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Research Paper on the HKEx's New Board Concept Paper 2017 from the Corporate Governance Perspective

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Executive Summary

This paper aims to explore the impact of the establishment of New Board to the overall corporate governance standard in Hong Kong under the continuous listing and corporate governance obligations proposed in the New Board Concept Paper issued by the HKEx applicable to New Board issuers which are also listed on NASDAQ/NYSE.

This is reviewed from three perspectives: (1) the comparison among Hong Kong, NASDAQ and NYSE corporate governance codes; (2) review of corporate governance performance of three Mainland titans specified in the New Board Concept Paper; and (3) review of corporate governance failure news of New Economy companies adopting a Weighted Voting Rights (WVR) structure.

1. Background

In the past decade, new economy companies, companies involved in Biotechnology, Health Care Technology, Internet and Direct Marketing Retail, Software, IT Services, Technology Hardware, Storage and Peripheral Sectors, have been found with promising growth rates. Yet, the majority of these companies can barely fulfill the requirements to list on the Hong Kong Stock Exchange (HKEx). One reason is that many of them are companies with Weighted Voting Right (WVR) structures. Furthermore, second listing of Mainland companies are currently prohibited pursuant to the Joint Policy Statement Regarding the Listing of Overseas Companies jointly issued by the SFC and SEHK in September 2013 (2013 JPS). This has pushed away opportunities from China despite the advantageous geographical proximity.

In response to this, HKEx proposed in 2017 to set up a New Board. In contrast with the Main Board and the Board of Growth Enterprise Market (GEM Board), the new boards are proposed with looser regulatory requirements and easier entry in order to attract new economy companies.

However, there are some questionable parts. The New Board Concept Paper issued by the HKEx in 2017 proposed that companies which have listed on recognised US Exchanges (NYSE and NASDAQ) will be exempted from having to provide equivalent shareholder protection standards written under the 2013 JPS[1]. While Appendix 14 of the Main Board Listing Rules requires issuers to act in accordance to 82 codes on corporate governance, the New Board Concept Paper only requires issuers to comply with corporate governance standards in respect to 8 areas.

This research paper will be centered at the current Hong Kong corporate governance codes and regulations. Through comparing the current requirements with those of recognised US Exchanges (NYSE and NASDAQ) and investigating 3 selected NYSE/NASDAQ listed companies, the report reviews how well these companies comply with the current Hong Kong corporate governance standards and explores whether being listed on NYSE/NASDAQ necessarily justifies the proposal of not applying Appendix 14 to New Board issuers on a wholesale basis.

[1] New Board concept paper, paragraph 115(b)(III)
https://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2017061.pdf

2. Corporate Governance Standards Comparison

This section compares how NASDAQ, NYSE and HKEx corporate governance standards differ from each other.

2.1 Board Composition

The HKEx Corporate Governance Code (the "HKEx Code") specifies that the board should have a balance of skills, experience and diversity of perspectives suitable for the issuer's business. It should include a balanced composition of executive and non-executive directors (including independent non-executive directors (INEDs)) to ensure the board can effectively exercise independent judgment. Non-executive directors should be of sufficient calibre and number for their views to carry weight. In addition to board composition, the board of every issuer should have a board diversity policy.[2]

On the other hand, for NASDAQ and NYSE listing rules, the majority of the board should be composed of independent directors.

2.2 Director Independence

On director independence, listing requirements of all three exchanges in general require an independent director to be free from any material interest in the issuer's business activities, as well as material relationship with the issuer, its subsidiaries and connected persons. Also, to be considered independent, a director should be financially independent.

For HKEx, the independence criteria are set out in Rule 3.13 of the Listing Rules. Serving on the board for over 9 years could be relevant to the determination of a non-executive director's independence. If a non-executive director serves more than 9 years, his/her appointment will be subject to a separate resolution approved by shareholders.[3]

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[2] HKEx Corporate Governance Code A.3 and A.5.6.
[3] HKEx Corporate Governance Code A.4.3.

For NASDAQ, the definition of independence is stipulated in Rule 5605(a)(2) of the Listing Rules; as for NYSE, the independence test is provided in Section 303A.02 of NYSE Listed Company Manual. Under the two US listing regimes, the board has a responsibility to make an affirmative determination that no such relationships exist through the application of the relevant rule. However, its discretion is not unfettered, as the relationships that will disqualify a person from being an independent director are clearly specified.

Besides, disclosure of identities of independent directors is required by HKEx and NASDAQ while it is not specified in the NYSE regime.

The HKEx Code also provides that non-executive directors (including INEDs) should hold at least one separate meeting a year without the presence of executive directors.[4] Meanwhile, the NASDAQ and NYSE requirements state that independent directors should hold separate meetings in a regular manner. Such practice enables oversight of independent directors and prevents any board malpractice.

[4] HKEx Corporate Governance Code A.2.7.

2.3 Board Committees

The board committees required to be established and their relevant composition are listed as follows:

<table>
<tr><th>By function</th><th>HKEx</th><th>NASDAQ</th><th>NYSE</th></tr>
<tr><td>Audit</td><td>- Non-executive directors only
- At least 3 members
- Independent majority</td><td colspan="2">- At least 3 members
- All must be independent</td></tr>
<tr><td>Remuneration</td><td>Not specified</td><td rowspan="2">Independent majority</td><td rowspan="2">All must be independent</td></tr>
<tr><td>Nomination</td><td>Majority of independent non- executive directors</td></tr>
</table>

Table 1: Composition of relevant Board Committees required by HKEx, NASDAQ and NYSE

2.4 Remuneration Disclosure

According to the HKEx Code, issuers should disclose details of any remuneration payable to members of senior management, on an individual and named basis, in their annual reports.[5]

For NASDAQ and NYSE, the US federal securities law requires concise and understandable disclosure of executive compensation. In the annual proxy statement, information concerning the amount and type of compensation paid to its chief executive officer, chief financial officer and the three other most highly compensated executive officers must be disclosed, so as the criteria used in reaching executive compensation decisions and the relationship between the company's executive compensation practices and corporate performance.[6] However,

[5] HKEx Corporate Governance Code B.1.8.
[6] https://www.sec.gov/fast-answers/answers-execomphtm.html

foreign private issuers (FPIs) may follow home country practice on this requirement, which will be discussed further in a later section.

2.5 Addressing conflicts of interests between directors and the company

When there is a material conflict of interest, pursuant to the HKEx Code, the matter should be dealt with by a physical board meeting instead of a written resolution. INEDs who, and whose close associates, have no material interest in the transaction should be present at that board meeting.[7]

In NASDAQ listing rules, it is stated that all related party transactions must be first approved by the Audit Committee and subsequently reviewed.

In contrast, under the NYSE listing regime, although it provides that a means for employees, officers and directors to communicate potential conflicts to the company should be set up, the measure to address conflicts of interests can be determined by each issuer without a clearly specified approach.

2.6 Risk oversight

According to the HKEx Code, to oversee the issuer's risk management and internal control system is a board function. Review of the effectiveness of the system should be conducted and reported to the shareholders at least annually.[8]

On the contrary, the NASDAQ standards do not specify on this area and measures for risk management can be tailored based on the multiple variables that constitute the issuer's risk profile.

For NYSE, risk oversight is an Audit Committee function. Guidelines and policies in respect of risk assessment and management should be devised by the Audit Committee.

[7] HKEx Corporate Governance Code A.1.7.
[8] HKEx Corporate Governance Code C.2.

2.7 Shareholders

An Annual General Meeting (AGM) is required under the HKEx Listing Rules. The chairmans of the board and various independent committees should attend and answer questions.[9] In addition, shareholders' rights to call for a general meeting and put forward new proposals are protected by the Articles of Association and the Companies Ordinance (Cap. 622). For the purpose of effective communication, a shareholders' communication policy should be set up and reviewed regularly pursuant to the HKEx Code.[10]

On the other hand, an Annual Shareholders' Meeting is also required under both US listing regimes, but FPIs listed on NASDAQ may follow home country practice on this requirement.

For companies listed on NYSE, methods for shareholders to communicate directly with the presiding director(s) must be disclosed either on or through their websites or in annual proxy statements. As for NASDAQ, no requirements regarding shareholders' communication are laid down.

2.8 Treatment for Foreign Private Issuers

In order to list on HKEx, foreign private issuer (FPI) is currently required to include in the listing document a summary of the constitutive documents and relevant regulatory provisions of the jurisdiction in which it is incorporated, in addition to observing the rules applicable to issuers incorporated in Hong Kong.

However, a more lenient approach is provided under both US listing regimes. NASDAQ-listed FPI may follow its home country practice in lieu of the Rule 5600 series regarding corporate governance, the requirement to disclose third party director and nominee compensation, and the requirement to distribute annual and interim reports only to provide a letter from outside counsel in the issuer's home country. The exemptions and home country practices should then be disclosed in annual reports, company website, and registration statement.

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[9] HKEx Corporate Governance Code E.1.2.
[10] HKEx Corporate Governance Code E.1.4.

Likewise, NYSE-listed FPI may follow its home country practice in lieu of the provisions in Section 303A (Corporate Governance Standards) except those governing Audit Committee, but it must disclose any significant ways in which its corporate governance practices differ from those followed by a domestic company.

2.9 Conclusion

To conclude, NYSE corporate governance standards are more stringent than that of NASDAQ. However, both US listing regimes fail to address all the elements of corporate governance covered by the HKEx Code.

	NASDAQ	NYSE
Fails to address	• Board diversity • Whistleblowing policy • Company Secretary • Continuing education of directors • Separate Corporate Governance Report	• Board diversity • Whistleblowing policy • Company Secretary

Table 2: Missing areas in comparison with HKEx Corporate Governance Code

In view of above, the New Board Concept Paper's proposal of not requiring New Board issuers which are also listed in NASDAQ/NYSE to comply with the entire Appendix 14 may jeopardise the corporate governance standard of Hong Kong listed companies.

This is especially the case for foreign private issuers on NASDAQ and NYSE since they are entitled to follow home country practices which are usually more easy-going. This infers that the HKEx would further surrender its governing power to regimes outside of the United States.

Therefore, such biased treatment and potential loophole should not be allowed if HKEx would like to strive for high corporate governance standards and maintain Hong Kong's status as a leading financial centre.

3. Case Studies: Alibaba / Baidu / JD.com

3.1 Introduction of the three target companies

During its consultation of the establishment of the New Board, the HKEx has stressed repeatedly of Hong Kong's loss in allowing "Mainland titans" listing on overseas markets instead of Hong Kong due to their incapacity to fulfill Hong Kong regulations as a result of their weighted voting rights structures, specifically citing Alibaba Group Holding Limited, Baidu Inc and JD.com Inc as examples.

As a result, Alibaba, Baidu and JD.com have been chosen to be our study targets. JD.com and Alibaba are well known e-commerce companies, and Baidu is a web services company which offers many services including the most frequently used search engine in China. The following section reviews how these Mainland titans perform against the current Hong Kong corporate governance standards.

Despite differences in business models, the three companies have a common characteristic in their shareholding structures - Weighted Voting Right (WVR) structure. Alibaba has its own "partnership" structure, which allows 27 people to decide the board of directors unless 95% shareholders against this practice. For the other two, they adopt in a structure of dual share classes. This practice divide the ordinary shares into two classes: class A and class B. Class B ordinary shares are having 10 times (for JD.com, 20 times) voting rights of class A ordinary shares, and the majority of them are held in the hands of the co-founder or chairman of the company.

Both measures allow the chairperson to maintain his power and authority without contributing proportionate capital. Although this can provide a better ground for long-term decisions, it creates the problem that decision makers bear less financial risks than the rest of the shareholders do. It is also difficult for shareholders put controversial decisions on hold. In Hong Kong, dual-class share structures and other structures resulting in disproportionate voting right per share are prohibited, but not in the US.

Therefore, it is vital to see to what extent the current corporate governance situation of these companies can meet with the HKEx Code requirements given that they may list on the New Board. This can further help us to understand the potential corporate governance issues that may be created in the future by the New Board proposal.

3.2 Methodology

For the three target companies, their respective annual reports and webpages on investors' relation are studied and checked against with the HKEx Corporate Governance Code.

The provisions that are not required in NASDAQ and NYSE standards were excluded from the case studies in order to achieve more representative and fairer results.[11] While the sample size may be small, the result is nevertheless significant and indicative as these companies are specified distinctively in the New Board Concept Paper by the HKEx.

[11] The excluded provisions are A.5.6 (Board Diversity Policy) and F.1.1 to F.1.4 (Company Secretary).

3.3 Results

With reference to the checklist for the HKEx Corporate Governance Code and reference to the information available for each target company, the statistical results of compliance rate of the HKEx Code Provisions (CPs) are produced as follows:

Number of CPs	Alibaba (NYSE)	Baidu (NASDAQ)	JD.com (NASDAQ)
Complied with	36 (43.9%)	10 (12.2%)	12 (14.6%)
Not complied with	6 (7.3%)	11 (13.4%)	9 (11.0%)
Uncertain	40 (48.8%)	61 (74.4%)	61 (74.4%)
Total of CPs	82 (100%)		

Table 3: Compliance rate of HKEx Corporate Governance Code Provisions, the full table of results is available in the Appendix

Among the three companies, Alibaba has the highest compliance rate of HKEx CPs, given its NYSE-listed status. As mentioned, NYSE listing requirements on corporate governance is more stringent than NASDAQ ones, and hence closer to the HKEx standards.

Both Baidu and JD.com, which are NASDAQ-listed, have significantly lower compliance rates. According to the Analysis of Corporate Governance Practice Disclosure in June Year-end 2015 Annual Reports (the “June Review”), in which the Stock Exchange of Hong Kong Limited reports the corporate governance reviews of over 1,000 issuers in Hong Kong, 97% of the Hong Kong issuers complied with more than 70 CPs, which makes a stark contrast with the current findings. Even for Alibaba which is NYSE-listed, its compliance rate is still far from satisfactory, let alone the two NASDAQ-listed companies.

Another point to note is that the percentages of CPs that are uncertain to be determined as fulfilled or not for all three companies are high, which is 74.4% for Baidu and JD.com, as well as 48.8% for Alibaba. Such finding indicates that the disclosure of corporate governance information for these US-listed companies is insufficient in comparison with HKEx standards.

While HKEx Main Board issuers are mandatorily required to include a corporate governance report prepared by the board of directors in their summary of financial reports, New Board issuers are only required to timely publish material information and transactions affecting the financial performance of the company. Furthermore, disclosure exemptions are also granted to foreign private issuers. While the uncertainty of compliance due to limited disclosure may not necessarily means poor governance or non-compliance with Hong Kong standards, the lack of transparency in this area is itself alarming.

All 3 companies expressly not complied with (3X)	
A.2.1	Separation of the roles of chairman and chief executive
2 out of 3 companies expressly not complied with (2X)	
C.2.6	Disclosure of a confirmation from management on the effectiveness of risk management and internal control systems
C.2.7	Disclosure of details of any significant areas of concern
E.1.1 - E.1.3	Effective communication regarding AGM (For companies listed in NASDAQ, AGM can be waived based on the situations.)

Table 4: Code Provisions with the lowest compliance rates

The CP with the lowest compliance rate states that the roles of chairman and chief executive must be separated and performed by two different individuals. This is the same case in Hong Kong as seen in the June Review. However, unlike HKEx-listed companies, no explanation is provided in the annual reports of these three US-listed companies.

Moreover, other CPs with low compliance rates concern risk management and disclosure, as well as effective communication with shareholders, which are important areas for investors' understanding of an issuer's background and risk exposure.

3.4 Conclusion

As a consequence, without having to meet the current shareholders' protection standards at HKEx and comply with all corporate governance codes and disclosure rules, there is a severe lack of guarantee in the corporate governance standards of New Board issuers.

In addition, there will be a lack of transparency and information flow for shareholders. From a practical perspective, without a comprehensive understanding of an issuer's risk profile and management, investors are subject to higher risk when investing in New Board companies.

Investment decisions made purely on past financial performance without adequate understanding of quantitative characteristics of the issuer is risky and unsatisfactory. In the long run, investors' interests will be at stake and market stability may be adversely influenced.

4. News on Corporate Governance Failure

Other than comparing guidelines and reports, potential problems can be discovered through news of the potential New Board issuers regarding their corporate governance failures.

4.1 Alipay spinoff (2011)

Alipay was essential to Alibaba's business. With this third-party mobile and online payment platform, online transactions have been facilitated and the majority of Alibaba's online retailing services have been benefited. Alipay was once an asset named under Alibaba.com, a company which went public in Hong Kong from 2007 to 2012, but got spun off in 2011 under a controversial move.

In May 2011, Yahoo and Softbank, large shareholders of Alibaba.com, were informed that Alipay had been spun off from Alibaba.com five weeks before and put into a separate company. Jack Ma, CEO at that time, defended his decision as "avoiding extra governance on foreign-funded payment companies", according to the new rules issued to govern third-party payment platforms by People's Bank of China in late 2010[12]. Still, Ma held 46% shares of the spun off company. Yahoo disclosed this information to its own shareholders, forcing Alibaba to compensate by making some agreements with Yahoo.

This raised an issue regarding these new companies - the insufficiency of governance by the Board of directors.

In this news, Alibaba apparently failed to disclose its CEO's decisions on time. Jack Ma, as a director of the Hong Kong-listed company at that time, was responsible to report any conflict of interest to the board. However, it was obvious that he didn't mention to the board on time and allowed others to respond to his acts.

This reflected a limited regulation on the decisions made by directors, despite agency issues may occur. This problem may get more serious when a WVR structure has been used on most new economy companies and it requires almost all remaining shareholders' votes to go against the director's decisions. In this sense, it can be worrying whether investors in the New Boards can monitor these potential

[12] http://www.gov.cn/flfg/2010-06/21/content_1632796.htm

new economy companies by any means and be rest assured that their corporate governance practices are up-to-standard.

4.2 Tesla Purchase of Solarcity (2016)

This was also regarded by critiques as an example of corporate governance failure.

In 2016, Elon Musk, CEO of Tesla Motor, offered a purchase of Solarcity, a company where Musk was the chairman on behalf of the company. In order to make the deal look fair, Musk launched a vote for the acquisition by excluding himself and 2 more involved partners. Yet, these three people still made presence in the deal making and half of the directors in the remaining board is related. The acquisition got passed, but the remaining shareholders got furious and this resulted in seven lawsuits within September and October 2016 to stop the acquisition. The acquisition is finally approved in November 2016.

This incident reflected that in some New Economy companies, the Board of directors may be involved in related party transactions and limited shareholders' rights. Meanwhile, there are insufficient or suitable measures for shareholders to reduce the conflicts of interest. The "seems-to-be-fair" voting with boards and shareholders indeed provided no grounds and no channel for shareholders to argue at all.

5. Conclusion

It is evident that the current NASDAQ and NYSE corporate governance codes fail to address all the elements covered by that in Hong Kong. Relying on NASDAQ and NYSE corporate governance rules may result in further surrender of regulatory power by the Hong Kong authorities as these companies are entitled to rely on their home countries, eg Cayman Islands, standards and codes.

Furthermore, NASDAQ and NYSE corporate governance codes do not mandatorily require the publication of corporate governance reports. This is main reason hindering a thorough review of corporate governance performance of the three Mainland titans Alibaba, Baidu and JD.com for our comparison in this paper. The lack of transparent disclosure and mandatory review of corporate governance controls severely hampers the overall corporate governance standard in Hong Kong.

As seen in the news quoted above, even the largest companies with strong financial powers can still be tripped by poor corporate governance. The lack of proper standards and controls would adversely influence the confidence and stability of our markets. Considering that Hong Kong investors are already subject to greater risks through the introduction of New Board which welcomes New Economy companies with WVR structures to list in Hong Kong, there is no reason not to require these companies to strictly follow the Main Board Listing Rules Appendix 14.

As mentioned in the Concept Paper itself, the Asian Corporate Governance Association had surveyed its members and claimed that investors would likely apply an average discount to the Hong Kong market of around 13% if non-standard shareholding structures became common. It can be foreseen that the release of corporate governance standards would undoubtedly further affect confidence levels.

We have great confidence that our well-developed financial and legal infrastructures would be sufficient to invite the targeted issuers without unnecessarily loosening our regulatory standards.

Appendix: Full Table of Results: Compliance Rate of Alibaba, Baidu and JD.com to the HKEx Code Provisions

(Note: T= Fulfilled; X = Expressly not fulfilled; ? = Not mentioned in reports)

	Baidu	**Alibaba**	**JD.com**
A. DIRECTORS			
A 1.1	?	T	?
A 1.2	?	T	?
A 1.3	?	?	?
A 1.4	?	T	?
A 1.5	?	?	?
A 1.6	?	T	?
A 1.7	?	?	X (The director can vote in respect of an interested transaction so long as his/her interest is declared.)
A 1.8	?	T	X (No third-party liability or product liability insurance)
A 2.1	X	X	X
A 2.2	?	T	?
A 2.3	?	?	?
A 2.4	?	T	?
A 2.5	?	?	?

A 2.6	?	X	?
A 2.7	X	?	?
A 2.8	?	T	?
A 2.9	?	?	?
A 3.1	?	T	?
A 3.2	?	T	?
A 4.1	?	T	T
A 4.2	?	T	?
A 4.3	?	?	? (< 9 years service)
A 5.1	T	X	T
A 5.2	T	T	T
A 5.3	X	T	T
A 5.4	?	T	?
A 5.5	?	X (not everyone independent)	?
A 6.1	?	?	?
A 6.2	?	?	?

A 6.3	?	T	?
A 6.4	?	?	?
A 6.5	?	?	?
A 6.6	T	T	?
A 6.7	?	T	?
A 6.8	?	T	?
A 7.1	?	?	?
A 7.2	?	T	?
A 7.3	?	T	?
B. REMUNERATION OF DIRECTORS AND SENIOR MANAGEMENT AND BOARD EVALUATION			
B 1.1	T	T	?
B 1.2	?	?	T
B 1.3	?	T	T
B 1.4	?	T	?
B 1.5	?	T	X
B 1.6	?	?	?
B 1.7	?	T	?
B 1.8	?	?	X (only listed approximate sums for compensation)

B 1.9	?	T	?
C. ACCOUNTABILITY AND AUDIT			
C 1.1	?	T	?
C 1.2	?	?	?
C 1.3	X	T	?
C 1.4	X	?	?
C 1.5	?	T	?
C 1.6	?	?	T
C 1.7	?	T	T
C 2.1	T	?	?
C 2.2	T	T	?
C 2.3	?	?	?
C 2.4	? (No method mentioned)	?	?
C 2.5	T	T	?
C 2.6	X	X	?
C 2.7	X	X	T (Risk Factors disclosed in Annual Report)
C 3.1	?	?	?

C 3.2	?	?	?
C 3.3	T	?	T
C 3.4	T	?	T
C 3.5			?
C 3.6	?	T	?
C 3.7	T	?	?
D. DELEGATION BY THE BOARD			
D 1.1	?	?	?
D 1.2	?	?	?
D 1.3	?	?	?
D 1.4	?	?	?
D 2.1	?	T	T
D 2.2	?	?	?
D 3.1	?	?	?
D 3.2	?	?	?
E. COMMUNICATION WITH SHAREHOLDERS			
E 1.1	X (AGM waived)	?	X (AGM waived)

E 1.2(a)	X (AGM waived)	T	X (AGM waived)
E 1.2(c)	X (AGM waived)	?	X (AGM waived)
E 1.3	X (AGM waived)	?	X (AGM waived)
E 1.4	?	?	?
E 2.1	?	?	?

-END-