



## Hong Kong Investment Funds Association

( company incorporated with limited liability 有限責任公司 )

Room 701, 7/F, Hong Kong House, 17-19 Wellington Street, Central, HK.

Tel: (852) 2537 9912 Fax: (852) 2877 8827, 2877 2368

Website: <http://www.hkifa.org.hk> E-mail: [hkifa@hkifa.org.hk](mailto:hkifa@hkifa.org.hk)

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May 21, 2020

Hong Kong Exchanges and Clearing Limited  
8<sup>th</sup> Floor, Two Exchange Square  
8 Connaught Place  
Central, Hong Kong

Dear Sir/madam,

### **Re: HKEX Consultation Paper - Corporate WVR**

On behalf of the Hong Kong Investment Funds Association (Appendix 1 – backgrounder of the Association), I attach a submission which outlines the views and suggestions of the fund management industry with respect to the captioned consultation paper.

First of all, we wish to reiterate our full support of the “one-share-one-vote” principle, as we believe is the bedrock of investor protection and sound corporate governance.

We understand the rationales outlined in Chapter 2 of the Paper for allowing Corporate Weighted Voting Rights (“CWVR”) – from increasing the competitiveness of the Hong Kong market to expanding the investment opportunity sets. And we also appreciate the efforts made by the HKEX to introduce measures to bolster investor protection under the proposed structure, but the HKEX and the issuers should make it clear to investors that despite all these mitigating measures, there are structural flaws which will fundamentally undermine investor rights.

With respect to the suggestions put forward in the Captioned paper, we have outlined our members’ detailed comments in Appendix 2. We wish to share a few key points:

#### **(1) A mixed structure - both individual and corporate WVRs**

We submit that there may be rationales for allowing different types of WVRs. But we have major reservations about allowing a mixed structure. We advocate a single structure, i.e. the issuer has to choose either having an Individual WVR (“IWVR”) or a CWVR.

In the CP, there are no detailed discussions about the policy justifications for different requirements for IWVR and CWVR (for instance, why would the proposal require a corporate beneficiary to maintain a minimum economic interest after listing and yet this is not required for an individual?) More importantly, why would different requirements be of benefit to investors?

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The proposed mixed structure can potentially result in convoluted outcomes. The requirements for IWVR and for CWVR differ at least in the following areas:

- Voting powers
- Economic interest
- Contribution to listing applicant
- Qualifications
- Ongoing requirements
- Sunset
- Lapse

If we put the factors together, which can have different variations, there is high variability in the outcomes. The complexity is further accentuated by the new and vague concepts of ecosystem and components. For instance, what are the possible conflicts of interest that may arise - within each type of WVRs, and between them; and how are they to be managed? Where do you draw the boundary of the ecosystem, who are the components and how do they interact with the issuer/beneficiary? What would be the potential issues arising from conversion, e.g. converting super shares to ordinary shares may potentially trigger a mandatory general offer? What if the individual beneficiary is reluctant to convert part of the WVR shares upon the sunset of the CWVRs?

Furthermore, it must be remembered that the CWVR proposal is primarily for issuers seeking a primary listing on the HKEX. For eligible applicants that wish to seek a secondary listing, their existing CWVR beneficiaries could continue to avail of the WVR without being subject to the proposed requirements.

The complexity, uncertainty and room for regulatory arbitrage would potentially give rise to huge information asymmetry, which militates against the interest of investors, especially for retail investors, who are unlikely to have the resources and means to full monitor, let alone, assess the implications to their rights.

In view of this, we strongly believe that the HKEX should not allow a mixed structure. If the HKEX insists on allowing a mixed structure, it should ensure the requirements are aligned.

For prudence purposes, what we would advocate is to adopt a phased approach, i.e. only allow a single structure (either IWVR or CWVR), say for two years to see how it works; and then based on the results, conduct a consultation to explore the possibility of introducing of a mixed model.

## (2) Ecosystem and the gate-keeping role of the HKEX

The “ecosystem” test is vague and couched in very general terms. Absence of something detailed, rigorous and robust, one would query how this would be transposed in a consistent and structured manner.

From a practical implementation perspective, one would reasonably expect that it

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would not be difficult for a listing applicant to put forward evidences to demonstrate some form of “synergistic relationships” between it and the CWVR beneficiary (very likely between the parent and a subsidiary). Without objective criteria or standards, on what basis would the HKEX and the Listing Committee be in a position to refute the cases being forward – especially if the case involves tech giants/unicorns? Will we end up in a situation where the HKEX would by default accept these applications; and the onus would fall on the HKEX if it were to reject an application? While it can be claimed that the vetting process is no different from the existing one, we must be mindful that the ecosystem/synergy concept brings in a much higher degree of subjectivity. In view of the potential legal as well as business considerations (ultimately, the HKEX is a profit-making entity), we believe it is important that the HKEX provides clear explanations of how it envisions it can effectively discharge its gate-keeping functions.

### (3) Investor protection measures as outlined in the Consultation Paper

Detailed comments are covered in the attachment. Suffice to say, there are a whole host of enhancements that need to be made to mitigate the detrimental impacts wrought about by such a structure, so as to bolster investor protection.

We are committed to lending support to the HKEX and the authorities to further boost the vibrancy and robustness of the Hong Kong stock market; as well as to ensure that investor interests are safeguarded and well protected. We welcome opportunities to have more dialogues to exchange views and ideas.

Yours sincerely



# Hong Kong Investment Funds Association

## HKEX Consultation Paper - Corporate Weighted Voting Rights:

### Comments/suggestions made by members of Hong Kong Investment Funds Association (May 2020)

#### **Overall principle**

#### ***Whether WVR regime should be expanded from individuals to corporates (Q1)***

As a general principle, we strongly believe that “One share one vote” (“OSOV”) is the bedrock of sound corporate governance and plays a pivotal role in the protection of investor interests. Differential voting rights, no matter what safeguards are instituted, will inevitably encroach upon investor rights.

However, we are cognizant of the clear policy intent and direction of the HKSAR Government and the authorities. And since introducing Corporate Weighted voting rights (“CWVR”) is a fait accompli, our focus is to come up with suggestions on how to mitigate the detrimental effects wrought about by WVR.

#### *CWVR – it should not come as a right by default, it is to be earned*

The listing applicant should understand that CWVR class share is a privilege and that it does not come in as a default. This privilege should be earned on listing and on an on-going basis. The ability to retain this privilege should be subject to the scrutiny of and explicit consent by the investors. Specifically, we believe that continued entitlement to WVR should require independent shareholders approval on an OSOV basis; and that there should be disclosure of voting results.

#### **Ecosystem (Q8, 9-14)**

A key concept that underpins the whole value proposition of CWVR is “ecosystem”. In view of its central role, we believe that it is important that the HKEX provides more insights as to its expectations when it assesses whether a listing applicant meets this test.

The discussions in the CP are couched in general qualitative terms. (e.g. under Para 156 (a) to (e.) and para 157, there are terms such as “community of companies”, “meaningful scale”, “growth and success... materially attributable to participate...”) While we understand that it may not be practicable to provide bright line tests, it would be important to understand what standards, metrics or tools that will be used by the HKEX to determine whether the listing applicant meets the relevant tests (e.g. is it by way of the quantum of information and technology shared within the ecosystem, and/or to ascertain how the CWVRB have been contributing to the revenue and profits of the

listing applicant?). We have query whether the concept has the degree of precision and legal certainty that is needed in a listing eligibility condition.

Also, based on Para 156, it seems that the applicant and the prospective CWVR only have to demonstrate “the ecosystem nexus” exists prior to listing. How about post-listing – what is the on-going obligation to demonstrate its continued compliance on an on-going basis? Should there be requirements to provide explicit positive confirmation?

Under Para 160, a 12-month period is allowed before the beneficiary’s shares will lapse permanently if the contribution is substantially terminated or materially disrupted... A 12-month lapse is unduly long. If the contribution (which is quid pro quo for the WVR privilege) is no longer available or materially curtailed, shouldn’t the privilege automatically, or at least as soon as practicable, be revoked? In any events, the period should not be more than six months.

### ***Economic interest (Q3 & Q6)***

Per the CP, the CWVRB “must have an economic interest of at least 10% in, and have been materially involved...at least two financial years prior to the data of its application...

Para 148 further says that for a CWVRB that holds an economic interest between 10% and 30% during the two financial years prior to the listing... it may increase its shareholding in the application to 30%.

To demonstrate that the CWVRB is materially responsible and contribute to the growth of the listing applicant during the track record period, it is important that a higher threshold is set. We propose two changes:

- increase the period from two financial years to three years; and
- increase the minimum economic interest of 10% to 30%

The CP puts forward a proposal of at least 20%, but less than 30% - purportedly to increase the competitiveness of the Hong Kong market. This is in effect using an indirect way to lower the threshold, which is not appropriate. Furthermore:

- 30% is a generally adopted threshold and in fact, as recent as the amended backdoor listing rules, 30% is the materiality threshold being used. For consistency purposes, we should stick to 30%.
- It is claimed that a threshold of 30% may affect the competitiveness of HK vs. jurisdictions such as the US. When a LA considers a listing venue, it would consider a totality of factors and the threshold is but one of the factors. We should not just single out one factor when we evaluate the competitiveness.

### ***Wedge ratio (Q7)***

The CP proposes that the CWVRB must carry no more than five times the voting power of ordinary shares.

We believe that the voting power multiple should be lowered to reduce the detrimental impact on the right of minority shareholders.

Assuming an economic interest of 30%, we believe that a multiple of 2.33 is more equitable. But if the policy intent is to allow a higher multiple so as to give the CWVRB a majority control - we believe that 2.5 is the absolute maximum as it already vests the CWVRB with a voting power of over 50%.

### **Market capitalization (Q15-16)**

Setting a market capitalisation threshold would be useful to prevent WVR from becoming the new norm.

The CP seems to allude that as there are only 4% of the companies that exceed the HK\$200 billion threshold, this threshold should suffice to guard against proliferation risks.

If this is deemed as a risk, how does the HKEX intend to manage it?

Does the HKEX has a figure in mind as to when would this percentage would trigger concerns, e.g. if WVR companies exceed 10% (bearing in mind that traditional economy companies can be in scope, it is likely that this trend will pick up)? And if and when this happen, what measure would be instituted, if at all, to address the “problem”?

In any event, to ensure that the threshold continues to be relevant and meaningful, we believe that the threshold should be reviewed regularly, say every two years.

### **Eligibility requirements (Q17-18)**

“A CWVRB must be a company with a primary listing on the Exchange or a Qualifying Exchange... (Para 168)

“Qualifying exchange” in itself does not necessarily guarantee robust investor protection. There should be mechanisms to enhance governance requirements, especially for companies that are incorporated in Cayman Islands and other offshore locations as they have been leveraging on US listing exemptions (e.g. exempted from certain reporting obligations and obligations to hold AGM) that are detrimental to minority shareholder rights.

On some major exchanges in the US, controlled companies, where the parent company has at least 50% of the voting power, can apply for exemptions from certain corporate governance requirements. For instance, they can be exempted to have majority independence of the board, and 100% independence for the nomination and corporate governance committees. Some Chinese companies that are listed on the New York Stock Exchange or NASDAQ and incorporated in the Cayman Islands are exempted from convening an annual shareholder meeting. As a result, some companies have never convened, stopped convening or only convene sporadically. Deprived of these channels, investors just do not have any official means to raise their

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questions or concerns with the board of directors.

We wish to understand what measures will be adopted by the HKEX to address this major gap.

### **Sunset Clause (Q. 22-26)**

Having a “sunset clause” would be helpful to mitigate the entrenchment risk. Studies indicate that even if there is an advantage to differential share class structures, such structures should not be permanent as they can lead to value deterioration over time.

#### Duration:

The HKEX proposes a 10-year sunset clause, with the possibility of extension of another 5 years.

10-year is too long, and would not be suitable for the dynamic and fast-changing nature of innovative businesses.

Various studies indicate that even at innovative companies where unequal voting structures correlate to a value premium at the time of the IPO, that premium dissipates within six to nine years; and the costs of the unequal voting structures outweigh the benefits. Based on these studies and to err on the side of caution, we would suggest that the term should be reduced by half, i.e. to 5-years.

#### Renewal:

Ideally, we believe that after the sunset period lapses, the voting structure should default back into the OSOV mode.

However, if the HKEX maintains that the WVR structure be maintained, we suggest that there should be at least the following safeguards:

- the decision of renewals should be subject to approval by a special resolution passed by independent shareholders; and the voting results be disclosed.
- each round, can renew for no more than three years. Because of the dynamic nature of the innovative businesses, the business cycle is much shorter and three-years is a more appropriate time-bar.

### **Related party transactions**

There is limited, if any discussions about how related party transactions (“RPTs”) will be monitored. We would suggest that the HKEX details how transactions are monitored over the approval period, the response to any breaches of the conditions set and the process of reporting, should any irregularities be discovered.

The board should disclose the process for approving, reviewing and monitoring RPT and any inherent conflicts of interest. We would call for issuers to set up an RPT

committee at board level, which will oversee and monitor transactions. There should be a lead member from this committee who will be the contact point for investors to raise questions re RPTs; and as a minimum, this member should be present at the result presentation sessions to answer questions.

It is claimed that under the proposed structure, CWVR beneficiaries can consolidate the issuers' top line financials, which is beneficial for market valuation. However, there is no guarantee that companies will provide a top-line breakdown by key verticals and/or business segments. Opacity in financial reporting may distort a company's valuation. For instance, persistently high revenue growth in some businesses may have masked the problems in other segments or businesses. To address this, we suggest that the HKEX mandates that CWVR provide detailed financial disclosures by business segments.

### ***Allowing both corporate and individual WVRs (Q 27-30)***

Theoretically speaking, these two should not be mutually exclusive; as their value-added to the listed cos may be different.

However, as the proposed requirements re CWVRs are different from those that govern individual WVRs in a number of areas, the complexity, uncertainty and room for regulatory arbitrage would potentially give rise to huge information asymmetry, which militates against the interest of investors, especially retail investors, who are unlikely to have the resources and means to fully monitor, let alone, assess the implications to their rights.

In view of this, we strongly believe that the HKEX should not allow a mixed structure.

If the HKEX insists on allowing a mixed structure, it should ensure the requirements are aligned. For instance, we believe that if an issuer is to have individual and corporate WVR beneficiaries, both should be subject to the same sunset terms – i.e. time-based (instead of one event-based and one time-based). And the duration of 5-yrs (initial) and 3-yrs (renewal) should apply to both. Furthermore, each party should not have majority voting power.

As a general principle, for prudence purposes, we would advocate a phased approach, i.e. only allow a single structure (either IWVR or CWVR), say for two years to see how it works; and then based on the results, conduct a consultation to explore the possibility of introducing of a mixed model.

### ***Other safeguards (Q 13 & 14, etc)***

We urge the HKEx to enforce additional safeguards to uphold shareholder rights, with no exemptions allowed.

- If there is a change in the control at the CWVRB, it should require approval by independent shareholders as this is a material change and would potentially affect, inter alia, the strategy of the CWVRB and the relationship with the listedco.
- Corporate representative – Per the Paper, the requirement to have a CR is to

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“introduce an element of supervision and control over the conduct of the CWVRB.” To enable investors to understand how the CR supervises and controls the conduct, It is important that there is a channel for them to maintain dialogues with the CR; and that the CR reports his/her observation re conduct of the CWVRB at the results presentation sessions – similar requirement as those prescribed for the lead member of the RPT committee mentioned above.

- Similarly, we believe that there should be a lead member amongst independent directors.
- For transparency purposes, we believe that for any voting that is held on a WVR basis, its result should be disclosed on both bases (i.e. result based on WVR; and result if OSOV had been used).
- In general, there should be a review of the HK Stewardship Code and Principles of Responsible Ownership to see how to further bolster them to foster stewardship.

(End)