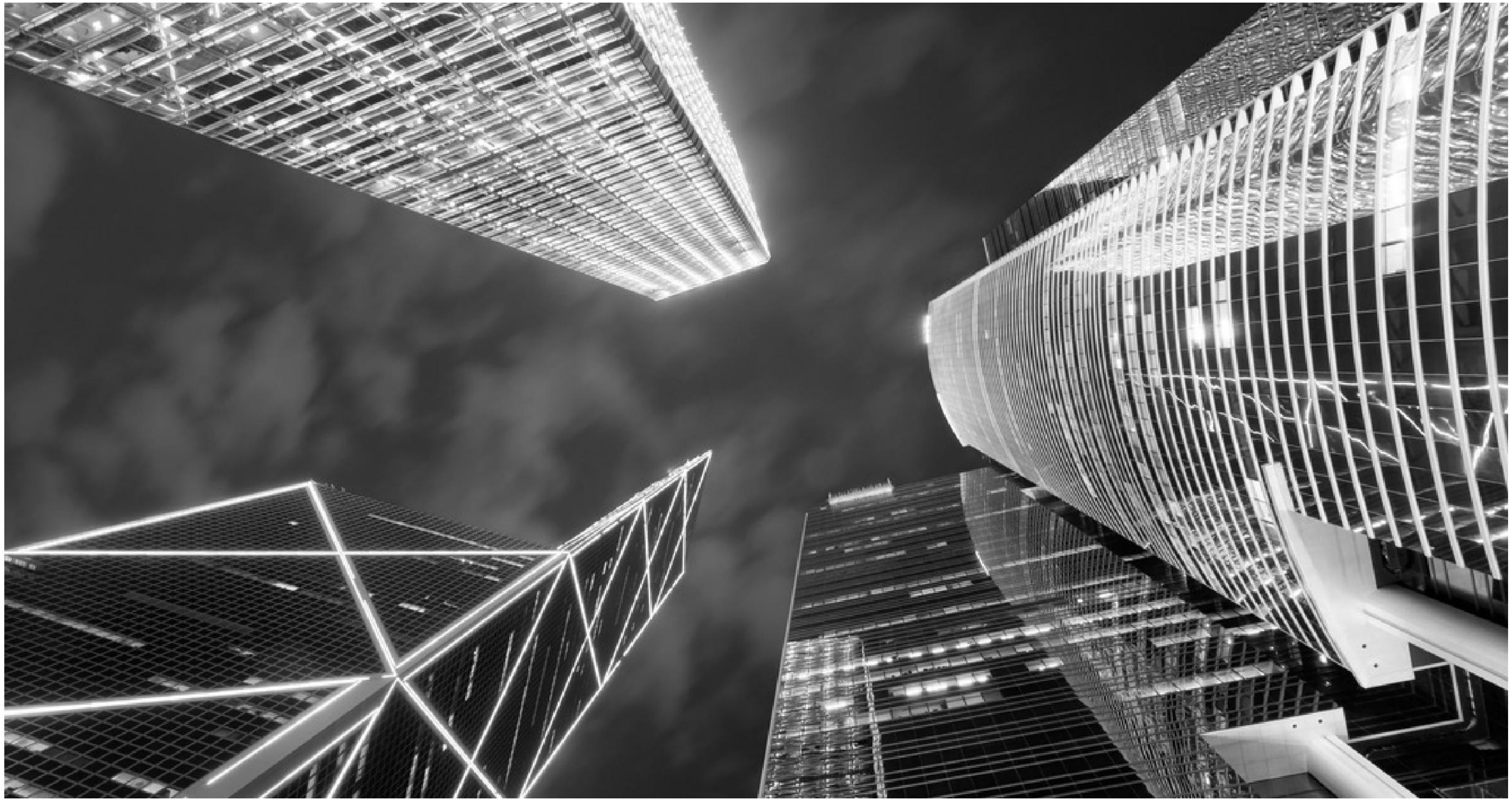
Hong Kong Stock Exchange's Weighted Voting Rights Concept Paper



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Introduction

Weighted Voting Rights (WVR) Structures

- 29th August 2014 - the Stock Exchange (“Exchange”) published a Concept Paper on whether companies with weighted voting rights (“WVR”) structures should be permitted to list on the Exchange
- WVR structures = structures which give certain persons voting power or other related rights which are disproportionate to shareholdings
- Various ways to create superior rights. All are referred to as Weighted Voting Rights (WVR) structures

Concept Paper

- **This is not a consultation paper : the Exchange expresses no view for or against**
- The purpose → to promote an informed and focused discussion by providing a neutral, factual and analytical presentation
- **Response Deadline is 30th November 2014**
  - Further Consultation will follow if there is in principle support for the idea

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The Prohibition on Weighted Voting Rights

- December 1989 - Initial Inclusion of Prohibition in Listing Rules

  "The share capital of a new applicant must not include shares of which the proposed voting power does not bear a reasonable relationship to the equity interest of such shares when fully paid ("B shares")." (Rule 8.11)

- The Exchange can agree to list a WVR company if the circumstances are exceptional, but no company with a WVR structure has been listed under this exception
- Main Board Rules also allow listed companies which already have B shares to list further B shares issued by way of scrip dividend or capitalisation issue
- GEM Listing Rule 11.25 contains similar prohibition but as there are no GEM listed companies with B shares, there is no exception for issuers with B shares in issue

The Prohibition on Weighted Voting Rights (cont'd)

- Rule 8.11 implements "one-share one-vote" policy and effectively prohibits the listing of companies with "dual class shares", i.e. companies with multiple voting shares, inferior par value shares and non-voting ordinary shares, as well as listing of new classes of these shares by existing listed issuers
- Aim of the policy -> align voting power with equity interest to ensure that all shareholders are treated fairly and equally (Rule 2.03(4))
- Although Listing Rule 8.11 is a restriction on 'voting rights', the Exchange interprets the rule to prohibit **all** WVR structures, including structures which give company controllers enhanced or sometimes exclusive rights to elect the majority of a company's directors

History of Weighted Voting Rights Structures

- 1970s First issues of B-shares

Features of B-shares

- One vote per share, i.e. equal to existing A shares' voting rights
- Lower par value, thus lower dividends payable (usually 10-20% of that of A shares)
- Traded at lower price

  Example: Swire Pacific's B share price = 1/5 of A share price
- March 1987 – Jardine Matheson Holdings Ltd., Cheung Kong (Holdings) Ltd. and Hutchison Whampoa Ltd. announced intention to offer B shares via bonus issue
  - -> Announcement triggered 3.7% fall in Hang Seng Index
  - -> Market rebound when listing of B shares was banned

History of Weighted Voting Rights Structures (cont'd)

The Standing Committee on Company Law Reform Report

- July 1987 Report – whether issue of B shares was in general interest of shareholders and public interest
- Points to Note
  - Issuance most likely used to stave off a hostile takeover bid
  - Acts as an inexpensive way for founding families and entrepreneurs to purchase voting power and consolidate control

  i.e., allowed companies' founders to retain control while still being able to raise equity finance
  - In the context of Hong Kong's 1997 return to Chinese sovereignty, B shares enabled a majority owner to transfer substantial portions of its capital overseas, while maintaining actual control in Hong Kong which could lead to "a lessening of confidence in Hong Kong as a major financial centre"
  - Difficulty in drafting effective controls over differential voting rights in legislation

History of Weighted Voting Rights Structures (cont'd)

- However, the Standing Committee considered that there remained a legitimate need for the continuing availability of B shares in *exceptional circumstances* where
  - "*national security or the interests of the community as a whole ….may make it desirable that ultimate control should be concentrated in particular hands, although there is support for the view that the use of B shares for these purposes is normally only acceptable when a company first applies for a listing and there is no question of protection for minority shareholders*".
- Listing Rule 8.11 was then introduced to prohibit the listing of companies where voting power and equity interest are not aligned, but allows the Exchange to approve the listing of such companies on a case-by-case basis in exceptional circumstances

Why the Change ?

- Listing Rules should *"reflect currently acceptable standards in the market place"* (Rule 2.03)
- The Exchange has received a number of enquiries regarding listing of companies with WVR structures
- October 2014 - Alibaba Group listed on New York Stock Exchange
  - Largest IPO ever: US$25 billion
  - Would not have been allowed listing in HK
- Alibaba would not have been allowed to list on the Hong Kong Stock Exchange because its governance structure would have contravened the Listing Rules' one-share one-vote requirement
  - Alibaba Group has a single class of ordinary shares but Alibaba's founders and senior management members are given the exclusive right to nominate a simple majority of its board members

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Competitiveness of Hong Kong

International listing venue of choice for Mainland Chinese companies

- 1993 July – first H-share company listing in HK
- 2009 to 2011 – HK topped world ranking of stock exchanges for IPO funds raised
- Some IPOs of Mainland Chinese companies ranked in global top 10 IPOs
  - 2010 – Agricultural Bank of China raised US$22.1 billion (dual listing on Hong Kong & Shanghai exchanges)
  - 2006 – Industrial and Commercial Bank of China Ltd. raised US$21.9 billion in Hong Kong / Shanghai listing
- **Mainland Chinese companies are the most important source of HKSE listings** At the end of 2013, they accounted for 57% by market capitalisation of the Hong Kong Stock Exchange and for 70% of total equity turnover

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Competitiveness of Hong Kong (cont'd)

Current Trend

- **2012-13 HK lost its top ranking of IPO funds raised to NYSE**
- **Trend continues in 2014**
  - Top exchanges in the first three quarters in 2014 were Nasdaq by deal vol. and NYSE by deal value while HK ranked 2^{nd} on both counts
- Technology sector accounted for the most IPOs in this period
  - globally 107 deals raised US$42.9 billion
  - US35.2 billion was raised in technology company IPOs on the NYSE and Nasdaq
- 64 IPOs on the Hong Kong Stock Exchange in the first three quarters of 2014 raised a total of US$16.7 billion and materials sector was the most active in terms of IPO funds raised

Source : *Ernst & Young Global IPO Trends Report 2014 Q3*

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Competitiveness of Hong Kong (cont'd)

- Hong Kong has been the worst place to invest in Mainland Chinese IPOs this year
  - IPOs record lower average returns
  - a higher chance of losses than IPOs of Chinese companies in Shanghai and New York

- 35 Chinese listings in Hong Kong this year
  - Only 18 have registered share price gains since trading started (data from *Dealogic*)
  - Returns from Chinese IPOs on the Exchange have been 11% on average

- Average share price of newly listed Chinese companies in New York has risen by about 1/3
  - Only one of the 12 US deals (mostly from the tech sector) has failed to rise

Source: "China IPOs in Hong Kong disappoint", Financial Times*, 10th November 2014.*

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Competitiveness of Hong Kong (cont'd)

- Most IPO share prices doubled after listing on the Shanghai and Shenzhen stock exchanges.
  - the markets were closed by regulators om 2013 and Chinese retail investors were "starved" of new IPOs

- Hong Kong's IPO market drives trading volumes in Hong Kong and thus the dearth of large listings in Hong Kong in recent years has coincided with low trading volumes

- Many hope that this will change with the new Hong Kong-Shanghai Stock Connect programme which launched on 17th November

Source: "China IPOs in Hong Kong disappoint" *Financial Times* (10th November, 2014)

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Competitiveness of Hong Kong (cont'd)

- Heart of the debate is Hong Kong's positioning as the gateway to international capital for Chinese companies in the light of popularity of the NYSE and NASDAQ for listing technology company stocks

- 31 October 2014 – 97 Mainland Chinese companies were primary listed in the US
  - 33% have a WVR structure but account for 86% of the market capitalisation of all US-listed Mainland Chinese companies
  - 72% of US-listed Mainland Chinese companies with WVR structures are IT companies
  - some of China's most competitive and popular companies are part of the NASDAQ Composite, but are neither in MSCI China or Hang Seng China Enterprises indexes, two of the most commonly tracked benchmarks of Mainland China stocks

Competitiveness of Hong Kong (cont'd)

- IT companies make up only 7% of the total market capitalisation of all Hong Kong listed companies
  - only Tencent and Lenovo are included in the 50 constituents of the Hang Seng Index
  - largest industries by market capitalisation on the Exchange are financials and properties and construction
- Alibaba Group is not the only Mainland company with a WVR structure which opted to list in the US in 2014
  - May 2014 - JD.com Inc. raised US1.78 billion on Nasdaq
  - April 2014 - Weibo Corp. raised US$285.6 million on Nasdaq

Competitiveness of Hong Kong (cont'd)

- US Exchanges allow companies of all types with WVR structures to list and these currently account for approximately 14% by market capitalisation of all large cap companies

  Examples: Google, Facebook, Visa and Mastercard

- Late 1980s – NYSE lifted its previous prohibition on listing of companies with WVR structures under competitive pressure from Nasdaq
- The US exchanges only allow new applicants to list with WVR structures and prohibit existing listed companies from adopting WVR structures post-listing if this would reduce the rights of the existing shareholders

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Competitiveness of Hong Kong (cont'd)

Current Challenges

- Concept Paper raised several questions:
  a) whether WVR structures should be allowed, but only for companies in the IT industry
    - because the most competition for listing Chinese companies is from the US, especially for Chinese technology companies, most of which have WVR structures
    - however HK would then be the only jurisdiction to restrict the types of companies which can list with a WVR structure while WVR structures are widely used in different industries

  b) whether it is sensible to only allow technology companies to list with WVR structures
    - from 2001 to 2013, 80% of US-listed companies with dual-share structures were primarily in the energy, financial and communications industries
    - although it is now predominantly Chinese technology companies that use WVR structures, this may change

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Competitiveness of Hong Kong (cont'd)

- Concept Paper notes importance of HK's ability to attract Mainland companies to list on Exchange to HK's continued relevance as China opens up
- As financial liberalisation in Mainland China continues, HK's position as gateway for investors in and out of China is under threat (e.g. risk that international companies will bypass HK if allowed to list in China)
- FSDC paper "Positioning Hong Kong as an International IPO Centre of Choice" comments that HK risks over-reliance on Mainland China as the source of its IPO candidates and recommends making "*every effort to diversify its 'client base' and actively open up to quality companies from all corners of the world*".

Competitiveness of Hong Kong (cont'd)

Shanghai-Hong Kong Stock Connect Pilot Programme

- Commenced on 17th November 2014. The programme is scalable in size, scope and market in the future and cross-border capital raising may eventually be permitted, subject to SFC and CSRC regulatory approvals
- Ability to list on the Exchange with a WVR structure might prove attractive both to foreign-listed companies with WVR structures and to privately-owned overseas companies with such structures looking for their first public listing
- The FSDC's paper also comments that the "one share one vote" principle (Rule 8.11) may have deterred the Hong Kong listing of overseas companies with genuine commercial or legal reasons for having WVR structures

Example: a legitimate desire to raise funds without diluting control

- FSDC Paper urges the Government and regulators to review the rule and consider whether modifications or partial relaxations are appropriate

Competitiveness of Hong Kong (cont'd)

COMPETITION WITH OTHER JURISDICTIONS

- Singapore does not yet allow listing of companies with WVR structures, but is revising its Companies Act to remove the existing prohibition on public companies issuing shares with multiple and non-voting rights
  - 2011 - Manchester United opted to list in New York rather than Singapore because of the superior voting rights attached to shares held by the company's owners. SGX vigorously defended the one-share one-vote principle citing the risk of entrenched control and potential questions on the fair value of shares carrying multiple votes in a takeover situation
  - At the end of May 2014, only 57 Mainland Chinese companies were listed on the SGX while the last Chinese company listed there in June 2012
  - China's Securities Regulatory Commission signed a deal with the SGX in November 2013 which will allow Mainland Chinese companies to list in Singapore without having to incorporate an overseas holding company
  - The agreement will allow Mainland companies to list directly in Singapore which should make it much easier for them to list and SGX is hoping to see more Chinese IPOs in 2015

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Competitiveness of Hong Kong (cont'd)

COMPETITION WITH OTHER JURISDICTIONS (cont'd)

- The UK prohibits "Premium Listings" of shares with mechanisms designed to consolidate power in the hands of a small number of individuals
- Premium Listing requires listed companies to meet the UK's super-equivalent rules which are higher than the EU minimum requirements
- WVR structures are allowed for "Standard Listings" of shares, but institutional shareholders in the UK have generally been hostile to these structures
- The London Stock Exchange ("LSE") attracted three Mainland companies to list in 2013 raising US$56.4 million but there are only 11 such companies listed there and all are listed on the LSE's Alternative Investment Market for smaller, growing companies
- No Mainland companies listed in the LSE have WVR structures

Empirical Studies and WVR Pros and Cons

ARGUMENTS AGAINST WVR STRUCTURES

a) **Proportionality**

- By buying additional shares, shareholders put more of their own capital at risk and are therefore entitled to a greater proportion of the company's future cash flows
- This ensures that shareholders have a proportional say in who manages the company for the purpose of producing future capital gains and cash flows and on whether cash flows will be paid out as dividends
- The one-share one-vote principle ensures that shareholders with the same interest are given an equal say on matters affecting the value of their shares

Empirical Studies and WVR Pros and Cons (cont'd)

ARGUMENTS AGAINST WVR STRUCTURES (cont'd)

b) **Empirical Evidence**

Empirical academic studies on the effect of a dual class share ("DCS") structure show a consensus view that investors generally apply a discount to shares with inferior voting rights in a DCS structure, which the studies argue reflects the following risks:

- **Controllers' consumption of private benefits**
  - DCS allows controlling shareholders to retain control while holding a relatively small equity stake in a company
  - Controlling shareholders will more likely extract personal benefits from the company as they can enjoy the full benefits they take out of the company, but suffer less downside through the reduction in the value of their equity stake in the company resulting from their extraction of private benefits
- A smaller equity interest could incentivise controlling shareholders to transfer quality assets out of a listed company to other companies in which they have a greater stake, and vice versa (known as "tunnelling" or "value shifting")

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Empirical Studies and WVR Pros and Cons (cont'd)

ARGUMENTS AGAINST WVR STRUCTURES (cont'd)

- **Entrenchment risk**
  - Shareholders' approval is required only for the most important matters, such as the appointment and removal of directors
  - Theoretically, the knowledge that they can be removed by shareholders should motivate directors to perform well and act in the best interests of the company as a whole
  - In a company with a WVR structure, the non-controlling owners may be prevented from removing directors who extract private benefits, fail to manage the business so as to maximise its value and performance or act contrary to the wishes of the minority shareholders

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Empirical Studies and WVR Pros and Cons (cont'd)

ARGUMENTS IN FAVOUR OF WVR STRUCTURES

a) **Long-termism**

- WVR structure gives incumbent directors the freedom to run a business to maximise growth and value for shareholders over the long term
- Entrenchment is detrimental for investors if a company performs badly due to poor management, but it can also benefit a company by insulating the directors from shareholder pressure to generate short term returns that are not in the company's long term interests

b) **Detrimental market impact**

- The prohibition on WVR structures restricts investors' ability to invest in companies using the structure, and thus renders the Exchange a less efficient marketplace for achieving the effective allocation of capital from investors to listed companies
- Controlling shareholders are prevented from diversifying their wealth into other entrepreneurial projects which could benefit the market as a whole

Empirical Studies and WVR Pros and Cons (cont'd)

ARGUMENTS IN FAVOUR OF WVR STRUCTURES (cont'd)

c) **Allow financing without dilution**

- Fast growing companies looking to list on the Exchange may already have had one or more rounds of private equity or debt financing and exhausted their ability to grow through private investment and founders will have diluted their stake in the company as a result
- WVR structure would allow the company to expand without diluting the founders' ownership any further and to maintain management continuity.

IMPACT OF WVR STRUCTURES

- Investors typically apply a discount to shares with inferior voting rights to reflect the risks of consumption of private benefits, underperformance and management entrenchment
- But there lacks a consensus as to whether those risks in fact have a negative impact on a company's performance and some studies provide evidence that laws and regulations can limit the negative impact of WVR structures

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The OECD Report on Proportionality

- December 2007 - The OECD Steering Group on Corporate Governance issued a paper on proportionality between ownership and control for listed companies. Its conclusions were:
  a) Subject to certain conditions, there is nothing "a priori" onerous about separating ownership from control, although those benefiting from a disproportionate degree of control may have incentives to seek private benefits at the cost of non-controlling shareholders
  b) Cost of regulating proportionality would be considerable, and simply ruling out voting right differentiation on companies' shares would be neither effective nor efficient because a number of alternative "proportionality limiting mechanisms" could be used to achieve a similar effect
  c) A better alternative would be the strengthening of corporate governance frameworks
  d) Specific problems can be dealt with through carefully targeted regulation

The OECD Report on Proportionality (cont'd)

- Three conditions which the OECD Report considers crucial are:
  a) Liquid and well-informed capital markets that are able to correctly price the likely disadvantage of "proportionality limiting mechanisms" to outside shareholders
  b) Laws and regulations preventing the extraction of private benefits from reaching socially unacceptable levels
  c) Proper implementation mechanisms, including prompt and affordable legal recourse for all shareholders

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Jurisdictional Comparison

- A range of approaches to WVR are adopted which fall into three main groups:
  a) Some jurisdictions allow WVR structures under both their corporate law and listing rules

     Examples: the US, Canada and Sweden

  b) Other jurisdictions allow companies to have WVR structures under their company law, but prohibit such companies from listing

     Examples: Hong Kong, the UK, Australia and Singapore

  c) Some prohibit both listed and unlisted companies from using WVR structures

     Examples: Germany, Spain and Mainland China

Alternative WVR Structures

- DCS are the most common type of WVR structure in the US
- These structures often give incumbent controllers either enhanced or exclusive rights to elect directors (usually a majority) to the company's board
- It is possible for Mainland Chinese companies to list in the US with alternative WVR structures
- Concept Paper seeks views on whether these alternative structures should be considered for companies seeking to list in Hong Kong

Alternative WVR Structures

The principal types of alternative structures identified are:

a) **Dual-class director election**

- 45 companies (3%) in the S&P 1500 Composite Index were controlled through shares allowing the holders to elect a fixed number or percentage (usually a majority) of board members
- The boards of 21 of these companies are split into two groups, each of which is associated with a share class
  - i.e. “Class A” directors and “Class B” directors
- Directors are elected at general meetings where Class A shareholders elect the Class A directors and Class B directors are voted for by the Class B shareholders
- One class of shareholders, typically the company’s founders, will have the right to nominate a larger number of directors to the board than the other class
- Examples: Nike Inc. and the New York Times Company

Alternative WVR Structures (cont'd)

b) Non-voting ordinary shares

- Have classes of non-voting ordinary shares and a separate class of shares carrying one vote per share, which are normally held by insiders
- Outside investors have little say in major decisions
- Examples of US-listed companies are Apollo Group Incorporated and Federated Investors Inc.

c) Hybrids

- Shares entitling holders to both multiple votes per share and the exclusive right to elect a majority of the board
- Examples of US-listed companies with these shares are Expedia Inc., the Hershey Company and the Ralph Lauren Corporation

Alternative WVR Structures (cont'd)

d) **Special control rights granted in Articles**

- WVR structure can give special control rights to particular persons through provisions in the articles only and the rights do not attach to any particular class of shares
- Examples
  - Autohome, Inc. – Mainland company listed on NYSE

    While the company's current controlling shareholders hold at least 39.3% of its total ordinary share capital, they are entitled, but not obligated, to appoint at least a majority of the directors to its board. They also have special rights to fill a vacancy following the removal of a director they appointed. Directors appointed by a controlling shareholder are not subject to retirement by rotation
  - JD.com - Mainland company listed on Nasdaq

    The quorum for a board meeting of the company is not achieved unless the founder is present. The founder has a casting vote where directors cast an equal number of votes in favour or against a particular issue and he must approve any appointment of a director to fill a casual vacancy. JD.com also has a dual-class share structure: the "B" shares held by the founder entitle him to 20 votes per share

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d) Special control rights granted in Articles (cont'd)

- LightInTheBox Holding Company Ltd – Mainland company listed on NYSE

  It has a single class shareholder structure that entitles shareholders to one vote per share on most shareholder resolutions. However, the company's articles provide that its founders have three votes per share on any resolution concerning a change in control of the company

- Alibaba Group Holding Ltd – listed on NYSE

  It has a single class of ordinary shares which entitle holders to one vote per share on all matters on which ordinary shareholders are entitled to vote. However, the Alibaba Partnership has the exclusive right to nominate a simple majority of the directors on the board. The election of each director nominee is subject to majority approval of the company's shareholders at the company's annual general meeting

Additional Considerations

POSSIBLE RESTRICTION TO NEW LISTING APPLICANTS

- DCS structures should only be allowed when companies apply to list on the Exchange (Standing Committee on Company Law Reform 1987 report)
  - Investors in such companies would acquire shares in full knowledge of the fact that their shares carry rights which are inferior to those carried by the shares held by the company's controllers
  - There is no question of their existing rights being reduced by the adoption of a WVR structure at IPO
  - If the implementation of a WVR structure in favour of the controlling shareholder(s) were permitted post-listing, this risked limiting the rights of the company's minority shareholders

Additional Considerations (cont'd)

POSSIBLE RESTRICTION TO NEW LISTING APPLICANTS(cont'd)

- NYSE and NASDAQ allow new listing applicants to list with WVR structures
- Any listing of shares on such markets that may prejudice the interests of the existing shareholders of the company is however prohibited
  - voting rights of existing shareholders of publicly traded common stock registered under s.12 Exchange Act cannot be disparately reduced or restricted through any corporate action or issue
  - Examples: the adoption of time phased voting plans, the adoption of capped voting rights plans, the issue of super voting stock, or the issue of stock with voting rights less than the per share voting rights of the existing common stock through an exchange offer (NYSE Listed Company Manual, Rule 313(A))
- Prohibit a company from creating a new class of security that votes at a higher rate than an existing class of securities or from taking any other action that has the effect of restricting or reducing the voting rights of an existing class of securities (NASDAQ's Stock Market Rules)

Additional Considerations (cont'd)

CIRCUMVENTION RISK

- Restriction that would permit only new listing applicants to adopt a WVR structure could lead to existing listed companies seeking to circumvent the restrictions
  - Means of circumventing the restriction include:

    Transferring assets/businesses to a private company and subsequently listing the private company with a WVR structure; spinning off assets or businesses as new listed companies with WVR structures or conduct reverse takeovers with such structures; or de-listing in order to re-list as a company with a WVR structure
- The Exchange can add general anti-avoidance provisions to the Listing Rules to prevent existing listed companies from circumventing the restriction
- Drawbacks are that the anti-avoidance provisions may not always succeed and that the decision as to whether a particular transaction constitutes an attempt to circumvent the restriction will be a subjective one in each case
- Question 2 of the Concept Paper asks whether WVR structures should be allowed for existing listed issuers or only for new listing applicants

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Additional Considerations (cont'd)

Restrictions in Use on US Markets

US listed companies generally impose restrictions on WVR structures voluntarily

Characteristic	Description of Restriction	Prevalence in Mainland Chinese Companies	Non-Chinese Examples
Restrictions on Transfer	Multiple voting shares must convert into OSOV shares if beneficial ownership is transferred to persons who are not "affiliated" with the original holders. Three companies (China Dangdang, Qihoo 360, and Qunar Cayman) also require conversion if an "affiliate" transfers the shares within six months of gaining beneficial ownership. One company (Mindray Medical) requires conversion if an "affiliate" transfers the shares at any time after gaining beneficial ownership.	27 of 30 companies (all except Shanda Games, eLong and LightInTheBox)	Facebook, Google, LinkedIn, Zynga

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Additional Considerations (cont'd)

Characteristic	Description of Restriction	Prevalence in Mainland Chinese Companies	Non-Chinese Examples
Minimum equity threshold held by founders or others	If at any time the founders of the company hold less than 5% of the multiple voting shares, all multiple voting shares in issue must convert into OSOV shares. One company (Autohome) sets this threshold at 39.3% of the sum of both classes of its shares and another (RenRen) sets it at 50% of the founders' total holding of both its share classes at IPO. iKang Healthcare sets this threshold at 8% of the company's total issued common stock. JD.com requires conversion of its B shares if its founder does not hold any. Two companies, in addition to the founder threshold above, require conversion of multiple voting shares if the holding of any non-founder changes by more than 50% (NQ Mobile and YY Inc). RenRen requires conversion if non-founders' total ordinary shareholding at IPO falls below 50%.	13 of 30 companies (58.com, Autohome, Baidu, China Dangdang, iKang Healthcare, JD.com, Jumei International, NQ Mobile, Perfect World, RenRen, TAL Education, Weibo and YY)	AMC Entertainment Holdings, Inc (30% of all outstanding shares threshold)

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Additional Considerations (cont'd)

Characteristic	Description of Restriction	Prevalence in Mainland Chinese Companies	Non-Chinese Examples
Change of control event	One company (Autohome) requires conversion of all multiple-voting shares into OSOV shares if there is a change in control of the company.	One of 30 companies (Autohome)	No example found
Retirement / incapacity / death of founder	One company (JD.com) requires conversion of all multiple voting shares into OSOV shares if the founder is no longer employed as the chief executive officer or cannot permanently attend board meetings due to his physical and/or mental condition.	One of 30 companies (JD.com Holdings)	Google, Zynga, LinkedIn, Groupon
Minimum threshold of shares outstanding	One company (Mindray Medical) requires conversion of its multiple voting shares into OSOV shares if the number of those shares outstanding falls below 20% of total share capital.	One of 30 companies (Mindray Medical)	LinkedIn, Zynga (conversion below minimum 10% of share capital threshold)

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Additional Considerations (cont'd)

Characteristic	Description of Restriction	Prevalence in Mainland Chinese Companies	Non-Chinese Examples
Vote of shareholders	A requirement for the conversion of all multiple voting shares into OSOV shares if holders of multiple voting shares vote for it.	None	Facebook (approval by majority of multiple voting shareholders) Groupon (approval by 66.6% of multiple voting shareholders)
Sunset clause	A requirement for the conversion of multiple voting shares into OSOV shares at a particular future date.	None	Groupon (conversion into OSOV shares after five years)

- Question 3 of the Concept Paper asks whether the Exchange should require any or all of the restrictions voluntarily adopted in the US by companies with WVR structures

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Additional Considerations (cont'd)

Possible Additional Restrictions for Hong Kong Listed Shares with WVR Structures

- A requirement for warnings in all corporate communications
- An "X" in their short stock names
- A cap on the number of votes that can be carried by one share
- Enhancing the powers of independent non-executive directors
- Additional circumstances that may require a company to unwind its WVR structure at either a shareholder or board level

Possible Restriction to GEM Board or a Professionals Only Board

a) Listing on GEM Board

  - However, the Growth Enterprise Market Listing Rules contain the same restriction on listing companies with WVR structures and amendments to those Rules would be required to allow them to list

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Additional Considerations (cont'd)

Possible Restriction to GEM Board or a Professionals Only Board (cont'd)

b) Listing on a newly-created board to which only professional investors would have access.

- This would however set the Hong Kong Exchange apart from other markets as there are no other markets which restrict the trading of ordinary equity securities to professional investors

  Shanghai Stock Exchange has announced plans to launch a new board for "strategic emerging industries" but this would not permit the listing of companies with WVR structures. The proposal is pending approval

- The Concept Paper did not address the more general question of the re-positioning of GEM or the creation of a professional board for listing companies with WVR structures, but the Exchange will take into account any views from the market submitted in response to the Concept Paper on the acceptability or desirability of using GEM, a professional board, or another separate board focused on, for example, specific sectors or companies with specified characteristics

Additional Considerations (cont'd)

Secondary Listing of Greater China Entities

- Debate on acceptability of a secondary listing on HKSE for Chinese companies with WVR structures already listed in US
- Currently, Exchange will ***not*** approve an application for secondary listing by a company that has its "centre of gravity" in Greater China (revised Joint Policy Statement for Overseas Companies issued by the Exchange and the SFC, September 2013)
- This reflects the Exchange's longstanding policy that the Exchange is the natural market for listings of Mainland and Hong Kong companies
- A US listed Chinese company can only apply for a dual primary listing on the Exchange and a secondary listing is not possible unless there is a change in policy
- The Exchange intends to review whether Chinese companies should be allowed to secondary list in Hong Kong at some point in the future

Additional Considerations (cont'd)

Possible Restriction to Companies in Particular Industries

- Hong Kong currently faces the most competition for listing Chinese companies from the United States especially for IT companies which account for 70% of the Mainland Chinese companies listing in the US with WVR structures and 90% of those companies by market capitalisation.
- Only two information technology companies (Tencent Holdings Limited and Lenovo Group Limited) are included in the 50 constituents of the Hang Seng Index.
- It is suggested that the use of WVR structures should be allowed only for companies in particular industries, such as IT companies to stave off competition from the US, while limiting risks posed by DCS. This would however make the Exchange the only major stock exchange to restrict the use of WVR structures to companies in a particular industry
- While WVR structures are particularly prevalent in the IT industry, they are also adopted by companies in a wide range of other industries. From 2001 to 2013, 80% of US IPOs by companies with DCS structures were of non-IT companies. While IPOs of IT companies are the main area in which the Exchange currently competes with the US exchanges, that may change in the future, raising the question of whether it is sensible to restrict WVR use to information technology companies now

Additional Considerations (cont'd)

Classification Issues

- Difficulty in defining IT companies
- According to Hang Seng Industry Classification (**HSIC**) System, certain types of "technology" companies in layman's terms may be excluded.
- Example: bio-technology and clean energy companies, companies in the telecommunications industry, etc.

Possible Restriction to "Innovative Companies"

- To only permit use of WVR structures by "innovative" companies that are likely to have a transformative effect on their industry or society in general
- Decision of whether a company is "innovative" would however be highly subjective
- A company that starts out as "innovative" will quickly become commonplace and raise the question of whether it should have to abandon its WVR structure at that stage.

Investor Protection Issues

- Hong Kong ranks 3rd in the world for investor protection: US ranks 6th (World Bank and International Finance Corporation's "Doing Business 2014")
- HK scored 9 out of 10 for regulation of connected transactions
- But, US ranked higher for ease by which shareholders can obtain legal redress for damages: US scored 10 and HK scored 8 out of 10 (OECD rich country average 5 out of 10)
- Concept Paper states US and Hong Kong "are actually quite closely matched in providing shareholders with legal means of redress through private actions"
- Differences between US and HK regimes:
  - US regime places greater emphasis on ease by which shareholders can bring private actions to obtain redress after abuse occurs and allows:
    - class action suits
    - payment of legal fees on contingency basis
  - HK regime puts emphasis on Rules to prevent abuse of control before it occurs (e.g. connected transaction Rules) and post-event legal action primarily carried out on shareholders' behalf by the SFC

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Investor Protection Issues (Cont'd)

Shareholders' Litigation Rights: Hong Kong

- 2 main methods for minority shareholders to bring private actions v listed companies:
  - **unfair prejudice remedy -** allows a member of a company (including a non-Hong Kong incorporated listed company) to petition the court for an appropriate order if company's affairs have been carried out in a manner unfairly prejudicial to the interests of all or some of the members (section 214 SFO)
  - **derivative action** - a member of a company can bring an action on behalf of the company against a wrongdoer (e.g. a director) (sections 731 to 738 of the new Companies Ordinance). It enables a shareholder to bring proceedings on behalf of the company where a director is in breach of its contractual or fiduciary obligations to the company
- Shareholder litigation relatively rare in Hong Kong – cultural reasons, difficulty and cost

SFC "surrogate actions" on shareholders' behalf

- FSDC Paper noted SFC "*repeatedly breaking new ground by conducting 'surrogate' actions*" on behalf of listed company shareholders using its powers under ss 212 to 214 SFO
- Examples include SFC application to court to wind up China Metal Recycling (Holdings) Limited, to protect the interests of the company's shareholders and creditors and interests of investing public. The application was made after SFC found evidence that the company had overstated its financial position in its IPO prospectus and annual report
- In 2012 court ordered chief executive of China Asean Resources to pay HK$10.7 million misappropriated by him to the company

Investor Protection Issues (Cont'd)

Shareholders' Litigation Rights: United States

- Shareholders can bring a class action lawsuit for violation of federal securities laws
- Shareholder class actions fairly common in US and shareholders' initiation of a class action lawsuit for violation of US federal securities laws more common than SEC enforcement action
- Class action law suits allow a representative plaintiff to sue on behalf of himself and all other persons (the class) who have the same or similar claims against the same defendant, where they each have a direct claim against the defendant for injury suffered by them as plaintiffs. They allow minority shareholders to pursue claims even when the amount of compensation sought, taken individually, would not justify the expense of a law suit brought individually
- However, shareholders' class action suits in US are brought almost exclusively to obtain compensation for misleading disclosure (normally misstatement of the co's financial position). They can also be used: to compel payment of a dividend, to protest the issuance of shares impermissibly diluting a shareholder's interest, or to obtain inspection of corporate books (in re. Worldcom, Inc)
- Class actions cannot be brought in relation to governance issues that might arise from a WVR structure (e.g. abuse of powers by the founders as directors)
- A shareholders' class action cannot be brought against the co's directors because the harm has been done to the company – not the shareholders (the injury to them is incidental to the injury to the company). The appropriate action here is a derivative action which a shareholder brings on behalf of the company for harm done to the company

Investor Protection Issues (Cont'd)

Shareholders' Litigation Rights: United States (Cont'd)

- Figures quoted in Stanford Law School's/Cornerstone Research's "Securities Class Action Filings 2013 Year in Review" indicate that:
  - there were 166 securities class action filings made in 2013
  - 97% of all claims involved allegations of misrepresentation in financial documents
  - 54% of all claims involved allegations of false forward-looking statements
  - 84% of claims were claims of securities fraud under Rule 10b-5
  - 152 securities class action claims were filed against listed companies in 2013 (55 against NYSE listed companies and 97 against Nasdaq listed companies)
  - in 2013, approximately one in 30 companies was the subject of a class action
  - filings against foreign companies were most commonly against Chinese companies
- However, most securities class actions settle before trial - according to studies, the median time for settlement is 3 years after filing of the class action

Investor Protection Issues (Cont'd)

Shareholders' Litigation Rights: United States (Cont'd)

- The principal claim in a class action suit is generally one of securities fraud under section 10(b) of the Exchange Act of 1934 and Rule 10b-5 of the SEC adopted under the Exchange Act. These provisions prohibit fraud by any person in connection with the purchase or sale of a security. The elements of a private right of action for damages under these provisions include (among others):
  - a material misrepresentation (or omission)
  - a wrongful state of mind
  - a connection with the purchase or sale of security
  - reliance
  - economic loss and
  - causation

Derivative Actions in US

- Where injury to shareholders is incidental to injury to the company and the shareholder has no direct claim against the wrongdoer, the appropriate action is a derivative action brought by one or more shareholders on behalf of the co against its directors/officers. Remedies are granted to the company with shareholders benefiting only indirectly

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Investor Protection Issues (Cont'd)

Derivative Actions in US (Cont'd)

- Plaintiff enforces a right that the corporation may itself assert but has failed to enforce or to hold directors accountable to the corporation
- Plaintiff must represent the interests of shareholders who are in a similar situation
- Aim of a derivative action is not a monetary settlement for the shareholder, but implementation of, or amendments to the company's corporate governance principles and practice
- Derivative actions most commonly involve charges that directors or officers are wasting corporate assets, or that a corporation's management or board of directors breached fiduciary duties owed to shareholders by negligence, mismanagement or self-dealing
- E.g. where co board authorizes issue of stock for no or grossly inadequate consideration, the appropriate shareholder action is a derivative action – not a class action. The injury has been suffered by the co, and the shareholders are injured derivatively
- In contrast, securities class action suits are primarily used in US where investors suffer loss due to company fraud or misleading disclosure which triggers a drop in the company's share price – here the plaintiff has a direct action against the company

Investor Protection Issues (Cont'd)

Hong Kong Position (Cont'd)

- Hong Kong already has ample legislative provisions to protect investors from false or misleading disclosure under Companies (Winding Up and Miscellaneous Provisions) Ordinance and SFO
- SFC is willing to step in to seek compensation for investors under the provisions of sections 212 to 214 of the SFO
- June 2012 court granted orders sought by SFC under s213 ordering Hontex International Holdings Company Limited to repurchase shares from IPO shareholders and investors who purchased Hontex shares in secondary market following disclosure of false/misleading prospectus information in breach of section 298 SFO
- SFC has also commenced proceedings under s213 against Qunxing Paper Holdings Company Limited alleging that materially false or misleading information was included in Qunxing's IPO prospectus

Investor Protection Issues (Cont'd)

Hong Kong Position

- The Law Reform Commission's May 2012 Report on Class Actions recommended the incremental introduction of a class action regime, starting with consumer cases and to be extended to other areas in light of experience gained. It noted however that in the context of securities cases:
  - In cases of misappropriation or theft of clients' assets by officers of SFC licensed corporations, the compensation scheme in Part XII SFO is a more effective remedy than litigation for clients with losses < HK$150,000. Investors with larger claims rarely sue for damages because defendants are often in liquidation and investors tend to prove in the liquidation for any loss
  - In cases of mis-selling:
    - Plaintiffs may be able to bring a "representative action" under Order 15 rule 12(2) of the Rules of the High Court ("Order 15"). This allows proceedings to be brought on behalf of a number of persons with the "same interest" in proceedings. In Prudential Assurance Co Ltd v Newman Industries, Mr. Justice Vinelott changed the "same interest" test to the "common ingredient test" – requiring that there must be "some element common to the claims of all members of the class" making it easier to bring a representative action
    - SFC can seek financial settlement for investors (as in case of Lehman mini-bonds mis-selling), but has no power to order a licensed person to pay compensation
    - Investor protection provisions in ss 108, 281, 305 and 391 SFO may give rise to individual and related claims against a defendant which could be basis for representative proceedings under Order 15

Investor Protection Issues (Cont'd)

Hong Kong Position (Cont'd)

- SFC can seek restitutionary remedies for shareholders under s213(2)(b) SFO for contraventions of the SFO
- Reform Commission report concluded that while regulatory action can achieve redress or benefit for individuals, it is not a substitute for better individual access to the courts through class action
- Very few representative actions under Order 15 have been commenced – mainly due to uncertainty as to its application and outcome. Commission concluded that there's a need for a more certain regime for multi-party litigation

Class Action Regime a Red-herring?

- Seems that a US-style class action regime in HK would not assist minority shareholders in bringing derivative actions against WVR company controllers who breach fiduciary duties to the company as US class actions only available where shareholders have direct claims against the wrongdoers. Class actions do not assist where a shareholder brings a derivative action

The case for Contingency Fees

- Although not explored in the Concept Paper, the ability to pay legal fees on a contingency fee basis would make it easier for minority shareholders to bring a derivative action on a company's behalf
- The need to take sole responsibility for funding litigation is primary obstacle to minority shareholders bringing derivative actions
- The Law Reform Commission's July 2007 Report on Conditional Fees concluded that conditions at the time were not appropriate for the general introduction of contingency fees

- **Chapter 7 Concept Paper**

Question 1: Should the Exchange in no circumstances allow companies to use WVR structures?

Please give reasons for your views.

Please only answer the remaining questions if you believe there are circumstances in which companies should be allowed to use WVR structures.

The Consultation Questions (cont'd)

Question 2: Should the Exchange permit WVR structures:

a) for all companies, including existing listed companies

b) only for new applicants (see paragraphs 147 to 152)

c) only for:

  - companies from particular industries (e.g. information technology companies) (see paragraphs 155 to 162), please specify which industries and how we should define such companies; or
  - "innovative" companies (see paragraph 163 to 164), please specify how we should define such companies; or
  - companies with other specific pre-determined characteristics (for example size or history), please specify with reasons.

d) only in "exceptional circumstances" as permitted by current Listing Rule 8.11 (see paragraph 81) and, if so, please give examples.

Please give reasons for your views.

If you wish, you can choose more than one of the options (b), (c) and (d) above to indicate that you prefer a particular combination of options.

The Consultation Questions (cont'd)

Question 3: If a listed company has a dual-class share structure with unequal voting rights at general meetings, should the Exchange require any or all of the restrictions on such structures applied in the US (see the examples at paragraph 153), or others in addition or in substitution?

Please identify the restrictions and give reasons for your views.

Question 4: Should other WVR structures be permissible (see Chapter 5 for examples), and, if so, which ones and under what circumstances?

Please give reasons for your views. In particular, how would you answer Question 2 and Question 3 in relation to such structures?

Question 5: Do you believe changes to the corporate governance and regulatory framework in Hong Kong are necessary to allow companies to use WVR structures (see paragraphs 67 to 74 and Appendix V)? If so, please specify these changes with reasons.

The Consultation Questions (cont'd)

Question 6: Do you have any comments or suggestions regarding the additional matters discussed in paragraphs 33 to 47 of this paper:

a) using GEM, a separate board, or a professional board to list companies with WVR structures (see paragraphs 33 to 41); and

b) the prospect of overseas companies seeking to list for the first time on the Exchange with a WVR structure or seeking a further primary or secondary listing here (see paragraphs 44 to 47)?

Question 7: Do you have any other comments or suggestions regarding WVR structures?

Responding to the Concept Paper

Submit the Questionnaire which is available on the Exchange's website at http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2014082q.doc **on or before 30 November 2014** either:

a) By e-mail to response@hkex.com.hk. The subject line should be marked:
   "**Re: Concept Paper on Weighted Voting Rights".**

b) By mail or by hand to:
   Corporate Communications Department
   Hong Kong Exchanges and Clearing Limited
   12th Floor, One International Finance Centre
   1 Harbour View Street
   Central
   Hong Kong
   Re: Concept Paper on Weighted Voting Rights

c) By fax to: 2524 0149.

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- "**Boutique Firm of the Year**" was awarded to Charltons by Asian Legal Business for the years 2002, 2003, 2006, 2007, 2008, 2009, 2010, 2011, 2012, 2013, 2014 and 2015
- "**Hong Kong's Top Independent Law Firm**" was awarded to Charltons in the Euromoney Legal Media Group Asia Women in Business Law Awards 2012 and 2013
- "**Equity Market Deal of the Year**" was awarded to Charltons in 2011 by Asian Legal Business for advising on the AIA IPO

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