We respond to HKEX's 2nd attempt to introduce 2nd-class shares via a "New Board", rather than cleaning up its existing boards and transferring listing regulation to the statutory regulator which oversees takeovers, the SFC. Coupled with recent moves to embed the Communist Party in the constitutions of state-controlled enterprises, HK and China risk a toxic combination of no votes for government and no votes for capital, leading to an emerging tycoon-Communist Party oligarchy. We propose a better approach.

One Board, One Regulator

7 August 2017

We mentioned in our article Preventing Cash Shells (3-Mar-2016) that Hong Kong Exchanges and Clearing Ltd (**HKEX**, 0388), the owner of HK's monopoly Stock Exchange of Hong Kong Ltd (**SEHK**), was proposing a "third board" for listing stocks, rather than addressing the problems with the existing Main Board and Growth Enterprise Market (**GEM**). As we said then, HKEX is "rather like a village that refuses to build a proper sewerage system and instead digs another cesspit to accommodate a larger population, ignoring the fact that eventually nobody wants to live in a disease-ridden village."

15 months later on 16-Jun-2017, HKEX has published a "Concept Paper" on a third board, or what critics are calling the "Turd Board", for obvious reasons. Possible marketing slogans are "Float your sh*t on the Turd Board". Kinder suggested names include "The Third Time Lucky Board" or the "Third-Class Board" - for companies that do not qualify for the other two boards. HKEX calls it the "New Board", with 2 segments - effectively a third and fourth board.

This article is Webb-site's submission on both the Concept Paper and the related consultation on the GEM. For reasons that will become apparent, we are not going to answer the loaded questions in HKEX's crafty questionnaires. The proposals take entirely the wrong direction to improve HK's markets. As detailed below, there are aspects of HK's listing criteria that play no role in corporate governance and should be abolished to facilitate listings, but we favour a single board, under a single statutory regulator (the SFC), combining listing and takeover regulation, and not the 4-board mess that HKEX advocates.

The HKEX Concept Paper jumps the gun on a consultation on listing regulation which ended on 18-Nov-2016 and for which, after 9 months' gestation, no conclusion has yet been announced. Our submission on that is here. The joint HKEX-SFC proposal was to move all listing policy issues to a new Listing Policy Committee (**LPC**), with equal representation from HKEX and the SFC. If that goes ahead, then HKEX's unilateral Concept Paper becomes rather pointless.

WVR 2.0

The Concept Paper is entirely motivated by a wish to list companies with what HKEX euphemistically calls "Weighted Voting Rights" or "WVR structures" - either listing second-class shares with reduced or no voting rights, or allowing peculiar governance structures such as that of Alibaba Group Holdings Ltd (NYSE:BABA), which has only one class of shares but entrenches management rights to nominate directors in its Articles of Association, thereby reducing the effect of voting rights held by shareholders. In either case, the ability of public shareholders, large or small, to engage in governance would be reduced or eliminated.

HKEX initially tried to do this in an Aug-2014 concept paper on proposals to put WVR structures on the Main Board. This resulted in a conclusions paper on 19-Jun-2015 containing draft proposals for primary listing of WVR structures in a second round of consultation, which was shot down 6 days later when the board of directors of the SFC (a majority of which is non-executive) unanimously rejected them, citing "core principles of fairness and transparency". As the SFC's approval is needed for any change to the Listing Rules, that was the end of it.

Undeterred, HKEX CEO Charles Li Xiaojia began pushing for a work-around, attempting to ring-fence the target companies in a third board. Such an arrangement would of course be entirely artificial and involve the same concerns stated by the SFC when it rejected the proposals in 2015, including:

> "The SFC is of the view that Hong Kong's securities markets and reputation would be harmed if WVR structures became commonplace...Unrestricted, post-listing transactions could over time result in the transfer of a significant proportion of existing listed businesses and assets to WVR structures. In the SFC's view, such a development would

be detrimental to our markets and the interests of the investing public generally."

Grouping WVR companies into a separate "board" doesn't solve that problem, and in any case, the shares would be traded and settled on the same platforms as the Main Board and GEM. In fact, HKEX is now proposing two new boards, both allowing WVR structures. One, dubbed "New Board PRO", would be restricted to "professional investors" and would allow companies with no financial track record and have a "light touch" to vetting. Given the capital lettering, perhaps PRO stands for Professional Rip-Offs. The other, "New Board PREMIUM" would be open to all investors, but given the inclusion of WVR structures, should probably be called "New Board DISCOUNT".

An emerging tycoon-Communist Party oligarchy

The push to strip equity owners of governance rights needs to be seen in a broader, political context. China is a country which already deprives its citizens, both in the mainland and in HK, of the right to elect their leaders, and now it is pushing via the HKSAR Government (**HKSARG**) and HKEX to deprive investors of voting rights to govern the use of their capital, on the "home soil" of HK, free of oversight by foreign regulators. At least US-listed Chinese WVR companies have some oversight from US regulators (in turn appointed by an elected government) and are subject to potential class action in the US courts even if their underlying assets (or contracts) are in China.

That lack of accountability, both in Government and for the use of capital, would be a particularly toxic combination. It would lead to further entrenchment of the Communist Party leadership alongside tycoons who are answerable to nobody but themselves, and work together with the leadership to further their mutual interests. A new oligarchy is emerging. Migrating overseas-listed Chinese companies back to Chinese soil, while maintaining their WVR structures, is part of that emerging picture.

This comes as an increasingly assertive Communist Party is now abusing the state's voting rights to amend the Articles of Association of state-controlled enterprises, including those listed in HK, to entrench its role. For example, China Petroleum & Chemical Corp (0386), aka Sinopec, recently did so, as did China Machinery Engineering Corp (1829). Datang International Power Generation Co Ltd (0991) will do so on 15-Aug. Notably, the PRC's pretence that it is a multi-party state is discarded by allocating these powers to "The Communist Party" rather than "The Government".

Institutional investors appear to have been asleep at the wheel when some of these amendments were passed, but even if they all voted against (as they should), the resolutions would still be passed, because HKEX has allowed the Government to vote its majority holdings in favour, despite the obvious conflict of interest.

If an individual HK tycoon were proposing to embed himself in the Articles of Association of a company he controls, perhaps regulators would raise a red flag, but HKEX does not oppose the Communist Party which, via state-controlled companies, is its single largest customer. The red flag that HKEX raises for them is the other kind, with a hammer and sickle on it.

Imagine the outcry if the Articles of Association of RBS Group plc were amended (using the UK Government's majority vote) to entrench the Conservative Party in its governance structure. Governments in multi-party democracies would never attempt such a thing.

Professionals are not isolated, they manage the public's money

Second-class shares are unpopular amongst investors even in democratic countries. In response to pressure from organisations such as the US Council of Institutional Investors, S&P Dow Jones Indices announced last week that it would no longer admit companies with multiple share classes to its S&P Composite 1500 indices (including the flagship S&P 500), although it has not (yet) evicted existing multi-class companies such as Facebook or Ford Motor.

Some would argue that nobody has to buy second-class shares if they don't want to, or even that the shares should be limited to "professional investors" - but this overlooks the fact that if more and more assets are held via WVR structures, then those professionals who manage the public's money - including asset managers, pension trustees, college endowments, sovereign wealth funds and so on, would have little choice but to own WVR shares in order to get diversified exposure to the economy.

The notion that professional investors are somehow able to overcome a deficit of voting rights or bad governance by listed companies, or that restricting the market to professionals would insulate the general public is false. Bad governance hurts us all. Investors do not acquire new rights by being "professional". The beneficiaries of all money managed by professional fiduciaries are ultimately the general public.

With so many scam stocks and corporate governance problems amongst HK-listed mainland companies, and with major overseas investor groups and index providers starting to rebel against second-class shares, the last thing HK needs is to weaken investor rights further. It would strengthen HK's reputation as the wild East rather than a trustworthy destination for capital.

Secondary listings: a path to evasion

Both new boards would also allow "secondary listing" of mainland companies with overseas primary listings (particularly, the USA), effectively outsourcing regulation to the USA and by-passing HK rules, but presumably in the hope that the bulk of the trading volume would migrate to HK. This would leave HK investors without some of the most important protections such as the HK rules requiring minority shareholder approval of connected transactions, while at the same time, the investors would be unlikely to be covered by US class action rights as their investments were made in HK. It's the worst of both worlds.

There are currently only 7 secondary listings in HK, of which 6 have only tiny amounts of shares in the HK clearing system, ranging from 0.01% to 1.37% of their issued shares. The exception is SouthGobi Resources Ltd (**SouthGobi**, 1878), which is the only one that conducted a public offering in HK while maintaining a primary listing overseas. Over 7 years, the proportion of SouthGobi's shares in the HK clearing system has risen from 16.13% to 97.05%, yet its primary listing regulator is still in Toronto. However, in 2014, the SFC's Takeover Panel revoked SouthGobi's exemption from the Takeovers Code, leaving SouthGobi with the unique status of being treated as a secondary listing by HKEX but as a public company in HK by the SFC under the Takeovers Code. That's what you get when you have split regulation.

If a company is going to have a substantial shareholder base and trading in HK, then it will need to conduct an offering in HK, and if it does that, then we believe that it should be treated as a primary listing under the Listing Rules and a public company under the Takeovers Code. Otherwise, we will see evasion by outsourcing on a grand scale.

HKEX has a WVR structure

Ironically, HKEX itself has a WVR structure (using its own broad definition) because only 6 of its 13 directors can be elected by shareholders, the others being directly or indirectly appointed by the HKSARG, although it only owns about 6% of HKEX. This peculiar structure reduces the ability of investors to engage in stewardship by electing the board. There is one other HK-listed company with HKSARG appointees, train operator MTR Corp Ltd (0066), but that is majority-owned by HKSARG, so HKSARG elects all the other directors (including the so-called INEDs) anyway.

By comparison, the US Government does not appoint any directors to the multiple competing stock exchanges there, nor does the UK Government appoint directors to UK exchanges. In both markets, substantially all the regulatory powers are held by statutory regulators, the US Securities and Exchange Commission and the UK Financial Conduct Authority (via the UK Listing Authority), while competing exchanges set their own criteria for trading stocks on a commercial basis. Put simply, a for-profit regulator like HKEX has a conflict of interest in setting and administering (or waiving) Listing Rules.

The so-called "New Economy"

In the concept paper and in other forums, HKEX has sought to portray the absence of WVRs (itself excepted) as a loss of so-called "New Economy" stocks. Of course, at any point in time at least since the Industrial Revolution moved us away from agrarian subsistence, part of the economy involved new technology. Railways were once new technology. Broadcasting was new. The transistor was new, and then the microchip, the personal computer and the internet were new. HKEX admits that "it is hard to define such companies" but rather desperately tries to define the "New Economy" as:

> "Industries include Biotechnology, Health Care Technology, Internet & Direct Marketing Retail, Internet Software & Services, IT Services, Software, Technology Hardware, Storage & Peripherals"

Defined in this way, the paper states that

> "companies from New Economy industries that have listed on our market in the past

> ten years make up only 3% of our total market capitalisation".

That is true but misleading. It is only natural that newer companies tend to be (but are not always) smaller than older ones, as they grow after listing if they are successful. The average size of IPOs in HK has declined from abnormally high levels over the last 20 years, but that is because the stream of giant state-owned enterprises (banks, insurers, petrochemicals and so forth) coming to the market has largely been exhausted. In that respect, HK is now returning to more normal conditions.

The 10-year window chosen by HKEX excludes HK's largest listed company, internet gaming, chat and payment firm Tencent Holdings Ltd (0700), which listed in 2004 and closed on 31-Jul-2017 with a market cap of HK$2,977bn (US$381.7bn), or 9.34% of the entire HK market of HK$31,878m. 10 years earlier, Tencent was worth just HK$64.53bn, and it was even smaller when it listed, at just HK$6.2bn.

Also excluded is Lenovo Group Ltd (0992), a leading global computer-maker listed in 1994, which ranked 98th by HK market cap at the end of July, and smartphone speaker-maker AAC Technologies Holdings Inc (2018), listed in 2005 and worth HK$128.5bn at the end of July. Smartphone camera-maker Sunny Optical Technology (Group) Co Ltd (2382) listed just over 10 years ago and was worth HK$102.0bn at the end of July but only $4.02bn on the day it listed, 15-Jun-2007 (and shrank to just HK$490m on 31-Jan-2009).

It is true that there is a concentration of Chinese internet stocks in the USA, including recently-listed Alibaba and older dotcom era companies such as NetEase Inc (NASDAQ:NTES) and SINA Corp (NASDAQ:SINA). Some of these have WVR structures, but many of them chose the US because of its existing investor and analyst base focussing on the internet. If WVR was the real reason that HK "lost" these listings, then we would also be losing listings from other sectors, such as property, manufacturing or finance. We haven't.

It is also unsurprising that HK's market, of which more than half is now mainland businesses, has a heavier weighting of manufacturing and property stocks. China is still a developing economy, and developing economies tend to be heavier on infrastructure investment and manufacturing, and lighter on services and technology. The HK market is a mirror of China's economy, not of the US economy.

Remember also that many of the US's most successful tech companies have only one class of share, including Microsoft, Apple, Intel, Hewlett-Packard and IBM. Each of them in their time was "New Economy", but none felt the need to disenfranchise shareholders.

A few authoritarian or emotionally insecure CEOs feel a need to protect their jobs with WVR structures, but losing those listings to the US (or any other market which races to the bottom, such as Singapore) is to HK's overall gain, because it implies that we have maintained, or improved, on standards which will attract other issuers with better pricing than they would get if we joined that race to the bottom.

Incidentally, another misleading comparison has been made by several commentators measuring the turnover of US-listed Chinese stocks against HK's market turnover, claiming that HK has "lost" this turnover. That comparison fails to recognise that due to the absence of stamp duty, transaction costs in the US are far lower than in HK, facilitating high-frequency trading that is simply not feasible in HK. If such stocks were instead listed in HK, their turnover would be substantially lower. Stamp duty is currently a 0.2% round trip for HK stocks.

The Enigma meltdown and systemic failure

The most recent demonstration of HK's systemic failure of listing regulation was the meltdown on 27-Jun-2017 of dozens of stocks in what *Webb-site* called the Enigma Network when we graphically identified it 6 weeks earlier. This collapse, on both the Main Board and GEM, was the biggest meltdown since the Penny-Stocks Incident of 2002, which led, after an initial inquiry (the PIPSI Report), to the Government's appointment of a 3-man Expert Group, which concluded in Mar-2003 that:

> "The listing function must be removed from the HKEx and performed by a new division of the SFC to be known as the Hong Kong Listing Authority".

That recommendation, which would have brought HK into line with the US and UK, was briefly accepted by the Government before it was dropped on opposition from local tycoons and HKEX.

So here we are 15 years later, and history, not having been learned from, is being repeated.

Since the SFC's creation, it has regulated public company takeovers via the Takeovers Code, overseen by the Takeovers Panel, of which your editor has been a member since 2001 and a Deputy Chairman since 2013, but front-line Listing regulation has remained with SEHK.

You might think that the Enigma meltdown would be enough to remind HKSARG and its new Chief Executive of this unfinished business, but we fear that they are more interested in pursuing the national agenda of furthering the oligarchy by listing WVR companies than they are in building a better quality market.

That's a shame, because ultimately HK and Chinese companies would be more competitive globally if they were governed to higher standards, both internally and externally through laws and regulations. All other things being equal, investors will pay more for stocks in a market with a strong governance framework, including investor rights and remedies, than stocks in a market which has raced to the bottom, because investors expect a fairer share of the returns from the underlying businesses. Higher prices are the flip-side of a lower cost of capital, which increases competitiveness as companies can take on projects with lower rates of return.

Scrap GEM, Go OBOR (One Board, One Regulator)

The New Board Concept Paper was launched simultaneously with a consultation paper on a review of GEM and consequential proposed changes to the GEM and Main Board Listing Rules, intended to isolate GEM from the Main Board by reinstating a requirement for a sponsor and a listing document to move up to the Main Board. There is also an SFC-inspired requirement to have a public offering (not just a placement) in GEM listings, as if that would prevent the formation of bubbles. It won't - there have been many bubbles on the Main Board despite the public offer requirement.

This really misses the mark. What HK needs is an end to the artificial distinction between GEM and the Main Board. We need a single board, let's call it the "One Board", with a single set of Listing Rules, taking the best aspects of both markets and improving on them. We need to remove archaic requirements that do not contribute to corporate governance and instead make the process of listing unnecessarily cumbersome or expensive. The One Board Listing Rules should be administered by the HK Listing Authority under the SFC, and the combined requirements should include:

1. Strictly one share, one vote.
2. A 3-year track record for a new entrant with an unqualified audit report, under substantially the same management as it will have at listing. Anything shorter than that belongs in the unlisted private equity or venture capital markets, with the possible exception of dedicated project companies managed by people with an existing track record of projects.
3. Very Substantial Acquisitions of other companies should be prohibited unless the target has a 3-year unqualified track record.
4. No requirement for a profit before listing - let investors decide, based on the 3-year track record, whether they want to own a loss-making company (or what HKEX euphemistically calls a "pre-profit" company). After all, in any given year, numerous existing companies are loss-making.
5. No requirement for a public offer tranche at listing (same as GEM). Whether to have one, and in what form, should be a commercial judgement for a listing applicant and its advisers.
6. No minimum market capitalisation. If a company is willing to pay the listing fees and satisfies track record requirements, let the market decide.
7. No minimum public float. Again, let the market decide, and stop suspending shares and trapping minority shareholders when the free float shrinks.
8. Full disclosure of the identities of subscribers (including beneficial owners of 10% or more of their votes or equity) and the numbers of shares subscribed in placings, whether at initial listing or subsequently.
9. Full disclosure of the identities of beneficial owners of counterparties to notifiable transactions (acquisitions, disposals or loans) by listed companies. No more hiding behind BVI curtains.
10. Mandatory quarterly financial reporting - something that Shanghai- and Shenzhen-listed

companies have been doing since 2002, as has every GEM company since 1999, as has almost every other market in Asia. The HK Main Board has been the laggard - it has only been a "Recommended Best Practice" in the Code on Corporate Governance. The 3 quarterly statements should include balance sheets and cash flow statements (GEM still doesn't), but do not need to be audited.

11. INEDs: boards or shareholders can continue to nominate candidates for election as Independent Non-Executive Directors, but controlling shareholders, executive directors and their associates must abstain from voting in the elections, due to their obvious conflict of interests. This will leave independent shareholders to elect the INEDs. Otherwise, INEDs serve at the pleasure of the King, making a joke of their independence.
12. Tighten the permissible general mandate to dilute existing shareholders by issuing new shares for cash, with a maximum of 5% enlargement in any year, at a maximum discount of 5% (currently: 20% at a 20% discount). Any larger size or discount should require a rights issue, or approval by 75% of votes cast by independent shareholders on a special resolution. This would raise HK pre-emption standards to the UK's.
13. Introduce a Cash Shell Limit as we proposed in 2016, to prevent listed companies hoarding excess capital or entering into transactions which would make them a cash shell. For details, click here.

Other issues

Separately, HKSARG must legislate to:

1. provide investors with access to justice in the form of class action rights. The loser-pays costs system will deter vexatious or meritless cases;
2. abolish the common law against champerty and maintenance, to allow litigation finance companies to finance litigation;
3. allow solicitors and barristers to work on a contingent fee basis, for the same reason. Existing legal remedies have remained largely unused due to these first three issues;
4. impose a statutory duty of care on auditors to shareholders and creditors, not just to the listed companies that employ them. When auditors fail in their duties, the losses accrue to shareholders and creditors, not to listed companies.
5. repeal the statutory monopoly of SEHK on running a stock market from the Securities and Futures Ordinance, and revoke the exemption of HKEX and its subsidiaries from the Competition Ordinance;

Last but not least, the SFC must require intermediaries who hold shares for clients, including banks and brokers, to notify clients of voting opportunities and provide an online mechanism for voting those shares at every general meeting. The intermediaries can either establish those systems themselves, or outsource it to Hong Kong Securities Clearing Co Ltd (owned by HKEX) which operates an online voting system for Stock Segregated Accounts. Currently, a lot of bad proposals are passed in shareholder meetings simply because retail investors are practically unable to vote. There is no point in having equal voting rights if they are not exercisable.

Organisations in this story

- HONG KONG EXCHANGES AND CLEARING LIMITED
- SECURITIES AND FUTURES COMMISSION

Topics in this story

- Competition
- Financial regulatory structure
- Listing rules
