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HKEx Publishes Consultation Conclusions on Proposal to Permit Corporate WVR Beneficiaries

On 30 October 2020, the Stock Exchange of Hong Kong Limited (the **HKEx**) published conclusions to its consultation on corporate WVR beneficiaries[1] (the **Consultation Conclusions**). The HKEx received a variety of views, with a majority of respondents agreeing with the proposal to allow corporates to benefit from Weighted Voting Rights (**WVR**), however the HKEx concluded that more time is needed for the market to develop a better understanding of Hong Kong's regulatory approach to listed companies with WVR structures and to monitor the operation of Chapter 8A of the HKEx Listing Rules (the **Listing Rules**), which permits individuals to benefit from WVRs.

The HKEx has however decided to treat Greater China Issuers that are:

- controlled by corporate WVR beneficiaries as at 30 October 2020; and
- primary listed on a Qualifying Exchange (the New York Stock Exchange (**NYSE**), Nasdaq or the "Premium Listing" segment of the London Stock Exchange's Main Market) on or before 30 October 2020

in the same manner as Grandfathered Greater China Issuers for the purposes of Chapter 19C of the HKEx Listing Rules. The move paves the way for a number of Chinese tech companies primary listed on the NYSE or Nasdaq to pursue secondary listings in Hong Kong.

The HKEx also indicated plans to consult on normalising the eligibility requirements applying to Greater China Issuers that do not have WVR structures and seek secondary listings under Chapter 19C. Currently, these companies can only secondary list on the HKEx if they are "innovative" companies with the features set out in paragraph 3.2 of HKEx Guidance Letter 94-18.[2] It additionally outlined plans for a consultation paper on a general review of its dual-primary and secondary listing regimes.

The Corporate WVR Beneficiaries Consultation Paper was published on 31 January 2020 (with the consultation period closing on 31 May 2020). For an overview of the January 2020 Consultation Paper, please see Charltons' February 2020 newsletter.[3]

1. Qualifying Corporate WVR Issuers

Grandfathered Greater China Issuers (Greater China Issuers primary listed on a Qualifying Exchange on or before 15 December 2017) are permitted to secondary list in Hong Kong with their existing WVR structures in place (regardless of whether they meet Hong Kong's requirements under Chapter 8A that apply to the WVR structure of a primary

1 HKEx. October 2020. "Consultation Conclusions: Corporate WVR Beneficiaries". Available at: https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/January-2020-Corporate-WVR/Conclusions-(Oct-2020)/cp202001cc.pdf?la=en

2 HKEx. "HKEx Guidance Letter 94-18 Suitability for Secondary Listing as a Qualifying Issuer under Chapter 19C". Available at: https://en-rules.hkex.com.hk/sites/default/files/net_file_store/gl9418.pdf

3 https://www.charltonslaw.com/hkex-publishes-consultation-paper-on-corporate-wvr-beneficiaries/

listing applicant) subject to meeting prescribed eligibility and suitability requirements under Chapter 19C of the HKEx Listing Rules. This grandfathering provision already allows the secondary listing of eligible companies with capital structures allowing corporate WVR holders.

Further to the consultation, the HKEx has decided that it will treat Greater China Issuers that are controlled by corporate WVR beneficiaries and primary listed on a Qualifying Exchange (as at 30 October 2020) (**Qualifying Corporate WVR Issuers**) in the same manner as Grandfathered Greater China Issuers for the purposes of Chapter 19C. A listing applicant will be regarded as "controlled by corporate WVR beneficiaries" if a single corporate WVR holder (or group of corporate WVR holders acting in concert) holds the largest share of the voting power in the listing applicant which amounts to at least 30% of the listing applicant's total voting power.

A Greater China Issuer applying for listing under this arrangement will have to comply with all other requirements of Chapter 19C and must demonstrate to the HKEx that:

i) it has a market capitalisation of at least HK$40 billion, or at least HK$10 billion with at least HK$1 billion of revenue for its most recent audited financial year (HKEx Listing Rule 19C.05);

ii) it is an "innovative company" (as defined in paragraph 3 of HKEX-GL94-18); and

iii) domestic laws, rules and regulations to which it is subject and its constitutional documents, in combination, provide the shareholder protection standards specified in HKEx Listing Rules 19C.07 and 19C.08.

Like other Chapter 19C secondary issuers, Qualifying Corporate WVR Issuers will be exempt from a number of Listing Rules under HKEx Listing Rule 19C.11. However, if trading in the shares of a Qualifying Corporate WVR Issuer migrates to the HKEx's markets on a permanent basis, these exemptions will no longer apply and the HKEx will treat the issuer as having a dual-primary listing. It will then be required to comply with the relevant Listing Rules after a grace period of one year, although it will be allowed to retain its existing corporate WVR structure, as is already allowed for Grandfathered Greater China Issuers.

2. Overview of Responses to the HKEx Consultation Paper

The proposal to expand the WVR regime to permit corporates to benefit from WVR received support from a majority of respondents (68%), with 9% of those supportive of the proposal on the basis of the proposed safeguards, and the remaining 59% supportive subject to amendments. Supportive respondents generally commented that the proposal would enhance the competitiveness of Hong Kong as a listing venue, attract listings by companies in high growth sectors and increase the range of investment opportunities if safeguards for minority shareholders and potential investors were sufficient and risks were disclosed.

Just under one third (31%) of respondents rejected the proposal, the majority of which were investment firms or organisations representing investment firms. Those in opposition disagreed in principle with permitting corporate WVR beneficiaries, based on the following concerns:

- the introduction of corporate WVRs would hinder the removal of under-performing management by shareholders and expose shareholders to the risks of management entrenchment;
- increased risk of misalignment of interests between the controlling shareholders of corporate WVR beneficiaries and the WVR issuer;
- the WVRs of the corporate beneficiary would effectively become tradeable and be used by someone who had not made a commensurate non-economic contribution to the development of the issuer;
- a corporate does not owe fiduciary duties to an issuer in the same way as an individual shareholder who is required to be a director of the issuer under Chapter 8A;
- the WVR of the corporate entity may exist in perpetuity;
- the proposed safeguards provide only limited protection to minority shareholders and, in any event, no safeguards can adequately mitigate against the risk of corporate WVR structures; and
- the proposals would lead to a deterioration of governance standards in Hong Kong, thereby weakening investor trust and making Hong Kong less attractive to both issuers and investors.

3. Proposals and Responses – a Granulated Review

a. Pre-listing 10% Economic Interest

The HKEx proposed that a corporate WVR beneficiary should:

- hold at least a 10% economic interest prior to listing; and
- be materially involved in the management or business of the listing applicant for at least two financial years before the listing application date.

A majority of supportive respondents agreed with the proposal as is, however some supportive respondents suggested amendments, including a higher level of economic interest in order to demonstrate commitment to the listing applicant (10–20%), with a longer period of material involvement (three years) also suggested by some respondents. It was also queried whether having a single representative on the board of the listing applicant would be sufficient to meet the material involvement requirement, with it being pointed out that investors with a 10% economic interest would not ordinarily be substantively involved in the management of the listing applicant.

On the other hand, opposing respondents were of the view that a 10% minimum economic interest prior to listing is too low and that a period of two financial years is too short to demonstrate the commitment of a corporate WVR beneficiary.

b. 30% Threshold and Single Largest Shareholder Requirement

Requirement at Listing

The HKEx proposed that a corporate WVR beneficiary own at least a 30% economic interest in the listing applicant and be the single largest shareholder at listing.

31% of supportive respondents agreed with the proposal, with the remaining supportive respondents suggesting amendments, including: that a corporate WVR beneficiary should meet the 30% threshold or be the single largest shareholder, but not both, while others stated the requirements were unnecessary.

41% of supportive respondents agreed with a 30% threshold, however others stated that:

- the requirement defeated the purpose of having WVR which is to allow a shareholder to control an issuer without the economic interest that is normally required;
- having to acquire shares to reach the threshold before listing may dissuade potential candidates from listing in Hong Kong given the considerable expense this would entail and the fact that innovative companies commonly go through series of pre-IPO financing which dilute the prospective corporate beneficiary's economic interest;
- corporate WVR beneficiaries should not be subject to a higher threshold than individual WVR beneficiaries (required to collectively hold a 10% economic interest at listing (under HKEx Listing Rule 8A.12)); and
- a 30% threshold would put Hong Kong at a competitive disadvantage to US Exchanges which do not have this requirement.

As for those in opposition, the 30% threshold was considered to be too low on the basis of a higher threshold being necessary to better align a corporate WVR beneficiary's interest with those of the other shareholders.

Respondents also voiced concerns with respect to the technical difficulties of complying with the Listing Rules if a corporate was required to increase their stake from 10% to 30% by the time of listing, particularly in view of the ownership continuity and control requirements (HKEx Listing Rule 8.05(3)(c)). This issue is compounded by the restrictions on pre-IPO investments shortly before an IPO (as outlined in paragraph 6.2 of HKEx-GL43-12[4]). A respondent also queried whether the HKEx would consider relaxing the restrictions in HKEx-GL85-16[5] to enable a corporate WVR beneficiary to comply with the 30% economic interest threshold.

Ongoing Requirement for 30% Threshold

The HKEx proposed that the WVR attached to a corporate WVR beneficiary's shares must lapse if the beneficiary fails to maintain at least a 30% economic interest in the WVR issuer on an ongoing basis after listing.

4 HKEx. HKEx Guidance Letter 43-12. Guidance on Pre-IPO Investments. Available at: https://en-rules.hkex.com.hk/sites/default/files/net_file_store/gl4312.pdf

5 HKEx. HKEx Guidance Letter 85-16. Placing to connected clients, and existing shareholders or their close associates. Available at: https://en-rules.hkex.com.hk/sites/default/files/net_file_store/gl8516.pdf

31% of supportive respondents agreed with the proposal. Concerns with this ongoing requirement were raised by other supporting respondents, particularly the fact that such a requirement does not apply to individual WVR beneficiaries. Other issues raised included that:

- an ongoing requirement would impact the ability of the issuer to raise funds through placing or to conduct acquisitions by issuing consideration shares in the future; and
- share-based employee inventive schemes may dilute the interest of the corporate WVR beneficiary and require it to incur cash outlay to maintain the 30% economic interest after listing.

Respondents also suggested a grace period to prevent WVR lapsing and others suggested a requirement to maintain a 30% economic interest on an ongoing basis <u>or</u> be the single largest shareholder on an ongoing basis, but not both.

c. <u>Exception from Requiring Share Issues on a Pre-emptive Basis without Shareholder Approval</u>

The HKEx proposed an exception to HKEx Listing Rule 13.36 to permit a non-pre-emptive share issuance to a corporate WVR beneficiary without shareholder approval solely for the purpose and to the extent necessary to enable it to comply with the ongoing 30% economic interest requirement, subject to the following conditions being fulfilled:

i) the subscription is solely for the purpose, and to the extent necessary, to allow a corporate WVR beneficiary to comply with the 30% economic interest requirement;

ii) the shares do not carry WVR;

iii) the subscription is on the same or better terms (from the perspective of the listed issuer) as the original issuance that required the corporate WVR beneficiary to subscribe for additional shares to comply with the 30% economic interest requirement; and

iv) the subscription price paid by the corporate WVR beneficiary for the anti-dilution shares is fair and reasonable, having regard (among other things) to the average trading price of the listed issuer's shares over the preceding three months.

38% of supportive respondents agreed with the proposal, while others suggested that:

- the subscription price should be benchmarked against an average or a discounted average trading price over a reasonable period of time and if the subscription price was lower than the stipulated price, a specific mandate of the shareholders should be required; and
- the exception should also include all situations that may lead to the corporate WVR beneficiary involuntarily becoming not interested in 30% or more economic interest in the issuer.

Additionally, with respect to condition (iii) above, a respondent commented that this requirement would be difficult to demonstrate in practice where the WVR issuer has issued consideration shares for the acquisition of an interest in a company and suggested (iii) be removed.

Meanwhile, a number of respondents suggested that an exception was unnecessary on the basis that there are other ways that a corporate WVR beneficiary could subscribe for shares to satisfy the 30% economic interest requirement, for example by buying shares from the open market or under a general mandate to issue new shares.

Other respondents indicated the need for shareholder approval of a non-pre-emptive share issuance in order to provide sufficient safeguards to minority shareholders. Opposing respondents however stated that any issuance of shares to the corporate WVR beneficiary should be subject to shareholders' approval on one share one-vote basis.

d. <u>Maximum Voting Ratio of WVR Shares for Corporate WVR Beneficiary</u>

The HKEx proposed that the corporate WVR maximum ratio be set at no more than five times the voting power of ordinary shares.

One third of supportive respondents agreed with this proposal, while 42% considered it to be unnecessary or too low. It was suggested that it should be aligned with (or be no lower than) the individual WVR maximum ratio (i.e. ten votes per share (HKEx Listing Rule 8A.10)) in order to alleviate any unfair bargaining leverage that an individual WVR beneficiary may have against a corporate WVR beneficiary. Alternatively, it was suggested that the maximum voting ratio should be a commercial matter left to the listing applicant and its shareholders to determine.

In contrast, opposing respondents considered that the ratio should be lower, stating that otherwise the aggregate voting power of the corporate WVR beneficiary would be too high.

e. Ecosystem Requirement

The HKEx proposed that a corporate WVR beneficiary should be required to demonstrate its contribution through the inclusion of the listing applicant in its ecosystem in order to benefit from WVR and that the ecosystem should be required to have the following characteristics:

i) there is a community of companies that has grown and co-evolved around a technology or know-how platform or a set of core products or services, owned or operated by the prospective corporate WVR beneficiary;

ii) the components within the ecosystem (including the listing applicant) benefit from, and contribute to, the ecosystem by sharing certain data, users and/or technology;

iii) the ecosystem has attained a meaningful scale;

iv) the core components within the ecosystem, and the listing applicant, are in substance controlled by the corporate WVR beneficiary; and

v) the growth and success of the listing applicant was materially attributable to its participation in and co-evolvement with the ecosystem and the applicant is expected to continue to benefit from being part of that ecosystem.

A majority (56%) of supportive respondents agreed with the proposal as is. Other supporting respondents raised issues, including that it can be practically difficult to define the scope of an ecosystem and identify the components controlled by a corporate WVR beneficiary, particularly given that innovative companies often cross-invest in each other.

Requests for clarification were also made, particularly with respect to terms such as “meaningful scale”, “community of companies” and “materially attributable to its participation”, with one respondent suggesting that the HKEx form an advisory panel (comprised of members familiar with the functioning of the new economy and characteristics of ecosystems) in order to advise it in the listing approval process.

As for companies in traditional sectors, it was pointed out by a handful of respondents that such companies may find it difficult to meet the ecosystem requirement and that the proposals should be more broadly drafted.

Some respondents also voiced concerns with respect to the interaction of the ecosystem requirement and the requirements of the Listing Rules, particularly the requirement that an issuer demonstrate its independence and the non-competition requirements.

Meanwhile, opposing respondents generally took issue with voting power being determined by reference to contribution and advantages contributed by an ecosystem and considered the criteria to be subjective and imprecise.

f. Size of Corporate WVR Beneficiary

The HKEx proposed that a corporate WVR beneficiary should have a minimum market capitalisation of at least HK$200 billion at the time of listing, which 49% of supportive respondents agreed with, with one respondent suggesting that the requirement should be ongoing after listing, with WVR lapsing if the requirement is no longer met.

A considerable proportion of respondents however found this threshold to be too high, stating that:

- existing ring-fencing measures and the proposed measures are sufficient;
- a HK$200 billion threshold would create a barrier to entry for smaller innovative companies (an important consideration given that there are a number of potential ecosystem developers with a market capitalisation below HK$200 billion);
- the requirement is anti-competitive; and
- excessive market capitalisation requirements may make Hong Kong a less attractive listing venue.

Respondents alternatively suggested an average market capitalisation requirement of HK$40 billion over the six months prior to listing or HK$10 billion if the listing applicant can demonstrate a strong symbiotic relationship with the corporate WVR beneficiary with reference to the characteristics of an ecosystem.

Some respondents also suggested the HKEx consider a profit, revenue, asset or cash flow test.

g. Imposition of Time-defined Sunset Period on Corporate WVR

Initial Sunset Period

The HKEx proposed that WVR of a corporate WVR beneficiary should be subject to a time-defined sunset, with an initial sunset period of not more than 10 years.

29% of supportive respondents agreed with the proposal, while others suggested shorter periods of five to seven years. Opposing respondents stated that the sunset period should be less than 10 years.

49% of supportive respondents disagreed with the imposition of any time-defined sunset, however in the event of a time-defined sunset period being adopted, they advocated longer periods of 20 to 30 years.

Renewal of Corporate WVR

The HKEx proposed that the WVR of corporate WVR beneficiaries could be renewed indefinitely, subject to independent shareholder approval for successive renewals of a period of five years.

29% of supportive respondents agreed with the proposal, while others suggested:

- the renewals should be voted by independent shareholders following a review and evaluation of the WVR issuer's performance;
- a super majority (i.e. 75% of shareholders present and voting at a general meeting) be required for the independent shareholder approval and that this requirement be enshrined in the issuer's articles; and
- a WVR issuer engage an external professional independent third party to issue an assurance statement at the end of each financial year to confirm there had been no termination or material disruption of the corporate beneficiary's contribution to the WVR issuer.

Respondents also suggested varying renewal periods, ranging from three years to no more than 10 years, and in the case of one respondent, 30 years.

Number of Renewals of Corporate WVR

The HKEx proposed no limit on the number of times the WVR of a corporate WVR beneficiary may be renewed, which just under one third (31%) of supportive respondents agreed with. Other respondents suggested limiting the number of renewals to varying degrees (two renewals or four renewals). Some respondents also suggested varying the length of renewal periods upon each renewal (i.e. a first renewal period of five years and two further renewal periods of three years). At the other end of the spectrum, two supporting respondents suggested there should be no renewals, which opposing respondents agreed with.

h. Conversion of Corporate WVR Shares upon the Fall-away of Individual WVRs

The HKEx proposed that upon the WVR of an individual WVR beneficiary falling away, the corporate WVR beneficiary would not be required to convert part of its shares into ordinary shares. This would mean that the corporate WVR beneficiary would have a greater voting power percentage after the lapse of an individual's WVR.

31% of supportive respondents agreed with the proposal stating that a corporate WVR beneficiary should not be penalised in terms of its rights by virtue of the lapse of individual WVR, an event outside its control.

Others, while agreeing with the proposal, suggested a corporate WVR beneficiary should have discretion to convert its WVR shares to ordinary shares and others raised concerns with respect to investment planning given that individual WVR fall-away may occur at any time.

On the other hand, a number of respondents asserted that a corporate WVR beneficiary should be required to convert a portion of their WVR to ordinary shares on the lapse of individual WVR in order to ensure fair and equal treatment of all shareholders. An alternative approach was also suggested whereby the percentage of increase in the percentage of voting power of the corporate WVR beneficiary arising from the lapse of individual WVR would be distributed among all shareholders.

A number of respondents also raised concerns with respect to implications under the Takeovers Code of a lapse of either corporate or individual WVR on the occurrence of a time-defined or event- based sunset and it was suggested that the HKEx and SFC provide guidance and further clarification.

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