

29 August 2018

Hong Kong Exchanges and Clearing Limited
10th Floor, One International Finance Centre
1 Harbour View Street, Central
Hong Kong

By email: response@hkex.com.hk

Dear HKEX Consultation Representative

Consultation paper on backdoor listing, continuing listing criteria and other rule amendments

Hermes EOS welcomes the opportunity to provide our comments on this consultation on backdoor listing, continuing listing criteria and other rule amendments.

Hermes Investment Management (Hermes) is an asset manager with a difference. With \$47.2¹ billion in assets under management, we focus on holistic returns – outcomes for our clients that go far beyond the financial and consider the impact our decisions have on society, the environment and the wider world. Its stewardship team, Hermes EOS, is one of the world's leading engagement resources, advising on \$463.7² billion, on behalf of over 40 institutional investors. The views expressed in this communication are those of Hermes EOS and do not necessarily represent the views of all clients. Our response to this consultation is explicitly supported by PNO Media (the Netherlands), VicSuper (Australia), Calvert Research & Management (US), BBC Pension Fund (UK) and Coal Pension Trustee Services (UK).

We strongly support your goal to curb speculative activities in the market and increase transparency, by regulating backdoor listing, tightening continuing listing criteria and requiring further disclosure related to connected transactions. We therefore support all proposed rule amendments set out in the consultation paper covering questions 1 to 20.

^{1,2} As at 31 March 2018

We support the proposed rule amendments relating to backdoor listing, including codifying the principle based test in the RTO Rules and extending the criterion to include any change in control or de facto control of the issuer, clarifying the “series of arrangements” criterion. We support modifying the bright line tests, codifying the “extreme VSA” requirements and imposing additional requirements to transactions classified as RTOs and extreme transactions. We believe that the proposed rule amendments enhance information disclosure to investors and ensure the quality of the issuers.

We also support the proposed rule amendments to continuing listing criteria to ensure the sufficiency of the issuer’s operations and assets. We welcome a 12-month transitional period for issuers to comply with the proposed rule amendments.

In addition, we support the proposed rule amendments to securities transactions and related party transactions to enhance information disclosure to shareholders, covering the outcome of financial performance guarantees; the identity of the parties and their ultimate beneficial owners, and their respective principal business activities; and the appropriateness or alternative size test for calculating percentage ratios of a notable or connected transaction. Furthermore, 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. For example, in the US, the Securities and Exchange Commission requires companies to disclose policies and procedures for approving related party transactions. We would welcome future enhancement to appropriate rules and regulations reflecting these requirements. For further information, please refer to our corporate governance principles for mainland China and Hong Kong, updated in December 2017, in which we refer to the importance of governance with regard to related party transactions, to ensure fair treatment of all shareholders, including minority shareholders. We review and update these principles on an annual basis.

In addition to the proposed rule amendments outlined in the consultation paper, we believe that there should be more reflection on related key issues – for instance, whether the ‘comply or explain’ approach for the implementation of the Corporate Governance Code is fit for purpose. While we commend the intention to allow companies to develop their best possible corporate governance mechanisms, we encourage companies to comply with the spirit of the rules and regulations.

In recent years, the trend has been to consider other alternatives to the ‘comply or explain’ approach to increase the accountability and transparency of listed companies, such as ‘comply and explain’. For example, in South Africa, the King IV Report on Corporate Governance emphasises ‘apply and explain’ with the focus on transparency, which came into effect in April 2017. Malaysia’s Securities Commission launched a new corporate governance code also in April 2017, featuring the ‘comprehend, apply and report’ (CARE) approach, which requires listed companies to develop policies and action plans if they are unable to meet corporate governance standards. We appreciate that the Hong Kong Stock Exchange will be aware of such developments and that it has led initiatives to improve corporate governance. We encourage further study of the alternatives in this respect.

Another point worth noting is that Growth Enterprise Market (GEM) fluctuations in the past years have not only been related to shell activities, but also other issues such as cross-

shareholdings. For instance, in May 2017, the publication of a report³ detailing the overlapping ownership of 50 GEM-listed companies, by an activist investor, triggered market fluctuation and prompted serious questions about corporate governance standards and practices locally. As a result, the stock prices of several companies in this network dropped significantly. In December 2017, a number of executive directors of the companies were arrested.⁴

We consider cross-shareholdings a practice that goes against market principles of fairness as companies are expected to do business with those they have shareholding relationships with, instead of those that best meet requirements. We recommend full disclosure of cross-shareholdings between companies, and an unwinding of any cross-shareholding which introduce conflicts of interest. Further information is available in the article *Untangling tight knots – Tackling Japan’s corporate governance dilemma* in our Q3 2017 public engagement report.⁵ In June 2018, the Tokyo Stock Exchange revised its corporate governance code, which urges companies to disclose their cross-shareholding policy and plans for reducing such arrangements with banks and business partners. We would endorse a similar revision in Hong Kong.

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

Yours faithfully

Two handwritten signatures in black ink. The first signature on the left is more compact and stylized, while the second signature on the right is more elongated and fluid.

Janet Wong and Emma Berntman
Hermes EOS

³ <https://www.bloomberg.com/news/articles/2017-10-13/-enigma-network-crash-spurs-hong-kong-s-largest-financial-raid>

⁴ <https://www.bloomberg.com/news/articles/2017-12-08/hong-kong-enigma-network-in-crosshairs-as-executives-arrested>

⁵ <https://www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2018/02/public-engagement-report-q3-2017.pdf>