BLACKROCK

23 March 2018

Hong Kong Exchanges and Clearing Limited
12/F, One International Finance Centre
1 Harbour View Street
Central
Hong Kong

Submitted via email to: response@hkex.com.hk

RE: Consultation Paper on a Listing Regime for Companies from Emerging and Innovative Sectors

Dear Sirs and Madams,

BlackRock[1] is pleased to have the opportunity to respond to the "Consultation Paper on a Listing Regime for Companies from Emerging and Innovative Sectors" ("Consultation Paper")[2], issued by the Hong Kong Exchanges and Clearing Limited ("Exchange").

BlackRock supports a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets while preserving consumer choice and assessing benefits versus implementation costs.

We welcome the opportunity to comment on the issues raised by this Consultation Paper and will continue to contribute to the thinking of the Exchange on any issues that may assist in the final outcome.

Unless otherwise indicated, the terms used in this letter shall have the same meanings as in the Consultation Paper.

Executive summary

We agree both the Exchange and Hong Kong as an investment destination will benefit from a more diverse range of companies in the Hong Kong market as it creates greater opportunities for investors. The proposed changes to the Biotech chapter of the Listing Rules appear consistent with this goal in our view. Further enhancements can be made to the current proposal regarding the listing of pre-profit and pre-revenue Biotech companies by including a wider range of Competent Authorities and additional disclosure requirements.

BlackRock is an advocate of the principle of "One-Share One-Vote" (OSOV), and we generally remain opposed to allowing companies to issue shares with weighted voting rights (WVRs), as they expose shareholders which are not WVR beneficiaries to risks of expropriation and management entrenchment and as this mechanism could lead to weakened corporate governance and stewardship standards. As such, we believe the substantial waivers allowed to companies seeking a secondary listing in Hong Kong raise significant concerns with respect to the protection of public investors.

While we have reservations in departing from the OSOV principle, we do recognise the Exchange's efforts to provide safeguards to mitigate the risks associated with WVR structures. Should the Exchange proceed with the current proposal for issuers with WVR structures and for secondary listings by qualifying issuers, we recommend exercising the highest level of diligence

[1] BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.
[2] Kindly refer to this link for the Consultation Paper: https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/February-2018-Emerging-and-Innovative-Sectors/Consultation-Paper/cp201802.pdf

in executing the safeguards for the protection of all shareholders, and propose the following protective measures:

- Require the disclosure of voting results calculated on a OSOV basis as well as voting results calculated based on WVRs;
- Require fully independent Corporate Governance Committee and Nomination Committee that are proposed to be mandated for companies with WVRs;
- Require issuers seeking a secondary listing in Hong Kong to be subject to Chapter 14A of the Listing Rules with regards to connected party transactions;
- Apply the same rules currently imposed on Non-Grandfathered Greater China Issuers to Grandfathered Greater China Issuers and Non-Greater China Issuers as well; and
- Consider the amount of shares listed in Hong Kong relative to the total issued shares of a secondary listed company, alongside its total transaction volume, when determining whether such a company has migrated the “bulk of its trading” to Hong Kong.

Cognizant of the separate consultation that will be launched to explore the option of allowing corporate entities to benefit from WVRs, we would like to share our preliminary thoughts on this issue. Where WVR ownership are extended to corporates, we think the Exchange should implement a timed expiration, or sunset, mechanism, or stipulate a review of an issuer’s WVRs by all shareholders on a OSOV basis every few years. This offers investors an added layer of protection against the potential risk of misalignment between ownership and managerial control.

We welcome further discussion on any of the points that we have raised.

Yours faithfully,

Pru Bennett
APAC Head of Investment Stewardship

Winnie Pun
APAC Head of Public Policy

Comments on the Consultation Paper

We appreciate the Exchange's decision to open up more investment opportunities on Hong Kong's platform while endeavouring to mitigate the additional risks that market participants will have to face. We note that in an attempt to strike a balance between the need to be more flexible in order to accommodate companies from emerging and innovative sectors, and the need to protect shareholders, the Exchange has left a lot of matters to be decided at the discretion of the Listing Committee. It would be good practice for the Exchange to provide more details on all these matters that are subject to its discretion, instead of leaving too much room for deviation from original intentions.

I. Biotech Companies

In general, we welcome the proposed changes to the Listing Rules for early-stage companies which operate in the Biotech sector.

On the eligibility of Biotech Companies for listing

The Consultation Paper expands eligibility from pre-profit companies, as detailed in the New Board Concept Paper published in June 2017, to now also include pre-revenue companies. The uncertainties associated with pre-revenue companies are higher than those of pre-profit companies. We are therefore concerned that, by allowing pre-revenue companies to list in the new regime, further uncertainties may be introduced to the new board. To counter shareholders' concerns, the Exchange has proposed suitability tests and requirements for early stage companies currently failing the Financial Eligibility Tests, as detailed in paragraphs 72 to 83. These suitability tests and requirements appear well developed and effective in ensuring a reasonable level of control in allowing those early stage Biotech Companies to list.

Recommendation 1.1: Include the Pharmaceuticals and Medical Devices Agency (PMDA) as a Competent Authority

One suggestion we have is for the Exchange to include the Pharmaceuticals and Medical Devices Agency (PMDA) as one of the Competent Authorities for the new Biotech chapter in paragraph 76, in addition to the US Food and Drug Administration (FDA), the China Food and Drug Administration (CFDA) and the European Medicines Agency (EMA). The PMDA is a government organization in Japan in charge of reviewing pharmaceuticals and medical devices, monitoring post-marketing safety, and providing relief compensation for adverse drug reactions and infections[3]. It is a reputable authority within the healthcare investment community globally. We believe it should be included as a Competent Authority not only because of its reputation but also because of the solid track record of new drug development in Japan.

Recommendation 1.2: Additional disclosures requirements for Biotech Companies

Another suggestion we have is in relation to disclosure requirements. We agree with the eight enhanced disclosure requirements proposed in paragraph 83 and would like to see two more requirements in order to better protect shareholders:

i. The company's ties with the Research and Development (R&D) team

- Given the strategic importance of the R&D function, especially to an early-stage Biotech Company, the departure of key personnel or other significant changes to the team would pose a threat to the Company's ongoing business development, potentially ruining its future.

- Investors need to understand how a Biotech Company has 'locked in' its R&D personnel to assess the company's ability to sustain returns from its R&D function. It would, therefore, be useful if companies were required to provide information on how they ensure key personnel are engaged, such

[3] Please refer to the organization's website for more details: https://www.pmda.go.jp/english/

as labour contract tenure, and whether any non-compete clauses or incentive structures are in place.

ii. Planned production capacity and technology details (applicable to companies in the Biologics segment only)

- We are pleased that the Exchange has made the distinction between various segments within the Biotech sector, and has identified four sub-categories in paragraph 75. It is particularly important to distinguish between pharmaceutical small molecule drugs and biologics: small molecules are manufactured using machines, and thus easier to produce efficiently at scale once successfully developed; for biologics, production involves elements such as yeasts are difficult to scale up. As such, companies engaging in biologics should disclose their planned capacity and technology details.

On managing the risk of Biotech Companies becoming shell companies

In light of the concerns that Biotech Companies listed under the Biotech chapter may become shell companies, the Exchange proposes several measures to mitigate the related risks in the Consultation Paper. We affirm the necessity for these measures in helping to prevent such companies from becoming targets for attempts to circumvent listing requirements.

Recommendation 1.3: Apply suitability test to assets that listed biotech companies are considering to acquire

We would like to point out that there is a risk of Biotech Companies being used to acquire shell companies which fall under the Biotech category. Paragraph 88 has stated that companies listed under the Biotech chapter are not allowed to engage in transactions that would result in a fundamental change to their principal business. However, we see the potential for these companies to acquire companies that are Biotech in name or nature but have very poor asset quality and provide little visibility into their production pipelines. We suggest that the suitability test detailed in paragraph 74 apply to assets that listed biotech companies are considering to acquire post-IPO as well.

II. Issuers with WVR Structures

In the spirit of creating greater opportunities for investors, we agree both the Exchange and Hong Kong as an investment destination would benefit from a more diverse range of listed companies. BlackRock is an advocate of the "One-Share One-Vote" (OSOV) principle and remains generally opposed to allowing companies to issue shares with weighted voting rights (WVRs). WVR structures amplify the risk of controlling shareholders and the management extracting private benefits to the detriment of the long-term economic interests of the company and its shareholders. Further, in our experience, companies with WVRs have less incentive to engage with shareholders with inferior voting rights, thereby running the risk of weakened corporate governance and stewardship standards.

The current proposal requires all beneficiaries of a company's WVR structure to collectively own a minimum of 10% and a maximum of 50% equity interest. Assuming the voting ratio to be capped at 1:10, this translates to 53% voting rights for an equity interest at the minimum of 10%, and 91% voting rights for an equity interest at the maximum of 50%. Using the same assumptions, WVR equity interest at 10% can already override decisions requiring simple majority votes, and WVR equity interest at slightly above 23% can already achieve a supermajority of 75%. This significantly jeopardises the meaningfulness of engagement and voting of those which do not benefit from WVR, and weakens efforts to promote good governance practices by both companies and shareholders, which are crucial to long-term value creation.

We believe the current departure from OSOV is far from ideal. Nonetheless, we recognise the Exchange's efforts to provide safeguards to mitigate the risks associated with WVR structures,

for example:

- The provision for the WVRs held by beneficiaries who are natural persons to fall away over time as the beneficial owner ceases to be a director, no longer meets the requirements of a director, dies or becomes incapacitated, and for the WVRs to lapse if a WVR beneficiary transfers his/her beneficial interest or economic interest in those shares;
- The requirement to vote on a OSOV basis to approve significant changes to the constitution, variation of rights attached to any class of shares, the appointment or removal of an independent non-executive director, the appointment or removal of auditors, or the voluntary winding-up of the issuer;
- The requirement for new IPO applicants with WVR structures to be subject to the Listing Rules, particularly Chapter 14A which requires significant connected transactions to be approved by independent shareholders; and
- The requirement for new IPO applicants with WVR structures to establish a Corporate Governance Committee and a Nomination Committee, each to comprise a majority of INEDs and be chaired by an INED.

Should the Exchange proceed with allowing the listing of companies with WVRs, we urge for the highest level of diligence in executing the safeguards for the protection of all shareholders. To achieve this, we would also like to propose the following recommendations.

Recommendation 2.1: Better disclosure of vote outcomes

- In cases where resolutions are not voted on a OSOV basis, we would like the Exchange to require such companies to disclose both the voting result calculated by taking into consideration WVRs, as well as the voting result calculated on a OSOV basis. This serves to openly reflect the opinions of non-WVR shareholders. We think this is particularly important where the views of WVR beneficiaries and non-WVR shareholders diverge.

Recommendation 2.2: Lower holding requirement to call a shareholder meeting

- As provided in paragraph 24 under Chapter 8A, the minimum stake required for non-WVR shareholders to convene an extraordinary general meeting is set at 10% of the voting rights on a OSOV basis. We think 10% is too high, considering that many other jurisdictions have a much lower threshold. For example, both the UK and Australia require a minimum of only 5% of voting rights in order for a shareholder or a group of shareholders to call a general meeting. In order to counter the dominance by WVR beneficiaries, we suggest the minimum in the new regime be set at 5% instead of 10%.

Recommendation 2.3: Requirement for transactions resulting in material change of business to be voted by all shareholders on a OSOV basis

- In the same way that Biotech Companies in the new regime are restricted from effecting any transactions that will result in a fundamental change to its principal business (paragraph 88), the Exchange should prevent companies with WVR structures from materially changing their principal business without the approval from the majority of its shareholders. In addition to the five items listed in paragraphs 28 and 128, we propose for the Exchange to include “transactions that would result in a fundamental change to the issuers’ principal business or cause the issuer to become cash shell” as a key matter that needs to be voted by all shareholders on a OSOV basis.

Recommendation 2.4: Fully independent Corporate Governance Committee and Nominating Committee

- The potential risks associated with the misalignment of ownership and control are heightened as WVR beneficiaries have a level of voting control that is disproportionately higher than their equity interests. We believe it is essential for the

Corporate Governance Committee and Nomination Committee for companies with WVR structures to be fully independent. Further, we would like to see the appointment of a lead independent director who can provide a dedicated point of contact for non-WVR shareholders.

Recommendation 2.5: Stronger rules relating to corporate holders of WVRs

- While the mechanism whereby WVRs will naturally fall away or lapse for individual beneficiaries appears well developed, there is currently no mechanism for corporate WVR owners. Aware that this is a separate issue subject to further public consultation, we would like to share our preliminary thoughts – we think the Exchange should impose additional restrictions on WVR beneficiaries which are corporate entities. If the Exchange is to proceed with allowing corporates to be WVR beneficiaries, it should be necessary to adopt a timed sunset mechanism, or to stipulate a regular review of WVR beneficiary status. We suggest the regular review be structured such that all shareholders can vote on a OSOV basis every few years to determine whether the corporate shall continue to enjoy its WVR beneficiary status.

III. Secondary Listings of Qualifying Issuers

The New Board Concept Paper released in June 2017 proposed full exemption to certain issuers from having to abide by Hong Kong's Listing Rules. This was cause for major concern as the exemption would expose investors in Hong Kong to companies that have corporate governance standards significantly lower than those currently required in Hong Kong. The current proposal offers some level of comfort as it requires Non-Greater China Issuers or Grandfathered Greater China Issuers seeking a secondary listing in Hong Kong to meet the Key Shareholder Protection Standards set out in Section 1 of the 2013 JPS.

However, we question the rationale for differentiating between Grandfathered Greater China Issuers and Non-Grandfathered Greater China Issuers. The date of the New Board Concept Paper Conclusion, i.e. 15 December 2017, seems an arbitrary date that has no relevance to the logic of determining whether a company should be granted the concessions that Non-Greater China Issuers and Grandfathered Greater China Issuers would enjoy. The Exchange should consider to apply the same rules across all three categories of issuers instead, and refrain from granting any concessions to a particular group of issuers.

Recommendation 3.1: Apply Chapter 14A of Listing Rules to secondary listings

We believe the Exchange also needs to address the risks associated with connected party transactions of these secondary listed issuers. The Consultation Paper proposes in paragraph 189 that "Non-Greater China Issuers and Grandfathered Greater China Issuers will be eligible to secondary list with their existing WVR structures and will not have to comply with the proposed ongoing WVR safeguards except for those that are disclosure requirements". In such an arrangement, not only will these companies be exempt from restrictions on increasing the number or proportion of WVR shares after listing and from requirements to vote for certain resolutions on a OSOV basis, but they will also not be subject to rules requiring affiliated parties to abstain from voting with regards to connected party transactions.

This problem is not dealt with in primary exchanges, such as the US, as often as it is in Hong Kong, where controlled companies are more prevalent. However, this can be a concern in the new regime as we expect many companies seeking a secondary listing in Hong Kong to be controlled companies that may take advantage of the lax constraints on connected party transactions. As such, we suggest for the Exchange to apply its requirement for affiliated parties to abstain from voting on connected party transactions to secondary listed companies. In other words, we believe these companies should be subject to Chapter 14A of the Listing Rules.

Investors of secondary listings remain vulnerable

Furthermore, we are concerned that investors of secondary listings remain in a very vulnerable position in the proposed structure. They continue to lack the access to class actions should the non-WVR shareholders be treated unfairly resulting in negative impact on shareholder value. Investors in the primary market of the US can bring class action lawsuits on a contingent fee basis if they are treated unfairly, however, based on our understanding, investors in the secondary market of Hong Kong can neither initiate a class action nor participate in class action lawsuits initiated by investors in the US. In fact, even if these companies become primary listed in Hong Kong upon "migration of the bulk of trading", investors in Hong Kong are precluded from partaking in class action when faced with deficient corporate governance practices. As much as it is an onerous process for companies to change their charters to a secondary listing in Hong Kong, the process for an individual investor to pursue a class action lawsuit is arguably even more arduous and expensive. Waivers allowed for these secondary listings will therefore open up a plethora of potential risks for investors in Hong Kong.

On the migration of the bulk of trading

BlackRock is supportive of the principle behind the proposed provision whereby, should the bulk of trading migrate to Hong Kong on a permanent basis, waivers to most of the requirements of the Listing Rules expire.

Recommendation 3.2: Adopt additional metric for considering a company to have migrated its bulk of trading to Hong Kong

Per Note 1 to Rule 19C.13, the current proposal considers a company to have migrated the bulk of its trading to Hong Kong "if 55% or more of the total trading volume of those shares over the issuer's most recent fiscal year takes place on the Exchange's markets". In our opinion, the amount of shares listed in Hong Kong relative to a secondary listed company's total issued shares the would also be a useful metric that should be considered. We suggest the Exchange makes the relevant amendments such that ***either*** of the below would trigger an upgrade of a secondary listed company to become a primary listing in Hong Kong:

i. if 55% or more of the total trading volume of those shares over the issuer's most recent fiscal year takes place on the Exchange's markets; ***or***

ii. if the issuers' shares listed in Hong Kong represents 55% or more of its total issued capital, on average over the issuer's most recent fiscal year calculated on a daily basis.

Conclusion

We appreciate the opportunity to address and comment on the issues raised by the Consultation Paper and will continue to work with the Exchange on any specific issues which may assist in the discussion of the proposed listing regime for companies from emerging and innovative sectors.