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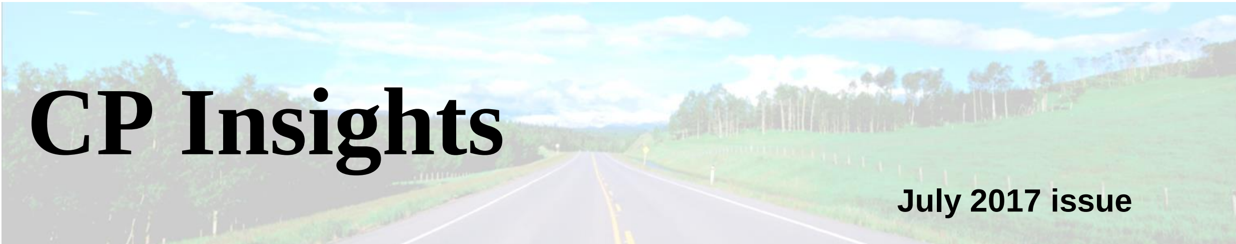

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The New Third Board - Way to safeguard HK's leading IPO position?

A Discussion on the Concept Paper on New Board issued by the Hong Kong Stock Exchange and Clearing Limited (the "HKEX") in June 2017 and its potential challenges when put into implementation.

The HKEX has commenced a two-month consultation on 16 June 2017 regarding the proposal to launch a New Board (also known as the "Third Board") on top of the existing Main Board and Growth Enterprise Market Board (the "GEM Board") in hopes to attract more technology firms to join the market. The consultation period will end on 18 August 2017.

Background of setting up the New Board

Hong Kong has been the world's leading initial public offering ("IPO") market by value, raising USD 24.53 billion last year. Despite Hong Kong's current success, a number of potential challenges will need to be addressed in order to secure its status as a predominant IPO centre in the long run.

<u>Geographic Concentration – Over Reliance on Mainland Issuers</u>

Mainland Chinese companies have dominated Hong Kong's IPO market, raising over HKD 156.6 billion in Hong Kong in 2016, representing 82% of total listing amount. There were 1,002 mainland Chinese firms listed in Hong Kong by the end of 2016 accounting for 63% of the total market capitalization and 69% of the turnover. It can be seen that the high value attained is driven mainly by the listing of a swathe of mainland companies and there is a need for Hong Kong to attract issuers from more diverse geographical areas.

<u>Concentration in Low Growth Sectors</u>

In addition to the geographical concentration, it can be seen that Hong Kong is acting slowly in adapting the fast growing industries into its market. The new economy industries (including include Biotechnology, Health Care Technology, Internet & Direct Marketing Retail, Internet Software & Services, IT Services, Software, Technology Hardware, Storage & Peripherals) consist only 3% of the total market capitalization of the Hong Kong market over the past 10 years as compared with 60%, 47% and 14% for NASDAQ, NYSE and LSE, respectively.

Insufficiencies in Current Listing Regime

Hong Kong constantly falls behind New York in attracting strong listing applicants from the technology and new economies sectors. This can be attributed to the deficiencies in the current listing regime as existing boards do not accommodate pre-profit companies, companies with non-standard governance features and Mainland Chinese companies that wish to secondarily list in Hong Kong, yet these are some of the common features of new economies companies. As such, the current regime in Hong Kong has been viewed as a hindrance to companies of such to be listed in the Hong Kong market.

Hong Kong will have to address these insufficiencies in the current regime and attract more diverse issuers in order for its leading IPO status to remain in the pole position. Carrying this objective in mind, the HKEX proposed the establishment of the New Board in hopes to serve wider range of issuers and to provide more diversified investment opportunities to the investors.

Main Features of the New Board

Characteristics Common to both PRO and PREMIUM

One of the distinctive features of the New Board is that both segments are open to New Economy companies with non-standard governance structures. Majority of technological companies, such as Facebook Inc., adopt the Weighted Voting Rights ("WVR") structure (as opposed to the conventional "one share, one vote" structure) to prevent dilution of the owner managers' control over the company after raising equity capital. Traditionally, these companies are prohibited from listing on the Main Board.

Currently, companies with a "centre of gravity", i.e. business focus, in Mainland China are banned from a secondary listing in HK pursuant to the 2013 Joint Policy Statement Regarding the Listing of Overseas Companies jointly issued by the Securities and Futures Commission of Hong Kong (the "SFC") and the Stock Exchange of Hong Kong Limited (the "SEHK") in September 2013 (the "2013 JPS") (Link: http://www.hkex.com.hk/eng/rulesreg/listrules/listsptop/listoc/Documents/new_jps_0927.pdf) with the intention to discourage such companies from seeking to avoid the more stringent rules that apply to primary listings by listing via an overseas listed shell.

These companies are now allowed however to list on either segments of the New Board without extensive changes of existing governance structures. Secondary listings in Hong Kong by Mainland companies are therefore welcomed.

Unique Characteristics of PREMIUM

PREMIUM targets at companies that do meet the financial and track record requirements of Main Board, but cannot list in Hong Kong due to the adoption of non-standard governance structures. PREMIUM is open to both retail and professional investors. As a result, a more stringent approach similar to the existing rules governing the main board is proposed to better safeguard the interests of the investors. Quantitative requirements, including but not limited to track records of profits, public float at listing and financial tests, equivalent to those of the Main Board applies to PREMIUM applicants.

Overseas applicants, in terms of place of incorporation and central management and control, to PREMIUM will be required to provide those equivalent shareholder protection standards in place with the SFC under the 2013 JPS. An exemption is granted to companies already listed on NYSE or NASDAQ.

Unique Characteristics of PRO

In contrast, PRO targets start-up companies which do not meet the financial or track record criteria of GEM or the Main Board, subject to a minimum market capitalization of HKD 200 million. It only opens to professional investors due to the higher risk exposure as a result of the “lighter touch” approach to initial listing requirements.

Regulatory cooperation requirement under the 2013 JPS would continue to apply but requirements to provide equivalent shareholder protection standard to those under 2013 JPS are proposed to be waived.

The Prospectus requirements are also exempted as long as Listing Documents provide accurate and sufficient information to enable informed investment decision.

The Benefits of Introducing the New Board

1. Maintain the Competitiveness as Leading IPO Market

The US market allows Weighted Voting Right (“WVR”) structures, which is prohibited in Hong Kong. The case where Chinese e-commerce giant Alibaba Group Holding Ltd. abandoned Hong Kong and opted to list in New York has called for permitting the listing of companies with WVR structures. WVR structure is common in innovative companies such as Alphabet Inc. and Facebook Inc. because founders want to retain control after raising equity capital through IPO. WVR structure gives founders voting control disproportionate to their economic interest in their companies. In aggregate, the IPO funds raised by companies in categories targeted by the New Board for which Hong Kong was unable to compete for totalled USD 49 billion in the past ten years, which represents 17% of the IPO funds raised in Hong Kong over the same period. Permitting WVR structure in the New Board means Hong Kong will be able to compete for the enormous amount of funds in the future.

2. Diversification of Market

Although Hong Kong was the top IPO market worldwide, companies currently listed on the HKEX are not diverse enough. The financial and property sectors make up 44% of the total market capitalization of the Hong Kong market. Only 3% of funds were raised from technology companies. The reason is that many high growth sectors, like Biotechnology, do not have a long track record of profitability as they have not yet reached the commercialization stage and spent most capital on research and development. The financial or track record criteria to list on the Main Board and GEM Board are insurmountable to them. As a result, in the last ten years, about 6,000 Mainland companies which do not meet Main Board profitability test or GEM Board cash flow test have shunned Hong Kong for other markets like NASDAQ, NYSE and NEEQ. The lower threshold of the New Board will likely attract high-growth new economy companies to list in Hong Kong and hence diversify Hong Kong stock market.

Issues of Introducing the New Board

Issue 1: Regulatory Arbitrage and lowering of control over listed companies

In the 2013 JPS, the "centre of gravity" test was introduced to prohibit Chinese companies from pursuing secondary listing in Hong Kong. The test was introduced "*based on our (the SFC and the SEHK) understanding of regulatory practices in major jurisdictions and after a review of recent experience of dealing with applications for secondary listings*". The Concept Paper also recognizes that the intention of the prohibition was to discourage Mainland companies from regulatory arbitrage (i.e. to avoid more stringent rules of the primary exchange board via an overseas listed shell).

However, the HKEX has lifted the prohibition for PRO and PREMIUM applicants from Greater China. The claimed basis was that "several" Mainland Chinese companies have listed on overseas markets for reasons other than regulatory arbitrage (e.g. for joining the US established investor ecosystem familiar with the technology sector). The Concept Paper has not imposed follow-up measures to mitigate the risks and considerations expressed in the 2013 JPS after lifting the prohibition. Taking into account that PREMIUM issuers are eligible to reach retail investors, a blanket waiver of all Mainland applicants from the "centre of gravity" test based on examples seen in "several" Mainland Chinese companies listing in the US can hardly be justified.

Furthermore, the HKEX proposed to waive the requirement for PRO applicants listed elsewhere and PREMIUM applicants listed on NYSE or NASDAQ to demonstrate equivalent shareholder protection standards to those in Hong Kong. As admitted by the HKEX, this is by implication a reliance on the standards of the respective applicant's jurisdiction of primary listing. HKEX explained that such waiver is based on the recognition of potential arduous arrangements for the applicants to vary their constitutional documents (including to call a general meeting and request super-majority shareholder approval). HKEX's voluntary surrender of its regulatory power to overseas jurisdiction, on the basis of inconvenience for the applicant to comply with the established standards in Hong Kong, exposes Hong Kong investors to considerable risks and adversely affects the stability of Hong Kong's financial markets. Hong Kong investors will be burdened to understand the standards of the shareholder protection standards in relevant overseas jurisdiction. The enforceability of these foreign standards through Hong Kong's legal system is also in doubt. Hong Kong investors may not understand their rights under the law of overseas jurisdiction and may not know how to exercise their shareholders' rights.

Issue 2: How to reposition GEM Board after setting up the New Board

Traditionally, the GEM Board was positioned by the HKEX as a "stepping stone" to the Main Board. The introduction of the two segments, PRO and PREMIUM, would undoubtedly raise questions to the positioning of the GEM Board. In fact, the HKEX proposed in a separate consultation paper to remove the "stepping stone" concept by raising GEM Board's initial listing requirements and remove the streamlined transfer process to the Main Board.

From the perspective of issuer applicants, the PRO and PREMIUM segments may be more attractive than the GEM Board due to their relatively lower initial requirements in certain aspects. GEM Board being positioned in the middle of the Main Board and the New Board may find its value limited, pushing issuers to pursue to be listed on the two ends.

From the perspective of investors, the increase from 2 exchange boards to effectively 4 (due to the division of segments for the New Board), may appear confusing. The difference between each board and segment may appear subtle which will in turn affect the investors' understanding of the respective risks they are exposed to.

Conclusion

Hong Kong has been established as a leading IPO venue and international financial centre. We acknowledge HKEX's efforts in reviewing its listing regime and market structuring to cater for evolving needs and maintain Hong Kong's competitiveness in the international financial community.

We agree with the need for setting up a New Board. We also appreciate the division of PRO and PREMIUM segments to cater for different risk appetites and investment backgrounds of Hong Kong investors. We agree with the HKEX that the introduction of the New Board would require subsequent changes to the GEM Board for healthy developments of Hong Kong's securities markets. We are optimistic that the reform would be received as a necessary response to the challenges faced by Hong Kong in light of the developments of our neighbouring markets.

However, there are still issues to be solved that are yet to be addressed by the concept paper. In its proposals to broaden Hong Kong's capital markets access by welcoming New Economy companies with non-standard governance structures and overseas listed company pursuing secondary listing in Hong Kong, the HKEX and SFC have surrendered substantial regulatory power and exiting shareholder protection standards that are pivotal to Hong Kong's current leading position. The US Bureau of Labor Statistics examined Silicon Valley firms between 1991 and 2009 and found only 50% survived the first 5 years. Within 10 years, only 25% survived. After 15 years of starting, only 13% of firms were still operating. Considering the risks already posed to Hong Kong investors from the New Economy companies' governance structures and their survivability, the HKEX needs to provide more convincing justifications to show that softening of regulatory standards would not threaten the stability of Hong Kong's financial markets.

Acknowledging the fact that the HKEX is only conducting the initial stage of inviting comments via a concept paper, we expect the HKEX to provide further elaborations, with strong empirical data, and measures in future consultations to maintain investors' confidence in Hong Kong's financial infrastructure in safeguarding their interests.

If you have any further questions regarding this issue of CP insights or have any topic you would like us to cover, please submit your response here https://goo.gl/forms/gDLVThTmxGvMl4r12.

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