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The Hong Kong Institute of Chartered Secretaries

Submission:

Emerging and Innovative Companies CP

21 March 2018

By Email Only: response@hkex.com.hk

Hong Kong Exchanges and Clearing Limited

12/F, One International Finance Centre

1 Harbour View Street

Central

Hong Kong

Attn: Corporate and Investor Communications Department

Dear Sirs

Re: Emerging and Innovative Companies CP

About HKICS

The Hong Kong Institute of Chartered Secretaries (HKICS) is an independent professional institute representing Chartered Secretaries as governance professionals in Hong Kong and Mainland China with over 5,800 members and 3,200 students. HKICS originates from The Institute of Chartered Secretaries and Administrators (ICSA) in the United Kingdom with 9 divisions and over 30,000 members and 10,000 students internationally. HKICS is also a Founder Member of Corporate Secretaries International Association Limited (CSIA), an international organisation comprising 15 national member organisations to promote good governance globally.

HKICS's Governance Focus

Reference is made to HKEX's *Consultation Paper, A Listing Regime for Companies from Emerging and Innovative Sectors (CP)*, and capitalised terms in this submission (Submission) has the meanings set out under the CP, where appropriate. This Submission is in response to HKEX's request for comments under paragraph 52 of the Consultation Paper. At the outset, HKICS would like to point out that as a governance institute, HKICS is primarily focused on the governance aspects of the proposals under the CP.

From that perspective, the CP raises novel governance challenges for Hong Kong as the proposed regime is first of its kind globally. HKEX under the CP asserts that market consensus is to go ahead with the reform despite arguments along the lines that the proposals are a race to the bottom. It is in the context of market consensus that HKICS is seeking not to visit the fundamentals but to suggest approaches to enhance governance under the proposals. HKICS must note that there will remain a gap from a governance point of view as to the risk that the WVR Beneficiary may have views different from those of non-WVR Beneficiary. This could extend to both substantial and minority shareholders. HKICS could only seek to provide enhancements but not bridge the gap which requires shareholder empowerment under legal reform (which is a much wider and complex topic and not the topic of the day).

HKICS's Overall Position

HKICS, based on Member views, made an earlier submission on 16 August 2017 under the Consultation on Concept Paper of New Board (*Earlier Submission*) to accept WVR as a concept worthy of exploring for the overall competitiveness of Hong Kong subject to there being appropriate and sufficient safeguards for shareholders in particular for retail investors' protection to bridge the gap between the governance issues flowing from WVR's inroad to the one-share-one-vote structure as Hong Kong. HKICS, based on further Member views to the CP, is now focused only as to enhancements to the proposals under the CP on the assumption that the CP contain reasonable attempts to provide safeguards to bridge the governance gap which could not be eliminated. HKICS also recognises the rationale of the proposals under the CP being intended for Hong Kong's overall competitiveness versus other major global listing venues particularly in respect of attracting companies from emerging and innovative sector (as identified under the CP).

As to Biotech Companies, the governance issue are not as acute as with WVR. HKICS, based on Member views, submits that the proposals dealing with inroads to the Financial Eligibility Tests including prior to achieving record of revenue or profits are sound and reasonable attempts to introduce emerging listed issuers to Hong Kong and there are market professionals better placed to comment on the commercial aspects of the proposals. As such most of our comments in this Submission is upon WVR and from the governance perspective as we are a governance institute.

Risk Disclosure/Directors' Training/Investor Education

While the WVR related proposals under the CP are reasonable attempts to bridge the governance gap by seeking to enhance investor protection, the fact is that these cannot fully protect investors from the

WVR Beneficiary outside of the Key Shareholder Protection Rights. We urge the SFC to require intermediaries to warn investors (except professional investors) investing in shares and derivative products with WVR associated risks the governance risks they are buying into. It is for the market to price the risk. HKICS recognises that when the market sentiment for emerging and innovative sector is positive, as is now the case, this may be regarded as cumbersome by investors. However, when market sentiments turns, or when issues arise within the governance gap between the rights of the WVR Beneficiary and non-WVR Beneficiary, the warning and acknowledgment from investors become important as an overall safeguard to Hong Kong's international reputation and market integrity. As such, we submit that the post-Lehman selling requirements for investment products be adapted for investors buying shares of issuers with WVR structures and their derivatives for an orderly development of Hong Kong's securities market.

There should be related directors' training and investor education. These should be focused on governance. The company secretary, under Section F of the Corporate Governance Code (CG Code), is in charge of facilitating directors' induction and their continuous professional development. HKICS would welcome working with the SFC/HKEX to develop governance training for directors and senior management in companies with WVR in the emerging and innovative sectors. The SFC has recognised HKICS as a source of help on governance related training under the SFC Enforcement Reporter (May 2017).

Governance Enhancement Proposals

As to the WVR related proposals under the CP, we have Member views on the following governance issues to seek to enhance the proposals:

- **Compliance Adviser**

HKEX requires an issuer with a WVR structure to engage a Compliance Adviser on a permanent basis to advise on matters commencing as from the date of the issuer's initial listing. An issuer must consult with and, if necessary, seek advice from its Compliance Adviser on any matters related to its WVR structure, transactions in which the beneficiaries of WVRs in the issuer have an interest, and where there is a potential conflict of interest between Non-WVR Shareholders and beneficiaries of WVRs in the issuer. It appears that the Compliance Adviser would under Listing Rule (*LR*) 3A.01 be any corporation or authorised financial institution licensed or registered under the SFO for Type 6 regulated activity and permitted to undertake work as a sponsor. We submit

that given the nature of the Compliance Adviser's mandate under Chapter 8A, the Compliance Adviser should be trained governance professionals, such as Chartered Secretaries, who have the expertise to give effective advice to the board and increasingly taking up the role of "guardian of governance". In any event, HKICS Members should also be qualified to act as a compliance adviser on WVR matters under Chapter 8A, and to give further clarity, we also suggest that references to WVR Compliance Adviser under Chapter 8A should be distinguished from the Compliance Adviser under Chapter 3A.

- **Reserved matters for a "one-share-one-vote" basis**

The CP suggests five items (1) to (5) below which should be subject to resolutions requiring voting on a "one-share one-vote" basis. In line with our submission on the Compliance Adviser, we have Member views that there should be additional items 6 and 7 below:

1. changes to the listed issuer's constitutional documents, however framed;
2. variation of rights attached to any class of shares;
3. the appointment or removal of an independent non-executive director;
4. the appointment or removal of auditors;
5. the voluntary winding-up of the listed issuer;
6. the appointment or removal of Compliance Adviser; and
7. matters proposed or recommended by the Compliance Adviser or the [WVR] Governance Committee [but not accepted by the issuer's board of directors];

- **Corporate Governance Committee**

On the need for a Corporate Governance Committee in listed issuers with WVR, we have Member views that reference should be a 'WVR Governance Committee' instead of Corporate Governance Committee. This is in order not to confuse their roles with the WVR Governance Committee being mandatory and the Corporate Governance Committee being optional.

Under the Corporate Governance Code (CG Code) D.3.1, a Corporate Governance Committee should be mandated:

'(a) to develop and review an issuer's policies and practices on corporate governance and make recommendations to the board; (b) to review and monitor the training and continuous

professional development of directors and senior management; (c) to review and monitor the issuer's policies and practices on compliance with legal and regulatory requirements; (d) to develop, review and monitor the code of conduct and compliance manual (if any) applicable to employees and directors; and (e) to review the issuer's compliance with the code and disclosure in the Corporate Governance Report.'

Under CG Code D.3.2:

'The board should be responsible for performing the corporate governance duties set out in the terms of reference in D.3.1 or it may delegate the responsibility to a committee or committees.'

There are listed issuers that do not believe that governance should be vested with a committee, but rather governance should be an issue for the company and its board of directors, senior management and across the company as a whole. To require a mandatory Corporate Governance Committee for a listed issuer with WVR should require reflection.

From the CP, it will appear that the main purpose of the committee, which is better referred to as a WVR Governance Committee, are:

'(1) to review and monitor whether the listed issuer is operated and managed for the benefit of all its shareholders; (2) to confirm, on an annual basis, that the beneficiaries of weighted voting rights have been members of the listed issuer's board of directors throughout the year; (3) to confirm, on an annual basis, that the beneficiaries of weighted voting rights have complied with rules 8A.13, 8A.17, 8A.20 and 8A.25 throughout the year; (4) to review and monitor the management of conflicts of interests; (5) to review and monitor all risks related to the issuer's WVR structure, including the issuer's compliance with requirements on connected transactions (Chapter 14A of these rules); (6) to seek to ensure effective and on-going communication between the issuer and its shareholders, particularly with regards to the requirements of rule 8A.36; and (7) to report on the work of the Corporate Governance Committee on at least a half-yearly and annual basis covering all areas of its terms of reference.'

As such, the WVR Governance Committee should be focused on the mandated matters identified above and should be a stand-alone committee. The Corporate Governance Committee should remain a choice upon listed issuers under CG Code D.3.1 and should be separate from the WVR Governance Committee.

Further, as a measure of good governance, the WVR Governance Committee (and even where HKICS Member views are not adopted, the Corporate Governance Committee) should be reporting with the financial reports, and not only annually. This is to keep the market informed of the WVR related compliance requirements. As a centrepiece to investor protection, HKEX should consider requiring third party assurance over the WVR Governance Committee's report. In any event, all committees should have the support of the company secretary as governance professional as set forth under Section F of the CG Code.

- **INEDs**

We have Member views that in order to have stronger check and balance effect in the board of directors of those WVR companies such that no board of directors can have unfettered authority or influence, WVR companies should have a higher INED representation in the board of directors. At present, INED representation is not less than one-third according to LR3.10A. For a better check and balance in the board of those WVR companies, INED representation should be at least 50% and subject to a minimum of four INEDs. In U.K. INEDs representation in the board for large-sized companies is at least 50%.

We also have HKICS Member views that for the voting right in the appointment of INEDs, as they are important for composing the WVR Governance Committee, the voting for the appointment of INEDs should be based on one-share-one-vote so as to reduce the WVR Beneficiary's influence on the INEDs and allow the chance for minority shareholders to vote for another INEDs when they are of the opinion that certain INEDs are not independent enough to monitor and check the WVR Beneficiary who could be an Executive Director.

As INEDs in the WVR Governance Committee have the important responsibility to monitor any abusive action from WVR Beneficiary and perform the check and balance in the board's function, the proper functioning of the nomination committee appointed in accordance with CG Code A.5.1 is important. We have Member views that WVR companies must appoint an INED to be the chairman of the nomination committee so as to avoid the nomination committee being dominated by the WVR Beneficiary (who could be the chairman). This change is in line with the requirement that the Audit Committee and the Remuneration Committee must be chaired by INED under LR 3.21 and LR 3.25 respectively.

Also, the INEDs should be qualified and/or experienced as to the mandated matters. The test under LR 3.13 is no more than a no-conflicts test and does not address qualification and/or experience. HKICS Member views suggest that the INEDs in the WVR Governance Committee be required to have governance experience to bring about legal, risk management and corporate governance experiences to the WVR Governance Committee (and reference could be drawn from LR 3.28).

Further, there should be a much stricter numbers/disclosure requirement for INEDs serving on the WVR Governance Committee, as they must devote personal attention and diligence on the issues set out above.

- **Skin in the Game**

There were HKICS Member views that to align the WVR Beneficiary with retail investors, the WVR Beneficiary must have skin in the game in respect of a primary listing.

In this connection, under the CP, while this appears to be the case on listing (at 10%), this falls away thereafter (presumably after any lock-up period) as set out in paragraph 22 of the CP. The retention of an interest in the shares serves as a powerful mechanism upon the WVR Beneficiary to take care of the interest of the retail investors as with his or her interest.

Further Submissions

We also have Member views on the following matters to enhance the proposals under the CP:

- **Biotech companies**

The new Chapter 18A and supplemental guidance set out certain criteria for a qualifying biotech company. One of which is that the Core Product must have been developed "beyond concept stage", as described in paragraph 75 of the Consultation Paper. Paragraph 75 describes that a Core Product must have passed the relevant Phase I trials/testing, and that the Competent Authority must not have objected to the product progressing to Phase II. However, it is not apparent from paragraph 75 whether the Phase I trials impose any minimum qualitative thresholds, such that the passing of initial trials would be indicative of the likelihood of success of the Core Product.

By comparison, a mineral company seeking a waiver from the track record requirements for a new applicant under LR 18.04 must demonstrate a "clear path to commercial production". There is no equivalent requirement proposed for early stage biotech companies. Given the significant uncertainty of success of new biotech products and the long lead time from R&D to production, the current proposed criteria under Chapter 18A appear to provide limited assurance of the longer term economic viability of companies permitted to list via this regime.

In respect of the requirement for a biotech company to have received meaningful investment by a Sophisticated Investor, it would be helpful if HKEX could elaborate on what constitutes "more than a token investment", e.g. by reference to a minimum amount or percentage of total invested capital.

Moreover, guidance should be introduced to ensure that the relevant Sophisticated Investor is independent of the founders/other significant shareholders of the listing applicant in order to establish genuine third party investment funding.

- **WVRs**

Paragraphs 106(c) and (d) of the Consultation Paper provide that the WVR beneficiary must have been materially responsible for the growth of the business (by way of skills, knowledge and/or strategic direction in circumstances where the value of the company is linked to intangible human capital) and that the individual must be one who has an active executive role within the business and be a director under proposed LR 8A.11. Only genuine founders who have made unique contributions to the business should benefit from WVRs and the above criteria broadly achieve this. However, LR 8A.11 only requires that the individual be a director, rather than a director in an executive capacity, to retain the benefit of the WVRs. An executive role of the WVR beneficiary should be essential to their ability to have, and retain, enhanced voting rights and would encourage the SEHK to revise Chapter 8A to reflect this.

The New Chapter 8A prescribes a minimum aggregate shareholding of 10% or more for WVR Beneficiaries. However, a minimum individual shareholding level should also be imposed, given that a genuine founder of the business ought, in ordinary circumstances, to be expected to retain a meaningful equity interest in the issuer which is consistent with the significance of his/her contribution to the business.

In the CP, the HKEX has proposed that the voting power attached to WVR shares be capped to not more than 10 times of the voting power of ordinary shares. However, this could be excessive and would prevent public shareholders from having a genuine say in the business through exercising their voting rights at general meetings. A multiple of not more than 5 times should be considered.

Takeover-related matters are not currently among the list of matters to be voted on the basis of one-share one-vote. WVR beneficiaries would potentially be able to frustrate a general offer under the Takeovers Code by using their WVRs to approve frustrating actions otherwise prohibited under Rule 4 of the Takeovers Code. Note 3 to Rule 4 provides that the Executive should be consulted on whether controlling shareholders and their respective associates should be permitted to vote on matters amounting to frustrating action. SFC/HKEX should consider whether that provides sufficient protection to minority shareholders or whether the position of WVR beneficiaries should be addressed specifically in the Listing Rules or through amendments to the Takeovers Code.

The effect of WVRs will mean that a hostile takeover of a company with WVR structure would be impractical, thus depriving minority investors in an underperforming WVR company of an exit option via a takeover transaction. The absence of a takeover threat also reduces the incentive (pressure) for managers of WVR companies to perform.

- **Secondary listings**

The new Chapter 19C of the Listing Rules proposes that Non-Greater China Issuers and Grandfathered Greater China Issuers will be able to apply for a secondary listing without being required to comply with the proposed safeguards on WVRs (save those on disclosure) and the HKEX's requirements on VIEs. HKEX states its reasoning for this to be because companies have already listed on other exchanges prior to the HKEX's proposals and it will be difficult for them to change their existing structures.

The aspect of this proposal that is particularly concerning is the new rules which enable these dispensations to remain in place for Non-Greater China Issuers and Grandfathered Issuers even if the bulk of trading migrates to Hong Kong. This provides a backdoor approach for companies to achieve a listing in Hong Kong without the carefully thought out safeguards proposed in the consultation paper. To allow this change would adversely impact the integrity of the Hong Kong market, and in particular its reputation internationally. This approach should be reconsidered.

- **Enhanced Disclosure**

There are HKICS Member views to specify clearly in the proposed LR 8A.40 that "An issuer with a WVR structure must identify all the ultimate beneficial owners' beneficiaries of weighted voting rights, regardless of their shareholding percentage, in its listing documents and in its interim and annual reports."

- **WVR beneficiaries**

There were also Member views that a more neutral reference, such as "WVR holders" instead of "beneficiaries" can be adopted. For information, SGX uses the terminology "owner managers" to describe the dual capacity of such holder of dual class shares.

Secondary Listing of Qualifying Issuers – unintended consequence upon compliance with the Takeovers Code

HKICS points out that transitional arrangements relating to the Takeovers Code can be fraught with unintended consequences. There may be an unintended consequence of the triggering of a mandatory general offer immediately upon a Greater China Issuer being required to comply with the exceptions set out in proposed LR 19C.11 (in particular, LR 13.23(2) requiring compliance with the Takeovers Code) following the expiry of the grace period of 12 months provided in Note 2 to proposed LR 19C.13. For instance, if a controlling shareholder holds 31% shareholding in a Greater China Issuer on the date of the Exchange's written notice of its decision that the majority of trading in listed shares has migrated permanently to the Exchange's markets and increases its shareholding by 3% to 34% during the grace period of 12 months, Rule 26.1(c) of the Takeovers Code will become applicable on the anniversary of the date of the Exchange's written notice, thereby triggering a general offer by the controlling shareholder for shares of the Greater China Issuer.

Further Guidance

We note that there could well be further guidance on what is an innovative company to permit WVR, and eventual development of issues including whether WVR shares can be issued because of corporate activities, like spin-off, for which there would be difficult governance issues to be addressed at the appropriate stage.

We look forward to consideration of the matters identified under this Submission from the governance perspective to enhance the proposals under the CP.

Should you have any questions, please feel free to contact Samantha Suen FCIS FCS(PE), Chief Executive, HKICS or Mohan Datwani FCIS FCS(PE), Senior Director, and Head of Technical and Research, HKICS at 2881 6177 or research@hkics.org.hk.

Yours faithfully,

David Fu FCIS FCS(PE)

President

The Hong Kong Institute of Chartered Secretaries