August 14, 2017

Hong Kong Exchanges and Clearing Limited
12F, One International Finance Centre
1 Harbour View Street
Central
Hong Kong

By post and email: response@hkex.com.hk

Dear Sir,

Re: ACGA Response to New Board Concept Paper

We welcome the opportunity to respond to the New Board Concept Paper.

The Asian Corporate Governance Association (ACGA) is a not-for-profit membership association chartered under the laws of Hong Kong. The association is dedicated to assisting companies and markets across Asia in their effort to improve corporate governance practices. In our educational outreach, we are guided by a practical, long-term approach. ACGA's operations are supported by a membership base of institutional investors, such as public pension funds and fund managers, as well as listed Asian companies, insurance and accounting firms, and universities. ACGA now has more than 100 corporate members, two thirds of which are institutional investors with around US$26 trillion in assets under management globally. They are also significant investors in the Hong Kong market.

High Level Comments

ACGA is opposed to the New Board proposal outlined in the Concept Paper. As a result, we have not responded to the detailed questions on the basis that we do not regard the concepts and details used to frame the "straw man" proposal and related questions to be an appropriate means of addressing the medium- or long-term development challenges of the Hong Kong market. Our reasons for taking this position are highlighted in the comments that follow.

ACGA believes that the analytical approach taken in the Concept Paper is flawed and, therefore, Hong Kong Exchanges and Clearing's (HKEX) chosen framework for defining and achieving desirable outcomes for the Hong Kong market is strategically unsound. The paper is almost exclusively focused on measures that would increase the number of IPOs. As a result, it fails to address a range of global market fundamentals that have a profound influence on Hong Kong's market value and potential as a global financial centre. While we strongly support HKEX's desire to encourage public debate about the future of Hong Kong's markets, we disagree with the approach taken on the core analysis used to support the New Board recommendations.

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The Limitations of the Listing Lens

The Concept Paper repeatedly equates the interests of issuers and intermediaries with the interests of the market. Indeed, it endorses the New Board "straw man" as "the best way of broadening capital market access in Hong Kong by opening up to a more diverse range of issuers". As a result, the exhibits and arguments presented in support of the New Board do little to provide a full strategic context for considering how changes to Hong Kong's market landscape might relate to the long-term interests of all market participants.

For example, the over-reliance on the listing lens ignores decades of relevant research and market experience establishing the importance of broad-based market governance to positive outcomes for both investors and issuers. This is crucial as we consider how to achieve such outcomes for the Hong Kong market in a period when the composition of investors and the nature of their investment process is changing with the shift to passively managed institutional product, which is more sensitive to market-level valuation trends.

As a result, the New Board proposals would only make sense if they were tested against broader investor, strategic, and regulatory trends that will likely shape how they might perform over the long-term. This would seem prudent as HKEX's experience with the underperforming GEM market, which was specifically designed to cater to higher risk companies, highlights how analytical over-reliance on narrow listing considerations can miss powerful market realities. Indeed, the long-term valuation dynamics of the Main Board and the trajectory of China's market development, including the uncertainty as to whether weighted voting rights (WVR) would ever be permitted for Mainland Chinese enterprises, arguably play a more material role in defining Hong Kong's competitiveness as a listing venue than the specific structure of the listing regime.

Quantity Does Not Equal Quality or Innovation

It is demonstrably the case that the volume of IPOs does not equal innovation or "diversity." It should also be noted that the "new economy" label used in the paper to define attractive listing candidates is not strategically robust from an investment perspective. To paint so-called "new economy" issuers and their shares with a uniform brush is to assume that Hong Kong investors believe technology stocks only go up. More analytical insight is warranted when basing a case on high-beta sectors which have skewed performance distributions with a small group of big winners and a large number of losers. Indeed, the repeated cherry-picking of data and timeframes in the Concept Paper's exhibits is reminiscent of pitch book logic and robs the analysis of the credibility needed for a successful policy debate, one that transparently addresses legitimate and competing interpretations of desired market outcomes.

Just as important, the Concept Paper arrives at its conclusions while ignoring a number of fundamental issues that are recasting assumptions around the outlook for global equity markets and exchanges. These include, but are not limited to, the rapid rise of passive investing, the growth of private markets and the associated decline in IPOs globally, the

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growing threat of blockchain to conventional exchanges, more coordinated approaches to defining global financial risk and encouraging system resilience, and increased pressure on index providers to address investor stewardship priorities and concerns about risk concentration in broad market indices, as witnessed in the recent decision of S&P Dow Jones to exclude companies with multiple share classes from joining the S&P 500 Index. This striking gap in the presentation deserves attention because the Concept Paper's limited focus on IPO league tables effectively assumes away any impact on Hong Kong from the most hotly debated topics today in global markets.

Another area where the paper is curiously undeveloped concerns the complex realities related to the competition for global mega IPOs. We question whether the desire to compete for the IPOs of Saudi Aramco, Ant Financial, or countless other potential mega IPOs should drive fundamental changes in market structure or regulatory policy. These one-off IPO opportunities are often disconnected from the long-term value drivers that shape sustainable market development and involve complex externalities sometimes related to national, but not market interests. Perhaps thought needs to be given as to how to create special mechanisms, possibly underwritten by the government, to deal with these situations. Hong Kong has arguably trod this path before with the Tracker Fund following the Asian Financial Crisis. Special conditions were also required as part of the Rusal IPO in 2010, to ensure that investors were not exposed to risks that would have been regarded as abnormal in the context of the Hong Kong market. Our key point is that the market as a whole should not be devalued simply to facilitate the listing of a single large firm.

Specific Comments

For the reasons outlined above, we believe the conceptual underpinnings of the New Board and the related discussion about design considerations rests on weak foundations. As a result, we believe that the proposed design criteria of the New Board deserve re-examination to reflect the following problems.

Going Down Market

The Concept Paper starts from the proposition that the future of the Hong Kong market rests with "walled gardens" for distinct issuers and investor groups. The "straw man" is based on the creation of two markets which would accept listings from companies with so-called "non-standard governance features" such as WVR, including secondary listings of Mainland Chinese companies. New Board PRO, for professional investors, would target listings by pre-profit early stage "new economy" companies and would utilise a light-touch listing regime. New Board PREMIUM would be open to both retail and professional investors and to listings which can meet higher standards than New Board PRO.

We see little evidence in the paper to support this design choice and are puzzled at the lack of attention to the likely impact on the Main Board. Indeed, segmentation distracts from and degrades Hong Kong's core value proposition as a mature and increasingly sophisticated

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market. The growth of the Main Board is an endorsement of Hong Kong's vital role as the international market for Chinese enterprises capable of meeting higher governance standards. By contrast, we have learned with GEM that a design strategy which rests on market segmentation, in the absence of a high-touch regulator, can undermine market credibility and the willingness of stakeholders to address more strategic issues of innovation or regulation.

The new market proposals are reliant on the unexamined belief that the Main Board can be ring-fenced from the new boards. This is surprising in a market that has been regularly sidetracked by back-door listings, shell company transactions, and opaque merger and acquisition (M&A) initiatives that have often undermined well-accepted standards of market governance. Moreover, the Concept Paper fails to address likely corporate responses to the New Boards as well as the growing impact of M&A on the shape of Hong Kong and China's markets. To make no mention of how the Main Board would change in the face of value leakage to the less regulated new boards seems almost reckless. Surely some well-considered scenarios could have been presented to focus the public discussion on likely future pathways for Hong Kong's market as a basis for considering policy choices and available risk mitigation strategies?

A second area of concern is the approach taken to secondary listings of China-nexus companies: the paper recommends a casual strategy of outsourcing governance and transparency risks to other market regulators in competing jurisdictions, putting a diverse population of Hong Kong investors in the hands of intermediaries. Here the difference between the interests of intermediaries with defined interests in listings as opposed to the bulk of investors, who rely on long-term market returns, is most stark. The limited governance fundamentals of the proposed new boards are inconsistent with active price discovery and trading trends that are associated with well-supported valuations and positive long-term market outcomes.

Finally, we believe the approach taken to the definition of "new economy" companies is flawed and would result in hazardous short-term measures that could threaten, rather than enhance, Hong Kong's ability to address the needs of truly innovative companies. The discussion in the Concept Paper effectively demonstrates the difficulty that HKEX, in its listing regulatory role, would face in reserving special listing considerations for "new economy" companies. The sector descriptors used in the paper would be just as likely to select for unremarkable manufacturers and service providers of briefly innovative commodity goods as they would equities with the unicorn characteristics so frequently cited by "new economy" enthusiasts. We would also caution that a principles-based listing process, which already struggles to cope with legally safe but misleading assertions about "innovative" technologies and the qualifications of entrepreneurs, is ill-suited to dense claims about patents, complex technologies, and new market developments.

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Recommendations

In light of our concerns about the analytical approach taken to support this paper, we believe that the Hong Kong market urgently needs a more coherent discussion concerning the design principles required to support long-term development of Hong Kong's markets. With this in mind, we would like to contribute to this discussion by urging more focus on the following elements.

Enhanced Governance Would Reduce the Risk Associated with Innovation

Strategies that enhance the governance foundations of the Hong Kong market have the potential to facilitate more resilient market innovation and development. The regulatory and legal resources of the Hong Kong market underpin the market's operations and valuation. These factors must be evaluated alongside listing rules, investor trends, and the interests of public groups when thinking about how any market developments will translate into tangible outcomes. ACGA's work on Asia's market eco-systems supports this analysis.

We highlight this point because we believe that there is now in Hong Kong a credible case for the listing of pre-profit companies. Institutional investors have well developed analytical and risk management tools to cope with pre-profit companies. Permitting pre-profit companies to list may also reduce the pressure for accounting manipulation. That said, this step, which has the potential to add to the risk profile of the market, should be accompanied by consideration of a range of enhanced governance options that would support this type of market development and innovation. We believe that investors and other stakeholders would respond with interest to more rounded market development proposals which address the following issues:

- **Continuous disclosure:** What steps can be taken to improve the performance of Hong Kong listed companies on their continuous disclosure obligations? Positive standards of continuous disclosure are regarded as an important risk mitigant by the largest global investors. These investors are experts at pricing risk, will analyse novel and innovative business models, and seek alignment with long-term focused companies. Unfortunately, their work can be undermined unless the Hong Kong market continues its efforts to ensure more timely disclosure and to discourage late, misleading, and boilerplate reporting that degrades the whole market.
- **Board governance:** More work is needed to improve the individual skill and competence of directors of Hong Kong listed companies. Boards need to meet higher risk management standards (see the recent Hong Kong Institute of Corporate Secretaries report) and address poor asset valuation practices which have suffered from an over-reliance on advisors and other intermediaries whose work often fails to meet credible international standards. More focus is also needed on pre-IPO governance preparation, in particular the appointment of independent directors and audit committees at an early stage. It is ultimately counterproductive to allow companies to come to market with directors who have a limited understanding of their roles and duties under law, and lack the practical skills needed to be directors.

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- **Delisting:** The Concept Paper correctly draws attention to the role that more pro-active and efficient delisting practices could have in safeguarding the Hong Kong market. We believe this is an important and productive mechanism to address if the goal is to enhance the vitality of Hong Kong's markets. A risk-tolerant IPO listing regime can result in market stagnation when delisting mechanisms are not properly and transparently deployed.

We would be pleased to discuss our comments and suggestions above in more detail with the Exchange.

Yours truly,

Jamie Allen
Secretary General

**This letter was prepared with the input of Melissa Brown, Specialist Consultant, ACGA.*

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