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The Hong Kong Stock Exchange's Concept Paper on a New Board and Consultation on Changes to the GEM and Main Board Listing Rules:

What You Need to Know

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The Stock Exchange of Hong Kong Limited (the **SEHK**) recently released its long-awaited concept paper on a potential new board (the **New Board Concept Paper**) and its related consultation paper on its review of the Growth Enterprise Market (**GEM**) and proposed changes to the GEM and Main Board Listing Rules (the **GEM and Main Board Consultation Paper**). Together, the papers form a holistic review of the Hong Kong listing framework, including the introduction of a new board in Hong Kong targeted at "new economy" companies, as well as proposed changes with respect to the listing criteria for the Main and GEM Boards.

The main impetus behind the New Board Concept Paper is to enhance Hong Kong's competitiveness in attracting high-growth companies in the new economy sector. The loss of Alibaba's listing to the New York Stock Exchange (**NYSE**) in 2014 due to Hong Kong not being able to list companies with weighted voting rights (**WVR**) structures has been well documented and prompted an earlier SEHK consultation focussed purely on the WVR debate, which was ultimately abandoned due to a lack of support from the Securities and Futures Commission (**SFC**) for the proposal put forward by the SEHK at that time.

The New Board Concept Paper goes beyond the previous WVR consultation by reframing the debate in the context of a new board targeted at new economy companies (the **New Board**) and proposes that various obstacles that might discourage new economy companies from listing in Hong Kong should not apply to listings on the New Board. These obstacles include: (1) the requirement for an applicant to have generated certain levels of profit or cashflow before it is eligible for listing; (2) the prohibition on WVR structures; and (3) the prohibition on secondary listings of PRC companies.

The separate but concurrent GEM and Main Board Consultation Paper proposes to increase the admission criteria for the Main Board and the GEM Board in order to emphasise the position of the Main Board as a premier board, reposition the GEM Board as a board for established SMEs and address concerns about the quality of the GEM market.

The SEHK is seeking responses to the both the New Board Concept Paper and the GEM and Main Board Consultation Paper by 18 August 2017.

This note sets out a summary of the key features of both papers and the rationale behind them.

The GEM and Main Board Consultation Paper: Changes to the Existing Boards

Summary

The GEM and Main Board Consultation Paper includes the following key proposals:

- **Main Board**: (1) enhanced admission criteria - minimum expected market capitalisation for profit test applicants to increase from HK$200 million to HK$500 million and minimum public float value to increase from HK$50 million to HK$125 million; and (2) increased lock-up period on controlling shareholders from one year to two years.

- **GEM**: (1) enhanced admission criteria – minimum expected market capitalisation to increase from HK$100 million to HK$150 million, minimum public float value to increase from HK$30 million to HK$45 million and cash flow test to increase from HK$20 million to HK$30 million; (2) mandatory 10% public offering; (3) eliminating the streamlined transfer process from GEM to the Main Board; and (4) increased lock-up period on controlling shareholders from one year to two years.

Timing

If implemented, the revised admission criteria are expected to take effect around six months after the date of the consultation paper (*i.e.*, around mid-December 2017). Companies wishing to list which may fall short of the revised criteria should bear this in mind when considering the timing of their listing applications. The SEHK recognises the GEM and Main Board Consultation Paper will likely trigger an influx of listing applications for both the Main and GEM Boards during the consultation period, and the vetting period for new listing applicants may increase as a result.

For GEM issuers wishing to transfer to the Main Board, there will be a three-year transitional period under which existing GEM issuers (and certain GEM applicants that submitted a listing application on or before the date of the consultation paper) can avail themselves of a transitional arrangement for GEM transfers to the Main Board.

Rationale

The SEHK is proposing to enhance the admission criteria for the Main and GEM Boards in order to ensure a clear distinction between the different boards. The other proposed changes to GEM (such as a mandatory 10% public offering and an increased lock-up period) are intended to improve the quality and liquidity of the GEM market.

Due to ongoing concerns with the quality of the GEM Board, the SEHK proposes to remove the stepping stone mechanism for GEM transfers to the Main Board so that the Main Board due diligence requirements cannot be circumvented. Subject to a transitional arrangement (as outlined above), GEM issuers wishing to move to the Main Board will have to appoint a sponsor to conduct appropriate due diligence, issue a prospectus-standard listing document, have published two full years of financial statements after its GEM listing (instead of the current one-year requirement) and not have been subject to any disciplinary investigation in relation to a serious breach or potentially serious breach of Listing Rules for two years (instead of the current one-year requirement).

The SEHK is proposing that the changes to the Main Board should occur irrespective of the outcome of any reforms to the GEM Board.

The New Board Concept Paper: Introduction of a New Board for “New Economy” Companies

Summary

The New Board Paper sets out a straw man proposal for a new (segmented) board with the following features:

- The new board is targeted at “new economy” companies.
- Unlike the existing boards, the new board would allow secondary listings of PRC businesses.
- The new board would be divided into two segments (PRO and PREMIUM), with the following key features:

	New Board: PRO	New Board: PREMIUM
Targeted issuers	Early-stage new economy companies	Established new economy companies with WVRs or other non-standard governance structures
Financial / track record criteria	No financial / track record criteria Cannot list on PRO segment if qualify for any of the other boards	Meets same financial / track record criteria as a Main Board listing applicant but fail to qualify for Main Board because of WVR structure
Minimum expected market capitalisation	HK$200 million – this is higher than that for GEM but lower than for Main Board	Same as for Main Board (which is proposed to increase to HK$500 million)
Public float requirement	Same as for GEM – 25% and minimum 100 investors	Same as for the Main Board – 25% and minimum 300 investors
Investors	Professional investors only	Retail and professional investors
WVR structures	Permitted	
Vetting process	Listing document does not need to be to a prospectus-standard; a financial adviser is sufficient and a lighter-touch suitability assessment	Prospectus and sponsor regime required
Overseas issuer incorporated outside an "Acceptable Jurisdiction"	No need to demonstrate shareholder protection equivalent to Hong Kong	Must demonstrate shareholder protection equivalent to Hong Kong, unless already listed on NYSE or NASDAQ
Key continuing obligations	Proposed to be the same as for the Main Board	

- New economy sectors include biotech, health care tech, internet and direct marketing retail, internet software and services, IT services, software, tech hardware and storage and peripherals. The scope of "new economy" is under consideration and further guidance is expected.
- The SEHK is seeking feedback on whether mandatory safeguards should apply to WVR companies and if so what form they should take. Feedback is also being sought on whether a New Board issuer should be delisted if it drops below a quantitative criteria (such as a share price below a certain threshold over a set period of time). No prescribed threshold is suggested in the New Board Concept Paper. For reference, the NYSE may initiate delisting procedures if an issuer's share price drops below US$1 over a consecutive 30 trading day period.
- Whether New Board issuers will be eligible for inclusion in major indices will depend on the rules of each index. The eligibility criteria for the Hang Seng Index as currently drafted would not include New Board issuers.

Pre-profit companies

Due to the higher risks of investing in pre-profit companies, the SEHK is proposing to limit the PRO segment to professional investors only (which would include high net worth individuals and companies that meet the prescribed thresholds under the Securities and Futures (Professional Investor) Rules). A professional investors-only segment would mean a lighter touch regulatory regime would apply. The SEHK proposes this would involve the appointment of a financial adviser (licensed for Type 6 regulated activity) and the preparation of a listing document that provides accurate information sufficient to enable professional investors to make an informed investment decision (rather than a Companies (Winding Up and Miscellaneous Provisions) Ordinance-standard prospectus). Certain issuers may be attracted by the lighter touch regime offered by the PRO segment.

However, retail investors would therefore be unable to invest in pre-profit companies even if they have very high valuations (so called “tech unicorns” such as SNAP Inc. (the maker of Snapchat) which was pre-profit when it listed recently on the NYSE with a market capitalisation of around US$30 billion). Query whether retail investors should be able to participate in such offerings where the expected market capitalisation is particularly high, and whether these types of high quality but pre-profit companies would wish to list on a board that offered no retail investors.

WVR companies

The New Board Concept Paper seeks views on how WVR companies should be governed and whether a PRO-segment WVR issuer should be governed in the same way as a PREMIUM-segment WVR issuer.

One potential approach is the disclosure-based approach adopted by the US, where no mandatory safeguards are imposed on WVR companies other than the disclosure of the WVR structure in the prospectus. The US model also prohibits companies without WVR structures from introducing them after listing.

However, given the differences between the investor protection landscape in the US and Hong Kong, the SEHK will be expected by many stakeholders to offer a more robust approach (in particular for the retail PREMIUM segment). Certain mandatory safeguards could be considered, such as: (i) a higher expected market capitalisation than for Main Board and non-WVR New Board issuers; (ii) sophisticated investors must have a material stake in the issuer at IPO; (iii) a maximum voting differential between the owner-manager shares and ordinary shares of, for example, 10:1 (however, this would mean companies like Snap Inc. would not be able to list on the New Board as the IPO investors in that case had shares which carried zero voting rights); (iv) no issue of multi-vote shares after listing except for rights issues that do not increase the owner-manager’s existing control; (v) mandatory loss of enhanced votes in certain circumstances (*i.e.*, when the underlying rationale for according enhanced voting rights to an owner-manager ceases to exist, such as on a sale of their shares or when they cease to hold their management role); (vi) enhanced corporate governance requirements as compared with Main Board issuers; (vii) multi-vote shares treated as one-vote shares for certain decisions such as the appointment of independent directors; (viii) sunset clauses; and (ix) holders of WVRs to be automatically deemed as connected persons.

The SEHK proposes that WVR companies which are already listed on the NYSE or NASDAQ with a good compliance record would be subject only to the disclosure-based approach with no additional mandatory safeguards (unless its governance structure is an extreme departure from Hong Kong governance norms). It is not clear if companies offering shares with zero voting rights would be considered an extreme departure.

Timing

If there is market support for the New Board, the SEHK aims to finalise the New Board listing rules in early 2018.

Rationale

<u>For Targeting New Economy companies</u>: The SEHK has stated that the key driver for the proposal is to secure Hong Kong’s future as a preeminent IPO centre, and it believes pursuing new economy companies is the way forward as such companies are in high-growth sectors.

This raises the question of whether it is fair to allow only new economy companies to list on the New Board and whether it is too short term to target only these types of companies. In addition, it is worth noting there will be no precise definition of a "new economy" company. The SEHK states in its FAQs that no fixed definition will be proposed due to the evolving nature of technology, but the key principle is to identify businesses in sectors where innovation, technology, IP and new ways of commerce in totality are the primary drivers for its growth and success. The Listing Committee will have ultimate discretion to determine this on a principle-based approach under a set of guidelines that will be developed. This raises the issue of regulatory uncertainty and potential inconsistent decision-making as regulators become involved in determining what is innovative.

The SEHK does not address whether there should be a continuing post-listing assessment of whether a company continues to qualify as "new economy" or any restrictions on the acquisition of old economy businesses by New Board issuers. Accordingly, there may be companies that initially list as "new economy" companies (and therefore benefit from the ability to have a WVR structure and/or the pre-profit entry requirements of the New Board) but acquire or enter old economy businesses after listing. A recent example is Amazon's acquisition of Whole Foods (a retailer with a bricks and mortar presence) in the US. In a more extreme scenario, this could allow an issuer to maintain its listing on the New Board even if a material proportion of its revenue or profits are later derived from old economy sectors, and over time could result in the transfer of a significant proportion of old economy (listed) businesses and assets to WVR structures. On the other hand, it seems difficult for a regulator to manage a framework that imposes restrictions or thresholds on investing in old economy sectors (with all the subjective assessment that entails), and any such restrictions would likely dampen the popularity of the New Board for issuers.

<u>For permitting pre-profit companies and WVR structures</u>: The rationale for permitting pre-profit companies and WVR structures is tied to attracting high-growth companies in innovative sectors where (1) such companies often prioritise market share over profits and some may even be without revenue (such as biotech companies at the research and development stage) and (2) WVR structures are more prevalent as a means to allow owner-managers to retain control.

In the US, retail investors can invest in pre-profit or WVR issuers from the old or new economy. However, it has often been argued that Hong Kong should not follow the US model, as it has a very different investor protection landscape (the lack of ability for shareholders in Hong Kong to bring US-style class action suits on a contingency fee basis and the higher proportion of retail investors in Hong Kong being just two of the differences). As a result, the SEHK is taking the segmented approach outlined above (with only professional investors being able to invest in pre-profit companies) and has limited the New Board to new economy companies (where the risks are perhaps more justifiable due to the high-growth sectors they are in).

The SEHK proposes that the same key continuing obligations applicable to Main Board issuers should apply to New Board issuers. However, in the case of pre-profit or WVR companies, or companies which did not need to demonstrate an equivalent standard of shareholder protection, query whether a higher level of corporate governance standards and/or more frequent financial reporting than is currently applicable to a Main Board issuer should apply.

<u>For allowing secondary listings of PRC businesses</u>: A number of large PRC companies have already listed on exchanges elsewhere (in particular the US in the case of new economy companies). Currently, such companies are prohibited from obtaining a secondary listing in Hong Kong due to a prohibition on the secondary listing of companies with a "centre of gravity" in Greater

China. This was introduced to prevent such companies from listing overseas (for example on exchanges with less credible regulatory standards) and then conducting a secondary listing in Hong Kong to avoid the more stringent requirements of a primary listing in Hong Kong.

Now that many large PRC new economy companies have listed on credible exchanges, the SEHK intends to allow PRC companies to secondarily list on the New Board. However, the New Board Concept Paper does not specify whether only PRC companies listed on certain exchanges (such as the US exchanges) would be eligible.

Conclusion

The SEHK frames the New Board proposal as a straw man proposal. There are currently open questions on fundamental issues such as the scope of what is considered as “new economy”, how post-listing transactions involving old economy businesses or assets will be dealt with and how WVR structures will be governed. Stakeholders are encouraged to engage in the consultation process and provide their views on whether the SEHK has struck the right balance between market development and investor protection – it is clear that a healthy debate will be generated by the proposal.

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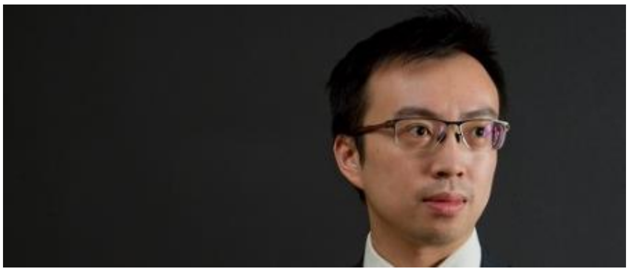

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