ICGN
International Corporate Governance Network

Hong Kong Exchanges and Clearing Limited
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Via Email: response@hkex.com.uk

15 August 2017

To the Hong Kong Exchanges and Clearing Limited and the Stock Exchange of Hong Kong Limited,

Re: **New Board Concept Paper**

The International Corporate Governance Network (ICGN) welcomes the opportunity to comment on the Hong Kong Exchanges and Clearing Limited (HKEx) consultation on the New Board Concept Paper (Concept Paper) that was released in June 2017.

ICGN was founded in 1995 and is an investor-led membership organisation of more than 600 individuals based in 47 countries from around the world. Our mission is to promote effective standards of corporate governance and investor stewardship to advance efficient markets and sustainable economies world-wide.

ICGN's members represent institutional investors with global assets under management in excess of US$26 trillion, and many of our members have significant investment holdings in the Hong Kong market. ICGN and its members offer an important investor perspective on corporate governance, and are a source of practical knowledge and experience with regard to governance and investment issues. For more information on the ICGN, please visit www.icgn.org.

Reflecting the importance of Hong Kong as a leading global financial centre, ICGN has responded to prior consultations by both HKEx and the Securities and Futures Commission (SFC) relating to corporate governance and investor stewardship in Hong Kong. We have been encouraged by many positive developments in Hong Kong, such as the introduction of Principles of Responsible Ownership in 2016 and the SFC's rejection of dual class shares in 2015.

The current Concept Paper clearly articulates the strategic challenges facing HKEx in a competitive global market for financial services, and does a good job explaining how the New Board proposal fits into the HKEx's strategic positioning. We understand the logic and potential benefits for HKEx and the local sell side institutions. However we believe the Paper has failed to demonstrate that such benefits would not come at an undue cost to its key stakeholders — in particular the investment community and its beneficiaries. As such, it is our view that the New Board as presented is a flawed construct. Our response to the Concept Paper consultation will therefore focus on high level issues relating to the fundamental concept of the New Board itself. It is our view that some of the more granular questions in the consultation are premature at this point.

Differential ownership rights and "non-standard governance structures"

A key feature of the New Board relates to what is called "non-standard governance structures". Given the prominence of Weighted Voting Rights (WVR) in this New Board framework this effectively reopens in Hong Kong the issue of dual class shares and differential ownership rights. It is clear why WVR or other dual class structures that insulate companies from market forces are popular with controlling shareholders, who often enjoy "private" benefits of control that are not shared with all other shareholders.

Point 60, on page 17 of the consultation, suggests the rationale that controlling owners in WVR structures always have at heart the long-term best interests of the company, as opposed to the "whims" of the short term interests of institutional shareholders. We will acknowledge that there is scope for the institutional investment community to focus more on long-term performance. At the same time we would also observe that it is also possible for the "whims" of controlling shareholders to act in their own private interests that may be distinct from the interests of the company itself and its minority shareholders. These entrenchment and expropriation risks are presented later in the Concept Paper (points 103 and 104), but they seem to carry limited weight in the HKEx deliberations.

It is important for a potential regulatory initiative such as the New Board to draw from the base of evidence that may speak in support of or against WVR, or differential rights more generally. We would point out that the Concept Paper cited no empirical evidence supporting WVR. But footnote 53 on page 24 provided a sampling of prominent academic papers that demonstrate shortcomings of controlled ownership structures and the separation of ownership and control.

We can add further research references that also present a negative case for dual class structures. For example, ICGN's recent Viewpoint on differential ownership rights[1] cited a recent research literature review of this topic by Stanford University academics David Larker and Brian Tayan. They conclude that "the evidence suggests that companies with dual-class structures tend to have lower governance quality".[2]

As another example, in an empirical study of dual class structures in the United States, the study's authors concluded "we find that firm value is positively associated with insiders' cash-flow rights, negatively associated with insiders' voting rights, and negatively associated with the wedge between the two." The authors go on to say that "a majority owner of a private company can rationally choose to sacrifice some firm value in order to maintain private benefits of control."[3] That may be well and good for the controlling owner. But it also suggests that these private benefits come at a cost to minority investors.

Regulatory competition

In putting forward the New Board concept we are concerned that the HKEx is bowing to competitive pressures that may lead to a "a race to the bottom"— not just in Hong Kong, but in other major markets around the world as well, including the US, the UK and Singapore. Our fear is that the highly competitive nature of the global market for new listings and IPOs runs the risk of compromising quality standards in the leading stock exchanges — and puts at a disadvantage the interests of minority shareholders and their beneficiaries, which include retail savers and pensioners.

We support innovation by stock exchanges, and believe it is healthy for exchanges to attract new companies to public equity markets. At the same time we encourage HKEx and other global stock exchanges to compete more on the "race to the top" of building quality and trust — and to avoid watering down governance standards for short-term listing benefits.

[1] See: https://www.icgn.org/differential-share-ownership-structures

[2] See: David Larcker and Brian Tayan, "Corporate Governance Matters", Second Edition, Pearson Education Inc., 2016.

[3] See: Paul A. Gompers, Joy Ishii and Andrew Metrick," Extreme Governance: An Analysis of Dual Class Firms in the United States "Review of Financial Studies 23 (2010): 83-120.

“PREMIUM” labeling/retail investor base

We have argued that the so-called “non-standard” governance structures that provide companies with “compliance flexibility” (page 6 of the consultation) may, at least in some cases, be euphemisms for lower governance and investor protection standards. We think this is particularly problematic with regard to the retail investor base that is being targeted for the PREMIUM segment. [4] It is our concern, particularly for a potentially unsophisticated investor base, that the word “premium” may be inaccurate at best, misleading marketing at worst.

In conclusion we appreciate the intention of the HKEx to innovate, but we are not convinced that the New Board is a good concept that is worth further exploring. As we have explained we believe that any potential benefits to the HKEx would in part be achieved by compromising the rights and interests of minority investors – both institutional and retail.

Should you wish to discuss our comments further, please contact George Dallas, ICGN’s Policy Director, by email at george.dallas@icgn.org.

Yours faithfully,

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[4] We appreciate that final branding of the segment may not make use of the term “premium”.