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By Email: [response@hkex.com.hk](mailto:response@hkex.com.hk)

23 March 2018

Dear HKEX Consultation Representative,

### **Re: Emerging and Innovative Companies**

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

Hermes Investment Management (Hermes) is an asset manager with a difference. With \$46 billion<sup>1</sup> 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. Hermes' stewardship team, Hermes EOS, is one of the world's leading engagement resources, advising on \$454 billion<sup>2</sup> on behalf of over 40<sup>3</sup> international institutional investors. The views expressed in this communication are those of Hermes EOS and do not necessarily represent the views of all clients.

We are disappointed with your decision to introduce the weighted voting right (WVR) shareholding structures. In our previous responses to the HKEX, which include the [Concept Paper on WVR](#) (November 2014) and the [New Board Consultation](#) (August 2017), we have stated the reasons for supporting the one-share one-vote shareholding structure. Multiple class share structures often disenfranchise minority shareholders, increasing the power of incumbent shareholders for a disproportionate financial stake. Our view is backed by academic research<sup>4</sup>. For example, Bebchuk and Kastiel (2017) noted that the costs of WVR structures tend to rise as time passes from initial public offering (IPO), and that WVR beneficiaries have perverse incentives to retain WVR structures even if they become inefficient over time. Cremers, Lauterbach and Pajuste

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<sup>1, 2</sup> As at 31 December 2017

<sup>3</sup> Our response to this consultation is explicitly supported by MP Pension, Pensioenfonds PNO Media and VisSuper Pty Ltd.

<sup>4</sup> Bebchuk and Kastiel (2017) The Untenable Case for Perpetual Dual-Class Stock Virginia Law Review 103: 585-631. Cremers, Lauterbach and Pajuste (2017) The Life-Cycle of Dual Class Firms European Corporate Governance Institute (ECGI) Finance Working Paper No.550/2018. Source: SSRN (<https://www.ssrn.com/en/>)

(2017) found that valuation premium of having legendary founders and cornerstone investors dissipates over time and turns into discount about six years after IPO in the US.

Supporters of WVR may argue that this is why sunset clauses are in place. However, we consider the conditions under which WVR beneficiaries will lose their rights, as proposed in this consultation, to be too simplistic and generic – including (a) death, (b) ceases to be a director, (c) is deemed by the Exchange to be incapacitated, or (d) is deemed by the Exchange to no longer meet the requirements of a director. The transition from being a value adding director to being incapacitated is a huge grey area. By the time the non-performing WVR beneficiary comes off the board of directors or loses the voting privilege, minority shareholder interests are most likely to have already been harmed.

In our article '*Regulators and listing rules – Why the principle of one-share one-vote remains crucial*' in the fourth quarter of 2017 public engagement report, we further considered regulatory inconsistency that could be triggered by the introduction of WVR. The rationale behind stewardship codes and guidelines that have emerged globally, including in Hong Kong the Principles of Responsible Ownership, suggests that appropriate shareholder rights and accountability mechanisms should be a key concern for regulators and governments. The dilution of such rights and mechanisms through the proliferation of listed companies that have share classes with differential voting rights at a time when investors are encouraged to become more active owners amounts to regulatory inconsistency. Based on our established global experience in stewardship, we have drawn references from Singapore to London and Brazil, commending on positive actions by companies that are converting non-voting shares to voting shares to improve corporate governance.

From page 4, there are detailed comments responding to each section set out in the consultation. In particular, we would like to highlight the following recommendations:

- Issuers with WVR structures to be required to establish a nomination committee comprised of a majority of independent non-executive directors (INEDs) and chaired by an INED.
- Introduce an annual advisory vote by shareholders under the one share one vote system to advise on whether the weighted voting share structure should continue.
- More guidance on timely disclosure on material developments and activities for emerging and innovative companies, including biotech companies beyond disclosure in semi-annual and annual reports.
- Introduce a mechanism to ensure that WVR structure is time bound with a comprehensive set of sunset clauses and safeguards. We consider the current sunset clauses as set out in the consultation paper to be too generic – the clauses are subject to arbitrary interpretation that may harm minority shareholders' interests.
- Lower the minimum stake requirement for non-WVR shareholders to call for a general meeting and to add shareholder resolutions. The proposed amendments in Chapter 8A.24 allow companies with WVR structures to set the minimum threshold at 10%, which we deem too high.
- WVRs seeking a secondary listing in Hong Kong should be subject to the requirement of establishing a corporate governance committee comprised of a majority of INEDs and chaired by an INED. They should also be required to appoint a third-party compliance adviser and to report on the key compliance matters discussed in the annual report.

- A comprehensive corporate governance committee progress report should contain the details of corporate governance issues identified, the actions taken by the committee members, the outcomes of their actions and the progress made during the reporting period. Key compliance matters as advised by the third-party compliance adviser should be disclosed in the corporate governance section of the annual report.

In addition to the above comments, we support the recommendations of the Council of Institutional Investors (CII) to introduce more objective rules for WVR companies, such as votes on key matters, including related party transactions involving entities associated with the WVR holders, to be made on a one-share one-vote basis. CII is a nonpartisan, non-profit association of U.S.-based retirement funds, foundations, endowments and global asset managers with combined assets under management exceeding \$3.5 trillion, in which we are a member.

To conclude, while trading shares is the main function of exchanges, the owners of a high proportion of the shares are interested less in trading shares but in being long-term owners of the companies in which they are invested. As significant stakeholders, as recognised by the stewardship codes developing around the world, our interests are not being served as well if the exchanges focus mainly on creating structures that disproportionately benefit the traders in shares and the founders of companies. We ask that the exchanges to respect the wishes of the long term owners of the shares whose interests are more in line with long-term economic growth and prosperity of Hong Kong.

Please do not hesitate to contact us if you have any questions. Thank you.

Yours sincerely,



Christine Chow, PhD  
Director  
Hermes EOS

## **1 Biotech companies**

We commend the Suitability to List criteria for biotech companies and the Restrictions on Cornerstones, detailed in Chapter 2. In particular, we find that the specific details in the Contents of Listing Documents for Biotech Companies section, Section 18A.04, appropriately reflect the concerns of investors. However, we recommend more guidance to be provided in ongoing disclosure, including more specific recommendations on timely disclosure beyond semi-annual and annual reports, as specified in Section 18A.07.

## **2 Issuers with WVR structures**

We are disappointed with your decision to introduce WVR shareholding structures. We are aware that this decision is primarily driven by competitive pressures among global stock exchanges to attract innovative high-growth companies to list, with an important objective of improving revenue for listed stock exchanges, such as the Hong Kong Stock Exchange (HKEX). We are concerned that minority shareholder protection is compromised under the deviation from the one-share one-vote standard. Multiple class share structures often disenfranchise minority shareholders, increasing the power of incumbent shareholders for a disproportionate financial stake. We recommend that issuers with WVR structure should be required to establish a nomination committee comprised of a majority of INEDs and chaired by an INED.

For innovative high growth companies, we acknowledge that founders and cornerstone investors may have a crucial role to play in a company's strategic direction and growth. However, we challenge whether awarding superior voting rights to the group referred to as the 'WVR beneficiaries' provides the right form of incentives. We are concerned that the sunset clauses proposed in this consultation are necessary but insufficient safeguards to ensure our expected level of minority shareholders protection.

We strongly believe that WVRs provide a form of privileges rather than rights. Such privileges should not be given in a one-off decision at the time of listing. In other words, the rights are not for the beneficiaries to lose, but for them to gain, on a regular basis, if a WVR structure is to be put in place.

We recommend that WVR structure should be subject to an annual shareholder advisory vote under the one-share one-vote system, similar to an advisory vote on executive remuneration, widely known as the 'say on pay' vote globally.

The rationale is derived from first principles based on the argument for WVRs, which is to allow persons who have been crucial to the high growth of the company to implement their long-term vision and strategic plan. Good governance should require key performance indicators to be met under regular assessment of the implementation of this plan. Also, for innovative companies, much of the firm valuation is vested with the founders and potentially actively involved cornerstone investors. For the long-term sustainability of the company, this value should over time be institutionalised as firm value embedded in the products, processes, structure and culture of the company. Creating a superior voting right class would only delay the process of value transformation from individuals to the company. An annual shareholder advisory vote with the participation of institutional shareholders will provide strong support of the continuation of any WVR structure.

### **2.1 Sunset clauses**

In Section 107 of the consultation, the HKEX acknowledged that the one-share one-vote principle continues to be the optimum method of empowering shareholders and aligning their interests in a company. We highly recommend a proper mechanism to be put in place to ensure that a WVR structure is time bound with a comprehensive set of sunset clauses and safeguards. We recommend the sunset clauses as set out in the consultation paper in Section 118, 119, 153 and 154 to be further refined to provide a more structured and transparent approach that sets out the conditions where sunset provisions will kick in.

One example is in relation to section 118 and 154 of the consultation which outline the conditions under which WVR beneficiaries will lose their rights – ‘Beneficiaries of WVR will be restricted to those individuals who are directors of the issuer at listing and remain directors afterwards. The WVRs attached to a beneficiary’s shares will lapse permanently if a WVR beneficiary: (a) dies; (b) ceases to be a director; (c) is deemed by the Exchange to be incapacitated; or (d) is deemed by the Exchange to no longer meet the requirements of a director set out in the Rules’. The transition from being a value adding director to being incapacitated is a huge grey area. More specific conditions should be set to assess suitability. Also, if a WVR beneficiary is not performing, according to section 128 of the consultation, the election of the WVR beneficiary is not subject to the one-share one-vote system. This suggests that minority shareholders would not be able to vote against or remove the WVR beneficiary even if the WVR beneficiary is deemed not to be acting in the best interests of all shareholders.

## **2.2 Corporate WVR beneficiaries**

We strongly recommend against corporates to become eligible as WVR beneficiaries. Allowing individuals to become WVR beneficiaries is already a significant deviation from one share one vote. Allowing corporates to become beneficiaries defeats the fundamental argument of granting visionary leaders the necessary voting privileges to implement their long-term vision and strategic plan. This proposal paves the way for permanent holding of WVR. It is confirming our opinion that this is a race to the bottom in corporate governance standards among listed exchanges that prioritise revenue generation over minority shareholder protection.

## **2.3 Safeguards**

On proposed safeguards, we recommend more specific guidance on how INEDs can ensure effective and ongoing communication between the issuer and its shareholders, particularly with regard to requirements related to the issuer’s shareholder communication policy which will be mandatory for issuers with a WVR structure. At present, Section E of the corporate governance code states that the board should be responsible for maintaining an ongoing dialogue with shareholders. Section A2.4 of the corporate governance code requires that the chair should ensure that appropriate steps are taken to provide effective communication with shareholders and that their views are communicated to the board as a whole. However, in practice, most Hong Kong issuers do not provide appropriate access to board members for the purpose of stewardship and shareholder engagement. We expect HKEX to introduce mechanisms that ensure governance in practice rather than in name. We expect improvements in shareholder communications of issuers under a WVR structure and also for all issuers.

## **3 Secondary listings of qualifying issuers**

Section 189 proposed that non-greater China issuers and grandfathered greater China issuers be eligible to secondary listing with their existing WVR structures, not having

to comply with the proposed ongoing WVR safeguards except for those that are disclosure requirements.

We believe issuers with WVRs seeking a secondary listing should also be subject to the requirement of establishing a corporate governance committee comprised of a majority of INEDs and chaired by an INED. They should also be required to appoint a third-party compliance adviser and to report on the key compliance matters discussed in the annual report.

We recommend the HKEX to further consider conditions of providing waivers for secondary listings. We believe the option of waivers will encourage companies to find loopholes where they can be listed in Hong Kong without the necessary minority shareholder protection. Having a primary listing overseas does not necessarily mean that sufficient investor safeguards have already been put in place. For example, we find the disclosure and shareholder communication requirements of foreign private issuers listed in the US significantly fall behind global best practice standards.

#### **4 Draft amendments to the rules**

Draft amendments in Chapter 8A.24 stated that non-WVR shareholders must be able to convene an extraordinary general meeting (EGM) and add resolutions to the meeting agenda. The minimum stake required to do so must not be higher than 10% of the voting rights on a one-share one-vote basis in the share capital of the listed issuer. We believe this threshold is set at too high a percentage. Section 566(2) and 567(1) of the Hong Kong Company Ordinance allow shareholders with at least 5% of total voting rights to call a general meeting. We recommend the HKEX to consider lowering the minimum stake requirement for non-WVR shareholders to convene an EGM and to add resolutions to the agenda to strengthen minority shareholder protection.

Draft amendments in Chapter 8A.33 require issuers with a WVR structure to include a summary of the work of the corporate governance committee. We recommend more specific guidance to be provided for the content of this summary report, which should include the key activities performed by the corporate governance committee, the key decisions made, the actions taken, a review of the progress made based on corporate governance issues identified in the previous reporting period, and the target set for the next reporting period. Some Hong Kong listed companies, such as CLP, are already providing such a detailed progress report of their board committees and we recommend companies to follow this local best practice.

Draft amendments in Chapter 8A.34 and 35 require issuers with a WVR structure to appoint a compliance adviser on a permanent basis. We recommend that key compliance matters put forward by this third-party compliance adviser should be disclosed in the corporate governance section of the annual report.