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Asia Capital Markets Institute Response to HKEx New Board Concept Paper

Given the multitude of stakeholders, managing a stock exchange and fostering the integrity of equity capital markets can be immensely complicated. The Hong Kong Stock Exchange (HKEx) is to be commended for putting forward its concept paper to explore a way forward in these times of rapid global market and technological development and competition.

Global Competition for Listings

The search for competitive advantage among stock exchanges, and their impact on the corresponding financial service participants and political economies, can be seen in this and other ongoing market consultations worldwide.

Market liquidity today is driven significantly by large cap companies, many of which were still emerging tech companies less than two decades ago,[1] and there has been a corollary rise in the negotiating leverage of large emerging companies that are seeking public company listings on stock exchanges (who are themselves listed) across different jurisdictions around the globe. Convenience to local investors and support for the growth of local asset management industries are also sought to be achieved through secondary listings to address time zone differences.

At the same time, there is a growing appreciation that funding through the capital markets for entrepreneurial enterprises which fuel innovation and jobs can positively impact the local real economy and at the same time potentially create new avenues for investment of savings and liquidity provided by speculation. Yet, this needs to be balanced by the attendant heightened risks when tapping public money to invest in earlier stage companies and business models.

As a result of these complex dynamics, public company stock exchanges and regulators worldwide are currently exploring ways to remain competitive by attracting new companies and new categories of listings, and thereby liquidity, to their respective markets, whether it is the Singapore Stock Exchange on dual class share structures,[2] the UK Financial Conduct Authority on

[1] "These are the world's 10 biggest corporate giants" (World Economic Forum, 16 January 2017); https://www.weforum.org/agenda/2017/01/worlds-biggest-corporate-giants/ ; "The World's Biggest Tech Companies are No Longer Just American" (August 17, 2017): https://www.nytimes.com/2017/08/17/business/dealbook/alibaba-sales-revenue-first-quarter-profit.html

[2] Singapore Stock Exchange, "Possible Listing Framework for Dual Class Share Structures" (16 February 2017): http://www.sgx.com/wps/wcm/connect/71f41364-8584-4da0-b8a5-7891dd16e52e/DCS+Consultation+Paper+%28SGX+20170216%29%28Final%29.pdf?MOD=AJPERES

the premium listing category for sovereign-controlled companies,[3] the London Stock Exchange AIM Rules Review[4] or the HKEx's current concept paper.

Hong Kong Regulatory Framework for Stock Exchanges

A reminder of the basis of Hong Kong's stock exchange regulatory framework may be instructive as a 'first principles' compass for the way forward.

Part III of the Hong Kong's Securities and Futures Ordinance[5] governs exchanges, and the threshold criteria for the Securities and Futures Commission (SFC) recognition of exchange controllers is that it is "*in the interest of the investing public* or in the *public interest*; or for the proper regulation of market in securities or futures contracts" (Section 59 – our italics). In fulfilling its statutory duties, the recognized exchange controller "shall –

(a) *Act in the interest of the public*, having particular regard to the *interest of the investing public*; and
(b) Ensure that the *interest of the public prevails where it conflicts with the interest of the recognized exchange controller*." (section 63 – our italics)

Furthermore, a condition of an exchange being listed was that it has entered into arrangements with the SFC that adequately ensures "the *integrity of the market* in securities or futures contracts traded on the stock market or futures market operated" (our italics).

Significantly, the Hong Kong Financial Secretary "may appoint not more than 8 persons to the board of directors of the HKEx where the Financial Secretary is satisfied that it is appropriate to do so in the interest of the investing public or in the public interest" (Section 77). This right has been consistently exercised by the Financial Secretary, where in accordance with the HKEx's Articles of Association, the board currently comprises six directors elected by shareholders, the Chief Executive of the HKEx, and six directors appointed by the Financial Secretary.

Accordingly, unlike the majority of important listed exchanges around the world, the Hong Kong government has a significant role in the corporate governance of the HKEx and, notwithstanding its relatively low shareholding in the HKEx, has in theory a significant say regarding any strategic initiatives (including relating to any takeover bids at a time when its main competitors such as the iconic New York Stock Exchange was acquired by a then 13-year old company[6] and the

[3] Financial Conduct Authority, "Proposal to create a new premium listing category for sovereign controlled companies" (July 2017): https://www.fca.org.uk/publication/consultation/cp17-21.pdf
[4] London Stock Exchange, "AIM Rules Review: Discussion Paper" (July 2017) http://www.londonstockexchange.com/companies-and-advisors/aim/advisers/aim-notices/aim-discussion-paper-july-2017.pdf
[5] Securities and Futures Ordinance (cap.571): https://www.elegislation.gov.hk/hk/cap571
[6] "ICE Completes takeover of NYSE" (Reuters, November 13, 2013): http://www.reuters.com/article/us-ice-nyse-sprecher-idUSBRE9AB16V20131112

London Stock Exchange's proposed merger with Deutsche Boerse was only blocked due to European Union antitrust concerns[7]).

Increasing Hong Kong and Asian Investor Access to Sector Diversity

Hong Kong's status has a top global IPO destination is undisputed, and is largely due to the flow of Mainland Chinese state-owned enterprises that have been listing in Hong Kong over the last 15 years.[8] The HKEx, the SFC and the Hong Kong capital markets professional community should be congratulated for being innovative these many years in adjusting to evolving markets, including through promoting dual-listed companies, e-IPOs, secondary listings and international company listings, while at the same time seeking to maintain investor protection and market integrity.

The seemingly increasing willingness of many stock exchanges around the world to consider the requests by large private companies in relation to retaining control and limiting certain minority shareholder protections and rights, notwithstanding the sale of equity securities to the public, has led to many commentators to decry a "race to the bottom".

While attracting the primary listing of such companies can increase liquidity and improve price discovery, as well as the profitability and growth of the exchanges and financial services industry participants, one key question to be considered is whether "the interests of the investing public" and the "public interest" are on balance appropriately being served by such reduction in corporate governance norms.

Similar considerations arise with the attraction of secondary listings of overseas listed companies, where the rights of the investing public in Hong Kong may potentially be less than the investing public in the primary listing jurisdiction, and the absence of high-frequency trading due to Hong Kong's stamp duty regime that drives the liquidity of many other markets may mean that the desired levels of liquidity may not arise.

Appropriate cost-benefit analyses should be conducted on each of these important aspects.

Some Observations for Consideration

In an era when technology is disrupting all companies (listed and private) and broad industries alike, we share some observations that may assist in the determination of a way forward.

(a) Naming and scope of New Boards

As a participant in the dotcom IPO boom on the ground in Silicon Valley in 2000, the author joins others who have seen the rise and fall of different waves of technologies and business

[7] "EU vetos Deutsche Boerse-London Stock Exchange merger deal" (Reuters, March 29, 2017): http://www.reuters.com/article/us-lse-m-a-deutsche-boerse-eu-idUSKBN1700XG
[8] "Hong Kong remains in pole position for IPOs" (South China Morning Post, June 24, 2017): http://www.scmp.com/business/companies/article/2099755/hong-kong-remains-pole-position-ipos

models. The phrase "New Economy" may not be advisable in an era when, as Marc Andresseen observed, "Software is Eating The World" [9] and so-called Fourth Industrial Revolution technologies are changing and being adopted by the most traditional industries.[10]

The Hong Kong Main Board has been the crown jewel of the HKEx as a destination of choice for some of the world's largest listings. The Cambridge Dictionary defines 'premium' as being "used to refer to something that is higher than usual quality"[11] and may inadvertently encourage future migration of companies from the Main Board, which we do not believe is the HKEx's intention. If the proposed boards are to be stand-alone ones and not stepping-stones to or from the Main Board, their naming should make that clear.

If the intention is to attract issuers, investors and a research analyst community to one or more particular growing (and currently largely absent) sectors, the HKEx may want to consider staking its claim and naming the broad sectors (eg, Healthcare, Fintech), or else simply use more normatively neutral terms such as Third Board and/or Alternative Board.

(b) Companies and investor base sought to attract

Proponents of private ordering argue that founder entrepreneurs should be given flexibility regarding the extent of their control and capital structure, including after they go public to combat short-termism that arises from pressures from quarterly earnings reporting.[12]

However, the international institutional buyside has been increasingly vocally opposed to weighted voting and similar rights which are at the heart of an equity holder's rights and protections, especially given the rising prevalence of passive investment in the global capital markets, which Moody's predicts will overtake active investment assets under management in the US within the next four to seven years.[13]

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[9] Marc Andreeseen, "Why Software Is Eating The World" (Wall Street Journal, August 20, 2011): https://a16z.com/2016/08/20/why-software-is-eating-the-world/

[10] Klaus Schwab, "The Fourth Industrial Revolution: what it means, how to respond" (World Economic Forum, 14 January 2016): https://www.weforum.org/agenda/2016/01/the-fourth-industrial-revolution-what-it-means-and-how-to-respond/

[11] Cambridge Dictionary: http://dictionary.cambridge.org/dictionary/english/premium

[12] Eg, "David Berger, Steve Bochner and Larry Sonsini, "Dual-Class Stock and Private Ordering: A System That Works" (WSGR Alert, May 17, 2017): https://www.wsgr.com/WSGR/Display.aspx?SectionName=publications/PDFSearch/wsgralert-dual-stock.htm ; NASDAQ "The Promise of Market Reform: Reigniting America's Economic Engine" (May 2017) : http://business.nasdaq.com/media/Nasdaq%20Blueprint%20to%20Revitalize%20Capital%20Markets_tcm5044-43175.pdf

[13] See eg, Moodys, "Asset Managers – Global: Passive Market Share to Overtake Active in the US No Later than 2024" (February 2, 2017): https://www.moodys.com/research/Moodys-Passive-investing-to-overtake-active-in-just-four-to--PR_361541

The recent announcements of S&P Dow Jones[14] and FTSE Russell[15] as a reaction to the IPO of Snap (where public shareholders effectively had no voting rights) should give some pause to the founders of such emerging companies and their investment banking underwriters, as well as the stock exchanges worldwide. MSCI's indices are generally more relevant to companies listing in Hong Kong, and its consultation regarding the treatment of such companies ends at the end of August.[16]

Exclusion from important indices will limit investor demand, and impact pricing and liquidity in the listed stock of emerging companies with such features. The HKEx will need to consider if it is willing to create board(s) open to investment by the Hong Kong public in large companies whose controlling founders consciously do not seek to attract large institutional investors through index inclusion.

It should be noted that some academics argue that the allowance of any deviation from listed company corporate governance norms should in any case be clearly delineated and have sunset or other protections to strictly limit their application and lifespan to their justifiable utility.[17]

Furthermore, the recent unprecedented "last resort" lawsuit in the Delaware courts by venture capital (VC) firm Benchmark against the founder entrepreneur of Uber, the world's most well-funded private company valued at US$68 billion, highlights that 'founder friendly' provisions risk creating corporate governance issues even in large private companies.[18] A key question to consider is how to ensure that passive institutional investors and the public would be able to adequately protect their interests in analogous ways to well-informed and well-funded VC firms with board seats if they consider any controlling entrepreneurial founder(s) of these private unicorns-turned-public companies are acting inappropriately.

(c) Enforcement of investor protections

Based on experiences in the aftermath of the dotcom bust, the combination of the long-arm of the extraterritorial application of US securities law and the US plaintiff bar that pursues class action lawsuits on a contingency fee basis should not be underestimated as a critical part of the US market discipline in relation to listing of US and overseas companies. Hong Kong must continue to find other ways to have comparable market discipline, especially

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[14] S&P Dow Jones Indices "S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rights" (July 31, 2017): https://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjimulti-classsharesandvotingrulesannouncement7.31.17.pdf?force_download=true

[15] FTSE Russell "FTSE Russell Voting Rights Consultation – Next Steps" (July 2017): http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf

[16] MSCI "Consultation on the Treatment of Non-Voting Shares in the MSCI Equity Indexes" (June 2017) https://www.msci.com/documents/1296102/1220bc04-83bd-44c1-8527-a4014ef51c8d

[17] Lucian A Bebchuk and Kobi Kastiel, "The Untenable Case for Perpetual Dual-Class Stock" (Harvard John M. Olin Discussion Paper Series, Discussion Paper No. 905, May 2017): https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2954630

[18] "The Era of 'Founder-Friendly' Startup Investing Is Over" (Fortune, August 14, 2017) http://fortune.com/2017/08/14/founder-friendly-startup-investing-is-over/

across borders, as has been sought by the SFC with the China Securities and Regulatory Commission.[19]

Startup or small and medium enterprise (SME) boards are increasingly the focus of stock exchanges such as SGX's Catalist and Deutsche Boerse's Scale,[20] but cross-jurisdictional enforcement remains economically prohibitive especially against startup companies from abroad. The colourful history of the LSE's AIM Board should be instructive in relation to the nature, evolution and potential reputational risk of such stock markets,[21] and so there is certainly merit to restricting this higher risk segment to accredited and professional investors only, which should also confer issuers with the benefit of lower transactional execution costs.

Especially if there be an appetite to extend the startup board to retail investors as well, one idea, in the Hong Kong public interest, may be to impose a stronger Hong Kong Centre of Gravity requirement for any listed startup companies – this can help ensure funds raised go towards Hong Kong entrepreneurship and jobs, and ease enforcement concerns and costs.

(d) Lessons from capital markets fintech developments

Many recent fintech developments and corollary regulatory guidance can provide ideas for the HKEx's proposed startup board as a capital raising platform that encourages entrepreneurship to create innovative new products and services, as well as jobs, as part of the development of what we call *online capital marketplaces*.[22]

The US Jumpstart Our Business Startups (JOBS) Act effectively opened the door with the regulation of equity crowdfunding in the United States. In practice, more accredited investors are joining these evolving models and platforms[23] (seen potentially as an offshoot of private placement and trade platforms), which corresponds to the HKEx proposal regarding a professional investor-only startup board. If the intention is to allow more Hong Kong retail choice of investment (and speculation that drives liquidity), concepts from equity crowdfunding regulations such as individual and aggregate investment limits can be helpful

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[19] "SFC signs MoU with CSRC to strengthen enforcement cooperation under Shanghai-Hong Kong Stock Connect" (October 17, 2014): https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=14PR127

[20] Deutsche Borse, "Scale, the new listing segment FAQs" (28 February, 2017): http://www.deutsche-boerse-cash-market.com/blob/2928738/fac409e26764d94105e9e49d29fd01ac/data/FAQ--Scale.pdf

[21] "AIM: 20 years of a few winners and many losers" (Financial Times, June 19, 2015) https://www.ft.com/content/ea2bd724-140c-11e5-abda-00144feabdc0

[22] Brian Tang, "Online Capital Marketplaces As New Asset Classes to Access Funding" in *The FinTech Book: The Financial Technology Handbook for Investors, Entrepreneurs and Visionaries* (March 2016): http://onlinelibrary.wiley.com/book/10.1002/9781119218906

[23] "Professional investors join the crowdfunding party" (Financial Times, March 16, 2017): https://www.ft.com/content/235b5198-08ce-11e7-ac5a-903b21361b43

to protect such investors,[24] but exemptions from prospectus requirement may require legislative amendment in Hong Kong. The fact that exchanges enable secondary trading beyond mere issuance and sale of largely illiquid securities through crowd or marketplace funding platform reinforce the importance of limiting retail investor exposure and risk to such markets.

Equity stock market development policy should also bear in mind the recent meteoric rise and corollary concerns regarding fund raising for innovative technology projects through token sales and what are sometimes known as initial coin offerings (ICOs). New tokens, altcoins and/or cryptocurrencies are being proposed and issued for projects that have expanded beyond pure play blockchain initiatives and pose a new form of 'competition' to conventional startup fundraising avenues and potentially to the proposed startup board. Funds raised from token sales and ICOs in the first half of 2017 have been reported to be in excess of US$1.2 billion,[25] and these digital assets may constitute "securities", or else would not provide buyers with voting rights nor securities law protections, notwithstanding that most of these tokens are listed and traded on cryptocurrency exchanges.

As more responsible players in this token sale and ICO space arise and strive towards best practices in light of regulatory uncertainty and the ever-prevalent concerns of "pump and dump" schemes" and "vapourware", it is important to note that there is a growing appeal towards good 'traditional' capital markets practices regarding disclosure, payment security, lockups and governance to battle a race to the bottom to fund these startups. In addition, it should be noted that especially since the US Securities & Exchange Commission (SEC) published its investigative report,[26] although there is an emerging trend towards either excluding the United States or limiting offers to US accredited investors only, there seems to less consensus regarding constraints to offers and sales made in Hong Kong.

(e) Expansion of Hong Kong's role as a Connector with Mainland China

Some of the most attractive and innovative recent developments from the HKEx relate to the Stock Connect launched between Hong Kong and each of Shanghai and Shenzhen Stock Exchanges, as well as the touted Primary Connect for IPOs, opening up the possibility of southbound Mainland Chinese investment into certain companies listed in Hong Kong.[27] Especially as it relates to large prospective first time or secondary listing issuers whose

[24] See eg, US Securities & Exchange Commission, "Updated Investor Bulletin: Crowdfunding for Investors" (May 10, 2017): https://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html
[25] AutonomousNEXT "Token mania" (July 2017): https://next.autonomous.com/download-token-mania/
[26] US Securities & Exchange Commission, "SEC Concluding DAO Token, a Digital Asset, Are Securities" (July 25, 2017): https://www.sec.gov/news/press-release/2017-131 ; see also Monetary Authority of Singapore, "MAS clarifies regulatory position on the offer of digital tokens in Singapore" (August 1, 2017): http://www.mas.gov.sg/News-and-Publications/Media-Releases/2017/MAS-clarifies-regulatory-position-on-the-offer-of-digital-tokens-in-Singapore.aspx
[27] "HKEx Chief Says Primary Connect a Key to Winning Saudi Aramco" (August 10, 2017): https://www.bloomberg.com/news/articles/2017-08-10/hkex-chief-says-primary-connect-a-key-to-winning-saudi-aramco

businesses are primarily based in Mainland China, additional visibility about how these initiatives may relate to the proposed new boards would be instructive.

Retaining credibility and market integrity are key

Credibility is key to the success of any market. It was not that long ago when the then US SEC chairman remarked regarding the landmark 2005 IPO on HKEx of the first major Mainland Chinese bank China Construction Bank (CCB): "We'd be kidding ourselves, however, if we didn't recognize that CCB could have done even better if it had been listed in New York rather than Hong Kong."[28]

Hong Kong, its Main Board and respective market participants have worked hard to earn and retain its credibility to attract and list world-class Mainland Chinese companies such as Tencent, Lenovo and ICBC, and international companies such as Glencore and Prudential, as well as retain the confidence of international institutional investors.

Disclosure is the historical and philosophical foundation of capital markets around the world, but its limitations are also increasingly being understood, including relating to prospectus lengths, investor education and real-time data sources and reporting. There remains an important role for structural protections to give public company investors (whether retail or institutional, local or international) the confidence to invest, especially for such a hybrid US-Mainland China model as Hong Kong.[29]

Yet, we believe that the recent sentiment from the first public speech of the new SEC chairman would not be out of place here in Hong Kong nor in Mainland China: "Our analysis starts and ends with the long-term interests of the Main Street investor".[30]

Asia Capital Markets Institute looks forward to working with the HKEx on growing and fulfilling its important role in acting in the public interest to maintain market integrity and helping ensure the capital markets continue to flourish and serve the real economy and people of Hong Kong.

Please do not hesitate to contact the author at [redacted] if you like to further discuss the concept paper and our response.

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[28] Christopher Cox, "Speech by SEC Chairman: Remarks before the US – China Joint Economic Committee" (October 16, 2005): https://www.sec.gov/news/speech/spch101605cc.htm

[29] Charles Li, "Position of Hong Kong – Questions and Thoughts" (HKEx, August 1, 2017): http://www.hkexgroup.com/Media-Centre/Charles-Li-Direct/2017/Position-Hong-Kong-for-the-future-questions-and-thoughts?sc_lang=en

[30] Jay Clayton, "Remarks at the Economic Club of New York" (SEC, July 12, 2017): https://www.sec.gov/news/speech/remarks-economic-club-new-york