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Legal & General
INVESTMENT MANAGEMENT

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Dear Sir/Madam

New Board Concept Paper

Legal & General Investment Management (LGIM) is one of the largest international investors with over USD 1.24 trillion of assets under management (as at 30 June 2017)[1]. We manage assets for a wide range of global clients, including pension schemes, sovereign wealth funds, fund distributors and retail investors.

In Hong Kong, LGIM is a significant investor with over USD 4.1 billion of equity invested in the region both in index and active funds. Furthermore, we have a growing presence demonstrated by the recent expansion of our trading and index fund management arm in Hong Kong. Our strategic commitment is long term and aimed to provide the best solutions for our clients.

As a significant investor, there is a responsibility to ensure that global markets operate efficiently and uphold the highest level of governance standards to protect the integrity of the market over the long term. Therefore, the opportunity to respond to the consultation by the HKEX regarding the 'New Board' is very important to LGIM.

We have decided to not respond to the individual detailed questions in the paper due to our fundamental disagreement with the concept but instead have provided below an outline of LGIMs stance on key topics and where we have strong views.

LGIMs POSITION ON THE 'NEW BOARD'

As a long term shareholder, LGIM has significant concerns with the proposal by the HKEX to introduce a New Board (New Board PRO and New Board PREMIUM) to the market. We believe that the new proposal has not fully considered the long term impact on investors, such as LGIM, and the consequences of a dilution in listing quality as a result of sub-standard governance rules being implemented e.g. weighted voting rights (WVR).

The HKEX has already experienced an underperforming Growth Enterprise Market (GEM), which was specifically designed to cater to higher risk companies in a different segment. This demonstrates the unintended consequences of narrow listing considerations and how lowering standards can impact market integrity.

[1] Including derivative positions and advisory assets. These figures include assets managed by LGIMA, an SEC Registered Investment Advisor.

As long term investors, we take our investor stewardship responsibilities very seriously on behalf of our clients. The introduction of different corporate governance and stewardship codes globally is evidence of this trend and the need to strengthen guidelines, not weaken them.

Therefore, a sound corporate governance framework is needed to support issuers, protect investors and shape a sustainable premium market. We do not support the rationale behind the development of a separate segment, with sub-standard governance standards, to compete for Initial Public Offerings (IPOs). Furthermore, the HKEX should ensure that any rules and regulations being introduced should protect the interests of public investors first and ahead of any commercial interests.

LGIMs CONCERNS

Below are the key concerns we have with the proposal:

- **Weighted Voting Rights (WVR)**

Voting rights are a fundamental characteristic of equity capital. It underpins effective investor stewardship, and is the central mechanism through which shareholders exercise their ownership rights.

We support the 'One Share – One Vote' principle which embeds the fair and equal treatment of ALL shareholders by allocating control in direct proportion to the level of economic interest and exposure to risk. If allocation of control is un-even, this raises the risk of a controlling group entrenching its positions and creating a disadvantage for non-controlling shareholders. In addition, investors will be impeded from taking appropriate action against company behaviour that may be harmful to their long term interests due to the absence of equal voting rights. Moreover, empirical studies have shown that there is no long-term benefit for public shareholders from the company being controlled.[2]

Therefore, we are NOT supportive of weighted or unequal voting rights because they are detrimental to the efficient functioning and integrity of the wider public market over the long-term. Perpetual control of a company without a corresponding capital at risk prevents the mechanisms of the market to hold management and the board to account for their use of capital.

- **Definition of New Economy companies**

LGIM is concerned with the approach taken by the HKEX that defines "New Economy" companies. We do not believe that by removing certain measures, which protect investors and enhance the quality of companies, will assist in attracting high growth companies or additional capital to the Hong Kong market.

We are unclear with the definition of "New Economy" and the companies which will be included in this category. The HKEX has stated that no fixed definition is proposed and that the Listing Committee will retain the ultimate discretion to decide which companies are eligible.[3] The lack of transparency around the decision making process does not help investors understand how companies adhere to good standards prior to listing and whether there is a certain threshold of protection which will assess the quality of issuers coming to the market.

[2] https://irrcinstitute.org/wp-content/uploads/2016/03/Controlled-Companies-IRRCI-2015-FINAL-3-16-16.pdf
[3] https://www.hkex.com.hk/eng/newsconsul/hkexnews/2017/Documents/1706163news.pdf, page 8

LGIM also does not consider that the current standards hinder high growth companies from coming to the market. In fact, high growth companies should be embracing these rules as they are designed to provide a stronger framework for business, protecting both the issuer and shareholders. Furthermore, there are plenty of examples of thriving companies already listed in global exchanges from the targeted sectors identified by the HKEX in the New Economy.

Innovation is a business concept in-built in all companies and every new generation witnesses new economies and sectors developing. We do not see any investment benefit from re-classifying these companies because businesses and markets are constantly evolving.

Therefore, we fail to understand why rules should be weakened in the New Board and would strongly advocate that standards are upheld to protect all participants in the market.

- **Pre-profit companies**

As a sophisticated investor who understands and can analyse the risk/return profiles of companies, LGIM does not have any significant concerns with the inclusion of pre-profit companies in the current listing framework. Equity is an important source of capital for financing growth to create future profitable companies and the effective facilitation of this capital transfer is a key feature of a sustainable financial market.

On the other hand, less sophisticated shareholders may not be able to make this assessment if they do not have the sufficient analytical capabilities or risk management tools e.g. retail shareholders. This means, in the absence of being able to understand and interpret company information, retail shareholders will be more exposed to the risks pertaining from pre-profit companies continuing to operate and aspiring to become a going concern.

Therefore, less sophisticated investors need greater awareness of how the risk/reward profile of the company changes by not making a profit. *Caveat emptor* (buyer beware) principles need to be in place with appropriate boundaries to isolate and protect the public interest.

- **Unintended consequences and impact on Main Board**

It is important that the HKEX understands the consequences of its decisions around amending its rules and the impact this will have on the quality of companies entering the market (both in terms of profitability and corporate governance). Rather than examining the issue from a short term perspective, the HKEX should seek to better understand how this will influence and shape the long term market.

LGIM is concerned with the potential side effects developing on the Main Board as a result of less stringent governance standards being applied to other Boards on the HKEX. For example, we view that the implementation of the New Board will worsen the quality of companies to the Hong Kong market overall and that HKEX’s key value proposition of being a mature and stable marketplace will erode over time.

We would like to see the continued growth of the Main Board in Hong Kong which plays a vital role as an international market for Chinese and Asian based enterprises being capable of meeting the HKEX’s current governance standards.

FURTHER RECOMMENDATIONS

The HKEX highlighted in the consultation, that there was a significant risk the market would be stagnant and there would be a lack of investor interest due to the low exposure to higher growth sectors.[4]

However, our view is that in order to address the issues highlighted, the HKEX needs to examine the principles needed to support the long term development of the market and provide a strong governance foundation to attract long-term capital and good quality companies across all sectors rather than concentrate on a particular group of companies.

Below are three main areas which we believe can provide a significant improvement in raising the quality of the market and appeal to new prospective issuers because of the attraction from international investors on higher governance standards:

1. Good quality disclosure and transparency

As long term investors, we believe that good quality disclosure is required to clearly represent the company's performance. The end goal is to create value for all stakeholders by providing transparent reporting. With good quality disclosure, investors are able to price risk better and seek alignment with long term focused companies.

2. Strong Board Governance pre-IPO

LGIM believes that having an effective board where directors are responsible for the management of the long term success of the business is critical to strong corporate governance structures. This consists of striking the right balance between having the right competence in the boardroom, a diverse skill set, relevant experience and having a deep knowledge of the company.

Therefore, we would encourage the HKEX to focus on governance preparations pre-IPO (e.g. having good established independent directors on the board before listing). LGIM has experienced too many boards being constructed just before an IPO with directors who do not understand the business. Furthermore, in terms of a newly listed company, we would encourage greater scrutiny on the 'quality' of directors in the boardroom pre and directly post IPO.

3. Delisting process

Whilst focusing on IPOs is important, attention needs to be given to delisting as it plays an essential part in the lifecycle of the market. Market stagnation can occur if delisting processes are not properly set and deployed. Therefore, we would be supportive of a more efficient and transparent delisting regime.

ACTIVITY IN OTHER MARKETS

As highlighted by the HKEX in the New Board Concept Paper[5], LGIM is witnessing a concerning trend in other markets whereby public shareholder rights are being weakened to encourage and enable companies with sub-optimal governance standards to list (for example, in the case of the UK, sovereign controlled companies are being considered). This is deeply concerning because

[4] https://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2017061.pdf, Page 13, paragraph 35
[5] https://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2017061.pdf, Page 14, paragraph 43

neglecting the safeguards that protect shareholders will encourage a ‘race to the bottom’ in those markets.

The proposal by the FCA in the UK has already received stark criticism regarding its proposal to create a new ‘premium international segment’ for sovereign controlled companies.

> *"Investors believe a premium listed segment without these investor protections is not a premium segment and will not provide the protections that investors expect"*
> **Chris Cummings, Chief Executive at the UK Investment Association, 13th July, 2017 2017.**

Furthermore, we disagree that not implementing these proposals could pose a threat to the Hong Kong market as an IPO centre. In fact, the Hong Kong market would be praised by international investors for upholding its standards allowing only good quality companies to enter its market.

Lastly, as one of the largest institutional investors globally with over USD 1 trillion of assets under management globally, LGIM is also a major user of indices. We have noted that FTSE Russell, S&P and MSCI have all recently launched consultations on the issue of unequal/non-voting shares. Our message to the global indices is consistent and aligned with the response given to the HKEX. We view both the regulator and indices as playing critical roles in protecting the interests of all shareholders which in turn lowers the cost of capital for issuers. We encouraged global indices to collaborate to ensure they implement consistent rules on issues such as voting thresholds. In addition, where rigorous rules are already in place, these should remain and not be further weakened.

SUMMARY

LGIM believes that this is an opportunity for the HKEX to differentiate itself and become a leading global stock exchange for all market participants. As a regulator, the HKEX can demonstrate its high standards by upholding and valuing shareholder rights.

Furthermore, as long term shareholders, we do not see any benefit from the implementation of the New Board. The risk of potentially exposing investors to bad actors and diminishing minority shareholder power by having WVR is greater than the perceived benefit of winning a few high profile listings in the short term. In addition, the substantial damage to the overall market reputation will reduce the integrity of the HKEX as a supervisor of the market.

Therefore, we would encourage the HKEX to reconsider its proposal to create a New Board. As a large and growing investor in Hong Kong, LGIM has a significant vested interest in protecting ensuring market standards are upheld.

Please also note that LGIM is a member of the Asian Corporate Governance Association (ACGA) and stand aligned with their response. We have attached their submission for your reference.

We hope that we have been constructive and remain at your disposal should you wish to discuss any of the points we have raised in further detail.

Yours sincerely

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August 14, 2017

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Dear Sir,

Re: ACGA Response to New Board Concept Paper

We welcome the opportunity to respond to the New Board Concept Paper.

The Asian Corporate Governance Association (ACGA) is a not-for-profit membership association chartered under the laws of Hong Kong. The association is dedicated to assisting companies and markets across Asia in their effort to improve corporate governance practices. In our educational outreach, we are guided by a practical, long-term approach. ACGA's operations are supported by a membership base of institutional investors, such as public pension funds and fund managers, as well as listed Asian companies, insurance and accounting firms, and universities. ACGA now has more than 100 corporate members, two thirds of which are institutional investors with around US$26 trillion in assets under management globally. They are also significant investors in the Hong Kong market.

High Level Comments

ACGA is opposed to the New Board proposal outlined in the Concept Paper. As a result, we have not responded to the detailed questions on the basis that we do not regard the concepts and details used to frame the "straw man" proposal and related questions to be an appropriate means of addressing the medium- or long-term development challenges of the Hong Kong market. Our reasons for taking this position are highlighted in the comments that follow.

ACGA believes that the analytical approach taken in the Concept Paper is flawed and, therefore, Hong Kong Exchanges and Clearing's (HKEX) chosen framework for defining and achieving desirable outcomes for the Hong Kong market is strategically unsound. The paper is almost exclusively focused on measures that would increase the number of IPOs. As a result, it fails to address a range of global market fundamentals that have a profound influence on Hong Kong's market value and potential as a global financial centre. While we strongly support HKEX's desire to encourage public debate about the future of Hong Kong's markets, we disagree with the approach taken on the core analysis used to support the New Board recommendations.

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The Limitations of the Listing Lens

The Concept Paper repeatedly equates the interests of issuers and intermediaries with the interests of the market. Indeed, it endorses the New Board "straw man" as "the best way of broadening capital market access in Hong Kong by opening up to a more diverse range of issuers". As a result, the exhibits and arguments presented in support of the New Board do little to provide a full strategic context for considering how changes to Hong Kong's market landscape might relate to the long-term interests of all market participants.

For example, the over-reliance on the listing lens ignores decades of relevant research and market experience establishing the importance of broad-based market governance to positive outcomes for both investors and issuers. This is crucial as we consider how to achieve such outcomes for the Hong Kong market in a period when the composition of investors and the nature of their investment process is changing with the shift to passively managed institutional product, which is more sensitive to market-level valuation trends.

As a result, the New Board proposals would only make sense if they were tested against broader investor, strategic, and regulatory trends that will likely shape how they might perform over the long-term. This would seem prudent as HKEX's experience with the underperforming GEM market, which was specifically designed to cater to higher risk companies, highlights how analytical over-reliance on narrow listing considerations can miss powerful market realities. Indeed, the long-term valuation dynamics of the Main Board and the trajectory of China's market development, including the uncertainty as to whether weighted voting rights (WVR) would ever be permitted for Mainland Chinese enterprises, arguably play a more material role in defining Hong Kong's competitiveness as a listing venue than the specific structure of the listing regime.

Quantity Does Not Equal Quality or Innovation

It is demonstrably the case that the volume of IPOs does not equal innovation or "diversity." It should also be noted that the "new economy" label used in the paper to define attractive listing candidates is not strategically robust from an investment perspective. To paint so-called "new economy" issuers and their shares with a uniform brush is to assume that Hong Kong investors believe technology stocks only go up. More analytical insight is warranted when basing a case on high-beta sectors which have skewed performance distributions with a small group of big winners and a large number of losers. Indeed, the repeated cherry-picking of data and timeframes in the Concept Paper's exhibits is reminiscent of pitch book logic and robs the analysis of the credibility needed for a successful policy debate, one that transparently addresses legitimate and competing interpretations of desired market outcomes.

Just as important, the Concept Paper arrives at its conclusions while ignoring a number of fundamental issues that are recasting assumptions around the outlook for global equity markets and exchanges. These include, but are not limited to, the rapid rise of passive investing, the growth of private markets and the associated decline in IPOs globally, the

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growing threat of blockchain to conventional exchanges, more coordinated approaches to defining global financial risk and encouraging system resilience, and increased pressure on index providers to address investor stewardship priorities and concerns about risk concentration in broad market indices, as witnessed in the recent decision of S&P Dow Jones to exclude companies with multiple share classes from joining the S&P 500 Index. This striking gap in the presentation deserves attention because the Concept Paper's limited focus on IPO league tables effectively assumes away any impact on Hong Kong from the most hotly debated topics today in global markets.

Another area where the paper is curiously undeveloped concerns the complex realities related to the competition for global mega IPOs. We question whether the desire to compete for the IPOs of Saudi Aramco, Ant Financial, or countless other potential mega IPOs should drive fundamental changes in market structure or regulatory policy. These one-off IPO opportunities are often disconnected from the long-term value drivers that shape sustainable market development and involve complex externalities sometimes related to national, but not market interests. Perhaps thought needs to be given as to how to create special mechanisms, possibly underwritten by the government, to deal with these situations. Hong Kong has arguably trod this path before with the Tracker Fund following the Asian Financial Crisis. Special conditions were also required as part of the Rusal IPO in 2010, to ensure that investors were not exposed to risks that would have been regarded as abnormal in the context of the Hong Kong market. Our key point is that the market as a whole should not be devalued simply to facilitate the listing of a single large firm.

Specific Comments

For the reasons outlined above, we believe the conceptual underpinnings of the New Board and the related discussion about design considerations rests on weak foundations. As a result, we believe that the proposed design criteria of the New Board deserve re-examination to reflect the following problems.

Going Down Market

The Concept Paper starts from the proposition that the future of the Hong Kong market rests with "walled gardens" for distinct issuers and investor groups. The "straw man" is based on the creation of two markets which would accept listings from companies with so-called "non-standard governance features" such as WVR, including secondary listings of Mainland Chinese companies. New Board PRO, for professional investors, would target listings by pre-profit early stage "new economy" companies and would utilise a light-touch listing regime. New Board PREMIUM would be open to both retail and professional investors and to listings which can meet higher standards than New Board PRO.

We see little evidence in the paper to support this design choice and are puzzled at the lack of attention to the likely impact on the Main Board. Indeed, segmentation distracts from and degrades Hong Kong's core value proposition as a mature and increasingly sophisticated

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market. The growth of the Main Board is an endorsement of Hong Kong's vital role as the international market for Chinese enterprises capable of meeting higher governance standards. By contrast, we have learned with GEM that a design strategy which rests on market segmentation, in the absence of a high-touch regulator, can undermine market credibility and the willingness of stakeholders to address more strategic issues of innovation or regulation.

The new market proposals are reliant on the unexamined belief that the Main Board can be ring-fenced from the new boards. This is surprising in a market that has been regularly sidetracked by back-door listings, shell company transactions, and opaque merger and acquisition (M&A) initiatives that have often undermined well-accepted standards of market governance. Moreover, the Concept Paper fails to address likely corporate responses to the New Boards as well as the growing impact of M&A on the shape of Hong Kong and China's markets. To make no mention of how the Main Board would change in the face of value leakage to the less regulated new boards seems almost reckless. Surely some well-considered scenarios could have been presented to focus the public discussion on likely future pathways for Hong Kong's market as a basis for considering policy choices and available risk mitigation strategies?

A second area of concern is the approach taken to secondary listings of China-nexus companies: the paper recommends a casual strategy of outsourcing governance and transparency risks to other market regulators in competing jurisdictions, putting a diverse population of Hong Kong investors in the hands of intermediaries. Here the difference between the interests of intermediaries with defined interests in listings as opposed to the bulk of investors, who rely on long-term market returns, is most stark. The limited governance fundamentals of the proposed new boards are inconsistent with active price discovery and trading trends that are associated with well-supported valuations and positive long-term market outcomes.

Finally, we believe the approach taken to the definition of "new economy" companies is flawed and would result in hazardous short-term measures that could threaten, rather than enhance, Hong Kong's ability to address the needs of truly innovative companies. The discussion in the Concept Paper effectively demonstrates the difficulty that HKEX, in its listing regulatory role, would face in reserving special listing considerations for "new economy" companies. The sector descriptors used in the paper would be just as likely to select for unremarkable manufacturers and service providers of briefly innovative commodity goods as they would equities with the unicorn characteristics so frequently cited by "new economy" enthusiasts. We would also caution that a principles-based listing process, which already struggles to cope with legally safe but misleading assertions about "innovative" technologies and the qualifications of entrepreneurs, is ill-suited to dense claims about patents, complex technologies, and new market developments.

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Recommendations

In light of our concerns about the analytical approach taken to support this paper, we believe that the Hong Kong market urgently needs a more coherent discussion concerning the design principles required to support long-term development of Hong Kong's markets. With this in mind, we would like to contribute to this discussion by urging more focus on the following elements.

Enhanced Governance Would Reduce the Risk Associated with Innovation
Strategies that enhance the governance foundations of the Hong Kong market have the potential to facilitate more resilient market innovation and development. The regulatory and legal resources of the Hong Kong market underpin the market's operations and valuation. These factors must be evaluated alongside listing rules, investor trends, and the interests of public groups when thinking about how any market developments will translate into tangible outcomes. ACGA's work on Asia's market eco-systems supports this analysis.

We highlight this point because we believe that there is now in Hong Kong a credible case for the listing of pre-profit companies. Institutional investors have well developed analytical and risk management tools to cope with pre-profit companies. Permitting pre-profit companies to list may also reduce the pressure for accounting manipulation. That said, this step, which has the potential to add to the risk profile of the market, should be accompanied by consideration of a range of enhanced governance options that would support this type of market development and innovation. We believe that investors and other stakeholders would respond with interest to more rounded market development proposals which address the following issues:

- **Continuous disclosure:** What steps can be taken to improve the performance of Hong Kong listed companies on their continuous disclosure obligations? Positive standards of continuous disclosure are regarded as an important risk mitigant by the largest global investors. These investors are experts at pricing risk, will analyse novel and innovative business models, and seek alignment with long-term focused companies. Unfortunately, their work can be undermined unless the Hong Kong market continues its efforts to ensure more timely disclosure and to discourage late, misleading, and boilerplate reporting that degrades the whole market.
- **Board governance:** More work is needed to improve the individual skill and competence of directors of Hong Kong listed companies. Boards need to meet higher risk management standards (see the recent Hong Kong Institute of Corporate Secretaries report) and address poor asset valuation practices which have suffered from an over-reliance on advisors and other intermediaries whose work often fails to meet credible international standards. More focus is also needed on pre-IPO governance preparation, in particular the appointment of independent directors and audit committees at an early stage. It is ultimately counterproductive to allow companies to come to market with directors who have a limited understanding of their roles and duties under law, and lack the practical skills needed to be directors.

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- **Delisting:** The Concept Paper correctly draws attention to the role that more pro-active and efficient delisting practices could have in safeguarding the Hong Kong market. We believe this is an important and productive mechanism to address if the goal is to enhance the vitality of Hong Kong's markets. A risk-tolerant IPO listing regime can result in market stagnation when delisting mechanisms are not properly and transparently deployed.

We would be pleased to discuss our comments and suggestions above in more detail with the Exchange.

Yours truly,

[redacted]

Jamie Allen
Secretary General

**This letter was prepared with the input of Melissa Brown, Specialist Consultant, ACGA.*

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