Capital Markets
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Client Alert

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Embracing New Economy Companies

The fast-growing new economy companies in China, which prefer to adopt a weighted voting right (WVR) structure, face restrictions in listing their equity securities in China. When these companies have advanced to a stage that requires large scale capital fundraisings, listing their equity securities outside of China becomes an attractive option for them. Historically, however, these companies must either abolish their WVR structures in order to be eligible to list their equity securities in Hong Kong, or (for those who refuse to compromise on the founders' control over the company), choose other listing venues such as those in the US.

Twenty-eighteen is bound to witness market and legal changes for WVR companies in Hong Kong and elsewhere. Following the Hong Kong Stock Exchange's (HKEx) phenomenal development to welcome equity listings of WVR companies, the Singapore Stock Exchange is also considering amending its listing manual to allow the listing of WVR structured companies. The PRC is proposing to set up a separate listing mechanism for the secondary stock listings of unicorns returning to the A-share market and for the primary stock listings of new economy companies. This trend of cross-border actions and reactions has been intensifying and accelerating the competition for new economy companies amongst PRC stock exchanges, the HKEx and the traditionally attractive US stock markets. New economy companies with WVRs are likely to have much greater bargaining powers on choosing their primary and secondary stock listing venues in the near future.

Current positions in China and Hong Kong

New economy companies in China are anticipated to grow rapidly given their unique contributions to the Chinese economies in recent decades. After a prolonged period of economic growth in the past 30 years, China is moving away from competing in the arena of cheap labour and low costs. To sustain its economic growth, China has shifted its focus towards innovative and technology industries. Many ambitious Chinese technology firms are positioning themselves as innovators in their areas of expertise and are investing heavily in R&D.

Hong Kong should be the ideal capital raising platform for Chinese companies given its geographical proximity, common language, culture and economic interests in relation to China. However, new economy companies listed on the HKEx in the past 10 years only comprises three percent of HKEx's total market capitalisation, in contrast to 60% and 47% for Nasdaq and NYSE. According to statistics collected by the HKEx, Hong Kong is lagging behind in attracting technology and new economy companies mainly because of its historical ban on companies using the WVR structure.

In China, equity securities with unequal voting rights are prohibited from listing on the PRC stock exchanges. Currently, only joint stock companies with limited liability incorporated in China are eligible to list their stocks on the exchanges in China.

The Chinese Company Law stipulates the principle of one share, one vote for joint stock companies and places emphasis on equal protection for all holders of ordinary shares, in particular, equal voting rights. Conditioned upon the Chinese government's legislative change on company law, foreign exchange relaxation and development of a mature capital market, acceptance of the WVR structure in the PRC seems to be a distant target. Nevertheless, both the China Securities Regulatory Commission (CSRC) and the two stock exchanges in the PRC have publicly announced their proposals to attract the listings of equity securities of the new economy companies in the past few weeks. Their targeted new economy sectors include biotech, cloud computation, artificial intelligence and high-end manufacturing. To demonstrate its determination to move forward, the CSRC recently granted an initial public offering (IPO) approval for Foxconn Industrial Internet, a new economy company, within 36 days, which sets a new record for the IPO approval process in China. The PRC regulator's attempt to lure listings of new economy companies' equity securities is obvious and influential.

Hong Kong: WVR structure for innovative companies

Under the HKEx's proposed reform, only innovative companies are permitted to adopt the WVR structure for stock listings in HK. Coupled with the main objective of attracting high quality and high growth companies, eligible companies have to demonstrate a genuine nature of innovation internally and externally. Internally, the nature of the innovation is expected to be demonstrated in terms of its distinctive core business, significant proportion of R&D, unique intellectual properties and outsized market capitalisation. Externally, an eligible company must show its success by:

(a) its track record and projection of high business growth;

(b) receipt of meaningful third party investments from at least one sophisticated investor; and

(c) recognition of the contribution of the WVR beneficiaries in the success of the company.

To limit applicants to well-established and high-profile companies, the expected market capitalisation of a WVR company is proposed to be at least HK$10 billion ($1.28 billion approximately) and at least HK$1 billion of revenue if expected market capitalisation is less than HK $40 billion.

More detailed guidance on suitability to list equity securities with a WVR structure is likely to be put forward by the HKEx in April. Since innovation is a concept that may change over time as technology, markets and industries evolve and develop, it will be a challenge for the HKEx to screen applicants seeking to list their equity securities with WVR structures to prevent superficial applications of new technology to an otherwise conventional business from taking advantages of the WVR structure. Nevertheless, as HKEx chief executive officer Charles Li publicly discussed, 90% of the cases on the interpretation of innovation can be settled objectively and consensually. Only 10% of the cases are expected to be more controversial. The reform is expected to be a meaningful change to Hong Kong's capital markets.

Safeguard measures

A basket of safeguard measures will be incorporated in a WVR company's constitutional documents to allow shareholders to take civil actions against the company if needed. Major protective measures include natural sunset clauses, a minimum of 10% voting power of non-WVR shareholders, and reservation of significant decisions for non-WVR shareholders.

Only directors of WVR companies seeking new listing on the HKEx can have WVRs. The directors' entitlement to the WVRs are not permanent and will cease when the director dies, ceases to be a director, incapacitates or transfers the interests of those shares. These natural sunset clauses are designed to avoid stipulating artificial basis and timeline to restrict WVR benefits that may cast unintended consequences to a WVR company's corporate activities.

To add additional protections, a WVR company to be listed on the HKEx must cap the voting power attached to WVRs at no more than 10 times of the voting power of ordinary shares. The proportion of WVRs cannot be increased after listing. To align the interests of WVR and non-WVR shareholders at the time of listing, the aggregate shareholding of WVR shareholders must be in the range of 10% to 50% of the underlying economic interests of the company's issued shares. This requirement is a one-off requirement and will not be imposed after listing. A simple illustration under this framework would be: a WVR beneficiary having 10% of its shares with a maximum voting rights of 10 times may exercise up to approximately 52.6% voting rights of a WVR company.

In contrast to the US listing regime that adopts a disclosure-based regime with less restrictions on the WVR structure, Hong Kong is proposing to adopt an enhanced disclosure and an enhanced corporate governance structure. WVR companies are required to display warnings and a distinctive W stock marker on listing documents and corporate communications.

For qualifying companies already listed on the New York Stock Exchange, the Nasdaq and the Main Market (Premium) of London Stock Exchange before December 15 2017, their secondary listing in Hong Kong may not require any changes to their existing WVR structures and constitutional documents. Most importantly, Chinese companies that were previously prohibited from secondary listing in Hong Kong due to so-called centre of gravity restrictions are now permitted to have a secondary listing in Hong Kong. In the context of spinoffs of WVR companies, the HKEx will launch a separate consultation on corporate WVR beneficiaries in around July 2018.

What's next?

According to the HKEx's updated accelerated timetable, the proposed listing rule amendments will become effective in late April 2018. The first batch of WVR companies is expected to be listed in Hong Kong soon afterwards. In the IPO pipeline, at least five Chinese new technology firms have indicated their interests to list their equity securities on the HKEx, including the mainland Chinese smartphone maker Xiaomi, with an expected valuation of up to $100 billion.

Public statistics show that around 200 Chinese new economy companies have considered listing stocks abroad and Hong Kong is one of the considered (or preferred) listing venues. Yet, in light of the proposed regulatory changes in various exchanges, whether Hong Kong can successfully attract targeted companies in the medium term remains uncertain. Moving forward, it is expected that the fastest moving stock exchange with the greatest execution level of accepting WVR structures can win this winner-takes-all listing venue competition.

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