

Hong Kong Exchanges and Clearing Limited
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By email: response@hkex.com.hk

8 April 2020

RE. Corporate Weighted Voting Rights Consultation Paper

Dear HKEX Consultation Representative,

We welcome the opportunity to provide our comments on this consultation.

EOS at Federated Hermes is a leading stewardship provider advising on £662 billion assets (as of 31 December 2019) on behalf of global international institutional investors. Our goals are to help people retire and invest better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world. EOS at Federated Hermes provides stewardship services on behalf of asset owners and asset managers.

We do not support any expansion of the existing Weighted Voting Rights (WVR) regime to enable corporate entities to benefit from WVR. We strongly believe that the principle of one-share one-vote is a prerequisite for effective stewardship. All shareholders should be given equal rights, which should be aligned with their economic interests and investment risks. As such, we advocate a one-share one-vote listing structure instead of the WVR framework. In circumstances where the introduction of corporate WVR (CWVR) is inevitable, please refer to section 6 for a summary of our position and recommendations. To facilitate effective stewardship activities, we encourage the Exchange to collaborate with the Hong Kong Securities Futures Commission (HKSF) to revise the Principles of Responsible Ownership, the stewardship code in Hong Kong.

We question whether it is appropriate to introduce CWVR. Investors globally have increasingly voiced concerns about the entrenchment of risks and the lack of accountability under the individual WVR structure.¹ The most recent high-profile case relates to the fall of WeWork, where the dual-class share structure gave the founder up to 20 times the voting power of other shareholders. Following public investors' questioning of the company's poor corporate governance and unproven business model, it withdrew its IPO application. The company's valuation dropped from US\$47bn in January 2019 to below US\$5bn in November 2019. Following the WeWork debacle, SoftBank Group, whose Vision Fund owns many "innovative" companies with dual-class share structures including WeWork, Alibaba and Uber, announced enhanced corporate governance requirements for potential investments in

¹ <https://www.ft.com/content/bc220535-5055-47ce-811d-fc4a56d32937>

February 2020.² The requirements cover a wide range of corporate governance aspects, such as the composition of the board of directors, founder and management rights, shareholders rights, and mitigation of potential conflicts of interest.

1. Financial reporting and related party transactions

We caution against other alleged benefits of the proposed CWVR structure. It is argued that under the proposed structure, corporate beneficiaries can consolidate the issuer's top line financials, which is beneficial for market valuation. In reality, companies do not necessarily disclose a detailed top-line breakdown by key verticals or business segments. Persistently high revenue growth rates in some but not all businesses and the opaqueness in financial reporting may distort a company's valuation. Furthermore, it can attract investigation from global regulators into companies' accounting practices and treatment of related party transactions.³

On a positive note, some companies are making initial steps to address investors' requests for transparency in financial reporting. For example, Alphabet improved revenue disclosure in its FY19 report: providing revenue breakdown by certain business segments⁴. Therefore, we urge the Exchange to ensure that corporate beneficiaries provide a detailed financial disclosure by business segments, should they be allowed to enjoy the alleged benefit from the CWVR structure.

We are concerned about the lack of discussion on monitoring related party transactions in the consultation paper, which can be a key risk of the proposed CWVR structure. In August 2018, we fully supported the Exchange's proposed rule amendments to securities transactions and related party transactions in our response to the Exchange's consultation paper on backdoor listing, continuing listing criteria and other rule amendments.⁵ The proposed rule amendments are in line with the expectations of global organisations, such as International Corporate Governance Network (ICGN).⁶ In addition, we advocate further disclosure by companies on how transactions are monitored over the approval period, the response to any breaches of the conditions set and the process of reporting, should any irregularities be discovered. Best international practice involves establishing a related party transaction committee at board level. Should the Exchange decide to put in place a CWVR regime, we expect an independent related party transaction committee to oversee and monitor the transactions. This committee should also be responsible for answering questions and queries from minority shareholders. We also recommend that there should be a direct line of communication between the committee and shareholders and their representatives as part of their stewardship activities.

² https://group.softbank/en/corp/news/press/sb/2020/20200212_02/

³ <https://www.thestreet.com/investing/stocks/alibaba-still-cooperating-with-sec-probe-as-it-forecasts-45-to-49-sales-growth-14277425>

⁴ https://abc.xyz/investor/static/pdf/2019Q4_alphabet_earnings_release.pdf?cache=79552b8

⁵ <https://www.hermes-investment.com/wp-content/uploads/2018/10/hkex-consultation-paper-response-29-august-2018-final-signed.pdf>

⁶ <https://www.icgn.org/related-party-transactions-how-ensure-adequate-protection-minority-shareholder-rights>

2. Additional safeguards to uphold shareholder rights

Companies listed on Qualifying Exchanges do not necessarily uphold strong corporate governance standards. On some major exchanges in the US, controlled companies, where the parent company has at least 50% of the voting power, can apply for exemptions from certain corporate governance requirements. Exemptions include majority independence of the overall board, and 100% independence for the nomination and corporate governance committees. Some Chinese companies that are listed on the New York Stock Exchange or NASDAQ and incorporated in the Cayman Islands are exempted from convening an annual shareholder meeting. As a result, some companies have never convened or have stopped convening their annual general meeting. If there is a lack of shareholder engagement culture among corporate beneficiaries, investors lose the only official opportunity to voice their concerns about a company's performance issues directly with the board of directors.

We thereby urge the Exchange to enforce additional safeguards to uphold shareholder rights, with no exemptions allowed. Firstly, the nomination and corporate governance committee of any CWVR issuer should only consist of independent directors. Secondly, issuers should convene an annual general meeting. Thirdly, board directors must uphold their fiduciary duty to actively engage with shareholders through different channels.

3. Ring-fencing

In general, we welcome the HK\$200bn market capitalisation threshold, with no exception allowed, as an attempt to avoid a proliferation of WVR structures. However, the share price and thus market capitalisation of "innovative" companies generally shows an upward trend in the medium to long term. We therefore think it is necessary to regularly review whether the HK\$20bn market capitalisation threshold remains fit for purpose. We suggest a review every three years.

4. Sunset clauses

If a CWVR regime were to be introduced, the Exchange should mandate that a sunset clause of no more than seven years should be in place. Critically, there should be no potential for the sunset clause to be extended beyond this initial seven-year period through shareholder approval. This requirement is in-line with the timelines that the Council of Institutional Investors (CII) has called each of NASDAQ and the New York Stock Exchange to adopt.⁷ Some companies in the US have successfully used time-based sunset clauses in recent years: Groupon (converted to a single share class after five years), Texas Roadhouse (converted after five years) and MaxLinear (converted after seven years).⁸ Without an effective time-bound sunset clause, a CWVR regime would raise significant questions for corporate governance and shareholder rights.

⁷ https://www.cii.org/dualclass_stock

⁸ <https://www.cii.org/lyftdualclassipo>

There are cases where sunset clauses have been overridden. FEMSA, the Mexican company with a WVR structure, introduced a time-bound sunset clause, which should have lapsed in May 2008. In April 2008, it proposed a resolution to remove the time-bound sunset clause. In return, it offered a high dividend to shareholders at the meeting. Minority shareholders chose dividend pay-out over the safeguarding of shareholder rights. As a result, the resolution was passed, and the WVR structure remains indefinitely.⁹ This case, which led to the entrenchment of a system that concentrates decision-making power whilst maintaining financial flexibility, highlights the limitations of sunset clauses to protect shareholder rights.

Furthermore, we believe that shareholders should have the right to decide whether the CWVR structure is fit for purpose. Therefore, instead of companies seeking shareholder approval for a potential extension of the CWVR structure, we advocate an annual review of the CWVR structure at the annual general meeting under a one share one vote system. Shareholders should be empowered to vote whether companies can continue to operate with the CWVR structure.

5. Hong Kong Stewardship Code – Principles of Responsible Ownership

We feel strongly that revising and strengthening the Principles of Responsible Ownership is vital to promoting active ownership and stewardship, and to mitigate some of the governance risks of the CWVR regime. As evident from other markets¹⁰, an effective stewardship code gives investors the opportunity and obligation to focus on long-term value drivers for companies. Engagement between board directors and investors on material issues is ultimately in the best interests of underlying beneficiaries. Engagement is a two-way, dynamic process that requires the commitment from investors and companies. Hong Kong benefits from a Corporate Governance Code and Stewardship or Responsible Ownership Code together that guide the expectations of ongoing and constructive engagement vital to a healthy investment ecosystem.

Accordingly, the revised Hong Kong Stewardship Code should highlight the importance of stewardship activities that address environmental, social and governance (ESG) issues. This focus would be well-aligned with the Exchange's commitment to the Sustainable Stock Exchange Initiative¹¹ and the recent introduction of ESG disclosure requirements for listed companies. As the best practices of stewardship continue to evolve, we suggest that the code reflects the need for investors to continuously develop their skills and expertise in line with evolving requirements. The stewardship code should cover a range of asset classes, rather than just equity.

In our view, the revised Principles of Responsible Ownership should emphasise stewardship outcomes, as well as policies and processes. This emphasis should translate into reporting requirements, so that investors can be held accountable for their stewardship activities. Investors should report transparently and regularly on the outcomes of a range of stewardship activities and their rationale

⁹ Refer to FEMSA 20-F filed on 30 June 2008 (p.18): <https://femsa.gcs-web.com/node/10651/html>

¹⁰ https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf

¹¹ <https://sseinitiative.org/stock-exchange/hkex/>

for voting decisions. We have stated our expectations in consultation responses on the Japanese Stewardship Code¹² and the Taiwan Stewardship Code¹³ respectively.

6. Summary of position

In summary, we do not support an introduction of CWVR regime for any company. Should the Exchange decide to proceed with the proposed regime, we urge the Exchange to ensure the effective implementation of all safeguards, which include the following:

- A corporate WVR beneficiary should own at least a 30% economic interest on an ongoing basis;
- The Exchange should review the HK\$200 billion market capitalisation threshold every three years;
- A sunset clause of no more than seven years should be in place, with no extension allowed under any circumstances, which is also applicable for individual WVR;
- There should be an annual review of whether CWVR or individual WVR are fit for purpose by shareholders at the annual general meeting;
- The Exchange should ensure that corporate beneficiaries provide detailed financial breakdowns by business segments or key verticals;
- An independent related party transaction committee should be established on the board to monitor and oversee related party transactions. Metrics should be established to reflect the key activities and outcomes of the work of this committee with disclosure in the annual report;
- The nomination and corporate governance committee of any CWVR issuer should consist of independent directors only;
- A CWVR issuer should convene an annual general meeting; and
- Board directors should be able to demonstrate to all shareholders how they uphold their fiduciary duty to actively engage with shareholders through different channels under the CWVR structure.

We are grateful for the opportunity to provide our views on these important corporate governance subjects. Please do not hesitate to contact us if you have any questions.

Yours faithfully,

Janet Wong and Sonya Likhtman
Engagement
EOS at Federated Hermes

¹² <https://www.hermes-investment.com/ukw/wp-content/uploads/2020/01/response-to-proposed-revision-to-japan%E2%80%99s-stewardship-code-jan-2020.pdf>

¹³ <https://www.hermes-investment.com/ukw/wp-content/uploads/2020/03/taiwan-stewardship-principles-2020-consultation-30-march-2020.pdf>