures, we fail to see how these provisions can hold any substance.

2. Enforcement

To be effective, the proposed safeguards around WVR will have to be consistently and robustly enforced by HKEX. Yet the Exchange has limited sanctioning powers and, being a for-profit entity, faces a significant conflict of interest between its commercial and regulatory imperatives.

We believe that some of the proposed safeguards, such as WVR being accorded only to directors and taken away if they cease to be active in their business, could be easily circumvented. Directors may cease to be active, yet remain on the board in a nominal capacity. Such behaviour may prove extremely difficult for the Exchange to ascertain in practice and therefore enforce.

We also have concerns about allowing individuals to hold their WVR shares in limited partnerships, trusts, private companies and other vehicles. It will be difficult in practice for the Exchange to monitor such entities, hence the risk of control shifting to another party behind the veil is surely high.

We note with interest the statements made in Paragraph 91 concerning accelerated de-listing of biotech issuers that "fail to maintain sufficient operations or assets." The language in Paragraph 146 regarding supplemental powers and sanctions for WVR issuers also speaks to the need for enhanced regulatory powers. With these and the above points in mind, we believe it would be appropriate for HKEX to report to the market on a regular—at least annual—basis concerning the status of HKEX's regulatory capacity and actions relative to new biotech and WVR issuers. This reporting process should provide transparency not just on changes to the rules, but also on the nature and status of any enforcement actions in order to eliminate the information gaps that often rob the market of clarity about expected standards.

We further recommend that the Exchange move ahead as quickly as possible in strengthening its delisting regime, one of the weakest links in its regulatory framework. Creating a transparent, effective and efficient delisting mechanism is one of the few effective remedies available to encourage more vigilant stakeholder behaviour and deal with recalcitrant issuers. The enhanced delisting mechanisms specified for biotech companies are a welcome risk mitigant, especially in light of the concerns highlighted about the potential for shell companies. Nevertheless, while we welcome HKEX's recent consultation on

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enhancing the delisting system[2], more may be required to prevent expropriation risk from emerging.

On the issue of "private enforcement", we note the requirement that WVR safeguards be incorporated in the issuer's constitutional documents to facilitate private legal actions against them. Yet given the limited legal remedies available to minority shareholders in Hong Kong, the high cost of going to court, and the dearth of litigation against listed companies, we believe that the efficacy of this measure will be limited. This may benefit institutional investors who are cornerstone investors, but this provision should not be viewed as a broad market remedy.

3. Safeguards

The Exchange proposes a range of safeguards to limit the governance and investment risk posed by WVR. As currently structured, we believe these safeguards will provide inadequate protection to investors. Our reasoning is as follows:

- **Ring-Fencing:** The consultation paper proposes a general rule that aims to ensure only new applicants will be able to list with a WVR structure. In addition, the proportion of WVR shares for each issuer will be set at IPO and issuers will not be able to issue additional WVR shares in subsequent fund-raisings.

  While these provisions have merit in limiting the impact of WVR, we believe they are unlikely to provide a strong bulwark against governance erosion in the index. Over time, it may prove extremely for the Exchange to resist pressure from existing listed companies to apply for WVR. Or they may seek an indirect route: we note with concern for example that spin-offs will be permitted to list with WVR structures. This will permit value leakage from "one-share, one-vote" companies to WVR structures and raises the possibility that WVR shares will be held by parent companies.

- **Eligible Persons:** The consultation paper proposes that WVR shares will only be available to "eligible persons", who must be directors of issuers, and that their shares will not be transferable to another person, including family members. Although the ban on transfer of WVR shares is significant because it eliminates the creation of WVR shares in perpetuity, we are not convinced that, absent clear penalties or sanctions, boards will be capable of effectively policing WVR shareholder directors. We note with concern that Hong Kong-listed company boards have a long history of tolerating inactive or incapable directors. This is particularly true of non-executive directors who are controlling or significant shareholders.

  Indeed, the rushed nature of this consultation process has highlighted the challenge of reserving special rights to ill-defined "eligible persons". That we are already seeing efforts to broaden this group to corporations confirms that HKEX will continue to

[2] HKEX consultation paper, "Delisting and Other Rule Amendments", September 22, 2017.

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struggle to align the extra-ordinary rights granted to WVR issuers with fair regulatory outcomes.

- **Limits on WVR Powers:** The Exchange has proposed that WVR shares carry no more than ten times the voting power of ordinary shares and that non-WVR shareholders must hold at least 10% of the votes eligible to be cast at the general meeting. Certain resolutions will also be decided on a "one-share, one-vote" basis, including material changes to constitutional documents, a variation of rights attached to any class of shares, the appointment and removal of independent directors, the appointment and removal of auditors and the winding-up of the issuer.

  While this formulation of WVR powers carries some safeguards, we worry that the ten times ratio, now enshrined, will become a de facto norm. It should also be noted that the safeguards structure does not rule out the possibility that the resolutions listed above could still be used to undermine minority shareholders' rights, as we sometimes see in the current regime.

  Regarding the voting right on independent directors: while this appears robust on the surface, its value in practice will be constrained by both issuer behaviour and the listing rules. Will issuers nominate independent directors who are genuinely independent and can make a difference in the boardroom? Will they engage in a dialogue with investors prior to nominating candidates? How will they react if minority shareholders vote down a candidate? Given that WVR is inherently designed to dilute outside influence, it is hard to answer such questions in the positive. Meanwhile, the formal regulatory framework continues to suffer from weaknesses in the listing rule definition of "independent director"—an issue we wrote about in our December 2017 submission to HKEX on the review of its CG Code. The rules as they stand effectively allow people closely connected to companies to become independent directors. We recommend that the listing rule definition of independent director be tightened as soon as possible.

- **Board governance:** Crucial elements of the proposed safeguards rest on measures to enhance the governance mechanisms in the board. WVR companies would be required to have a corporate governance committee consisting of independent directors "to ensure that the issuer is operated and managed for the benefit of all shareholders and to help ensure the issuer's compliance with Hong Kong rules…" While this is a welcome gesture, for the reasons given above questions remain about the substantive power of this initiative in view of the limited impact of independent directors in many issuers.

  There is also a requirement that all WVR issuers must have a nomination committee comprised mainly of independent directors and in accordance with Section A5 of the Corporate Governance Code. The one difference is that in a WVR company the committee must be chaired by an independent director. What the consultation paper

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does not say is that the CG Code (Code Provision A.5.1) also allows the chairman of the board (typically an executive or connected director) to sit on the committee. Even if the board chairman does not chair the nomination committee, his influence will remain strong and almost certainly dominant.

- **Time-based sunset clause:** The one safeguard not included in the consultation paper is the concept of a sunset clause. Yet the single most compelling safeguard HKEX could offer to the investor community is a time-based sunset clause of around seven years. We understand that the Exchange is not incorporating sunset clauses into its proposals for competitive reasons (ie, the concern of losing IPOs to the US, where formal sunset clauses are not required). Yet such clauses are becoming best practice for WVR issuers in the US, where there has been a lively practitioner and academic debate about the dangers of WVR in perpetuity. Seven years is increasingly being seen as the fairest possible compromise between issuers/exchanges, who typically seek 10 years or more, and investors, who prefer no more than five years.

While ACGA maintains its strong opposition to WVR, we would be happy to work with HKEX to ensure a stronger safeguards regime.

Yours truly,

Jamie Allen
Secretary General

**Melissa Brown, ACGA Specialist Consultant, assisted in the writing of this submission.*

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