



ICGN

International Corporate Governance Network

Corporate and Investor Communications Department
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By email: response@hkex.com.hk

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To the Corporate and Investor Communications Department:

RE: Emerging and Innovative Companies CP

The International Corporate Governance Network (ICGN) is pleased to respond to the Hong Kong Exchanges and Clearing Limited (HKEX) consultation paper (CP) on A Listing Regime for Companies from Emerging and Innovative Sectors.

Led by investors responsible for assets under management in excess of US\$26 trillion, ICGN is a leading authority on global standards of corporate governance and investor stewardship. Our membership is based in more than 45 countries and includes companies, advisors and other stakeholders. ICGN's mission is to promote high standards of professionalism in governance for investors and companies alike in their mutual pursuit of long-term value creation contributing to sustainable economies world-wide. Our policy positions are guided by the ICGN Global Governance Principles and the ICGN Global Stewardship Principles, both of which have been developed in consultation with ICGN Members and as part of a wider peer review.

As a leading global financial centre, Hong Kong is important to ICGN and its members, and we recognise Hong Kong's role in particular with regard to providing finance to Asian companies and regional leadership in standards of corporate governance. ICGN has engaged in past governance consultations relating to Hong Kong, most recently in our response to the New Board Concept Paper in 2017.¹

Our response to the current CP effectively begins where our earlier consultation submission leaves off: ICGN is fundamentally opposed to dual class share arrangements and differential ownership rights. ICGN and the vast majority of its investor members believe that differential ownership wrongly separates economic versus voting control, and can diminish accountability to and alignment of interests with minority shareholders. Hence, while we do not have specific comments for the sections of the CP relating to biotech companies, we would like to express our opposition to what is being proposed in the CP about issuers with weighted voting rights (WVR) structures, as

¹ See ICGN Comment on HKEX's Consultation on the New Board Concept Paper, August 2017: https://www.icgn.org/sites/default/files/12.%20ICGN%20Response%20to%20HKEx%20Third%20Board%20Consultation%20August%202017_0.pdf

well as register concern about the sections relating to secondary listings of qualifying issuers.

Issuers with WVR structures

We recognise that this CP includes the introduction of various protections relating to WVR structures that are intended to mitigate the risks for investors. We would also acknowledge that many of these protections would be welcome if the WVR proposal is implemented. But while we will make some comments about the protections in our response, our main point is not to focus on this structural detail given our objections to the CP's main thrust.

ICGN has regularly commented about differential rights in regulatory consultations around the world, and has also expressed its views in Viewpoint reports in 2017.² To recap our arguments, we believe that differential rights structures, even if positively intended to help nurture new and innovative companies, are fundamentally flawed, and that separating ownership and control can lead to negative consequences, particularly for minority shareholders. Concerns in particular relate to the diminished accountability to minority shareholders and entrenchment of controlling owners—both of which can lead to private benefits to controlling owners at the expense of minority shareholders. We cite again academic evidence which suggests that minority shareholders may be the net losers in differential ownership arrangements:

- A recent research literature review of differential ownership by Stanford University academics Larcker and Tayan concludes “the evidence suggests that companies with dual-class structures tend to have lower governance quality”.³
- In an empirical study of dual class structures in the United States, the study's authors (Gompers, Ishii and Metrick of Harvard, Stanford and Yale, respectively) 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.” 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.⁴

Part of our frustration with this CP is that HKEX also seems to be well aware of these arguments, as is captured in your statement “the Exchange believes that the ‘one-share, one vote’ principle continues to be the optimum method of empowering shareholders and aligning their interests in a company.” Yet while you recognise this principle you also choose to compromise it. ICGN supports market innovation and healthy growth of listed companies, but we think it is both inappropriate and unfortunate that the competition for listings is reaching a point that principles of this nature must be compromised, particularly given the asymmetric benefits/disadvantages. We believe in this case that the net losers, at least in the first instance are minority shareholders, given diminished minority protections. But we believe that over time this can extend to the disadvantage of the market as a

² See ICGN Viewpoint on differential ownership structures, February 2017: <https://www.icgn.org/differential-share-ownership-structures> and its Viewpoint on the inclusion of non- or limited-voting shares in stock indices, November 2017: <https://www.icgn.org/inclusion-non-voting-or-limited-voting-shares-stock-market-indices>

³ See: David Larcker and Brian Tayan, “Corporate Governance Matters”, Second Edition, Pearson Education Inc., 2016, page 333.

⁴ 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.

whole, and result in higher discount rates – and higher costs of capital—for issuers in the market with WVR structures.

In light of these fundamental objections we do not wish to dwell on the more granular nature of the incremental protections being proposed. We acknowledge that many of the protections proposed will be welcome if this MVR regime is to be implemented. However we do not believe these will necessarily mitigate the related risks. We focus on three specific points:

- We believe there is scope for a more explicit sunset provision requirement rather than the somewhat convoluted MVR beneficiary arrangement being proposed, and that HKEX should not avoid use of sunset requirements if only to avoid competition with other exchanges.
- Moreover, we believe there is inevitable scope for subjectivity with regard to the determination of companies suitable to list with a MVR structure, and we would again express the concern that HKEX – given its conflicts of interest—may have a difficult challenge in achieving the objective vetting of prospective issuers in light of these competitive and commercial pressures. The question of what constitutes an “innovative” company is potentially subject to wide interpretation, particularly true over time, when many companies evolve and mature.
- Finally, with regard to the minimum 10% of votes to non-MVR shareholders, we believe the 10% threshold proposed is effectively meaningless, allowing only for a token level of minority shareholders to vote, with virtually no impact on the outcome. For such a threshold to have any teeth, it should be at least 25%.

As an overarching point on top of these specific consideration we are specifically concerned that as a listed entity itself HKEX is conflicted given its competitive and commercial pressures vis-à-vis other exchanges. While recognising the competitive challenges faced by HKEX and other exchanges, we are concerned that investors – as customers of exchanges-- are losing out to the issuing community, the interests of controlling owners, the underwriting industry (sell side and advisors)—and indeed the interests of the HKEX as a listed entity. It is disappointing to see compromise and a race to the bottom by major stock exchanges at a time when we would hope for greater leadership and a race to the top in consideration of all the market’s stakeholders, including investors. The governance of stock exchanges in this regard is a topic that ICGN will continue to explore with its policy work.

Secondary listings of qualifying issuers

ICGN has no problems with companies having secondary listings—or with stock exchanges promoting secondary listings. We recognise in particular with HKEX the important base of issuers from Greater China that might contribute to HKEX’s growth. However, again in this case we voice our opposition to the “concessionary route” being proposed, as it brings with it the risk of watering down Hong Kong market standards to attract secondary listings. We note in particular there is scope for additional companies with WVR structures entering the Hong Kong market through this route, and believe it is a particular—and inappropriate-- weakening in standards to not require the same protections to Non-Greater China Issuers and Grandfathered Greater China Issuers that are being proposed for the Emerging and Innovative Companies segment. Hence, we think the risks of these secondary listings as presented in the CP are even greater to Hong Kong market than the proposed new segment for Emerging and Innovative Companies. Again, we are concerned that the private interests of HKEX may be coming at the expense of the investment community by proposing this “concessionary” access with inadequate protections for minority investors.

In conclusion, ICGN has great respect for the HKEX and the many positive contributions it has made to good governance in the important Hong Kong market and East Asia generally. But we are concerned that the introduction of WVR structures for emerging and innovative companies is a step backward, not forward. We are also concerned that the proposal relating to a secondary listing for qualifying issuers could have the net effect of allowing yet more companies with WVR structures to effectively slip in through the back door with minimal protections. We believe this works against the interests of institutional investors and minority shareholder rights – and in turn will affect investor perceptions negatively about the governance standards and protections in the Hong Kong market.

We hope that our feedback and comments are helpful in your deliberations. Should you wish to discuss our comments further, please contact me or George Dallas, ICGN's Policy Director, by email at george.dallas@icgn.org.

Yours faithfully,



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