

# Hong Kong Gears Up to Welcome Dual Class and Biotech Winners

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After six months of debate, the market welcomes the [Consultation Conclusions to the Hong Kong Stock Exchange's New Board Concept Paper](#), issued on 15 December under an upbeat press release titled "HKEx Proposes Way Forward to Expand Hong Kong's Listing Regime". The Exchange's new blueprint indicates a positive, if somewhat cautious, step forward in opening up Hong Kong to new classes of listing candidates.

## Opening the door for dual class share and biotech companies

The proposed New Board (comprising the PREMIUM and PRO segments) has been shelved. The market was concerned that creation of a new trading board would create unnecessary complexity and in any event, it was believed that quality issuer would always choose the Main Board and there were doubts as to whether establishment of the New Board would be the best way at this stage to achieve the goals identified.

The Exchange has therefore decided on a simpler solution. It will rewrite some of the Main Board rules to let in two very carefully specified classes of target listing candidates, namely, high-growth innovative companies with weighted voting rights (WVR or dual class share structures) and pre-revenue biotech enterprises.

## Dual class companies

The opening of doors to dual class share structures has been handled with abundant caution. The entry requirements for WVR companies are highlighted in the box below:

### WVR company entry requirements

- minimum expected market capitalisation of HK\$10b
- if below HK\$40b of market capitalisation, meets higher revenue test of HK\$1b in the most recent audited financial year
- qualifies as a "new economy" company, namely:
  - has been successful due to the application of new technologies, innovations, business models, etc. in the core business
  - has research and development (R&D) as a significant contributor to value and cause of expense
  - has had its success demonstrably attributable to unique features of innovation / IP
  - has an outsized market cap or intangible asset value
  - high business growth as measured by operations, users, customers, unit sales, revenue, profits, market value, etc., with a continuing trajectory
- meets the following requirements in relation to the WVR structure
  - the WVR holders must have been materially responsible for the growth by way of skills, knowledge or strategic directions
  - the WVR holders must have an active executive role and assume the role of directors at the time of listing
  - has suitable shareholder's protection mechanisms (see the box "Safeguards over WVR" below)

- has received meaningful third party funding from a sophisticated investor (including financial institutions), retaining at least 50% of investment at time of listing, with a minimum 6-month lockup (but this does not apply in a spin-off or other exceptional circumstances)
- is a “genuine” candidate fitting the target profile – demonstration of the above factors on a superficial basis will not be accepted, and the Exchange may reject extreme case of non-conformance with governance norms (e.g. shares with zero voting rights)

## Limits over the use of WVR

A hot topic of debate during the consultation process was the risk that WVR may be abused by already-listed companies. The Exchange proposes to deal with this by “ring fencing” measures, namely:

- Only new applicants can have WVR structure.
  - Anti-avoidance measures will be put in place to prevent circumvention.
  - Circumvention will constitute a breach of listing rules and will bring into play the normal regulatory enforcement powers.
- After listing, a company is prohibited from increasing the proportion of WVR in issue, or issuing any further WVR shares (except in a rights issue or open offer).

## Safeguards over WVR

- WVR can be held by eligible persons only – “sunset” provisions
  - must be directors – the WVR will cease upon cessation of directorship, death or incapacity, or transfer of the share
  - must meet minimum equity thresholds at time of IPO to make sure WVR holders’ interests are aligned with other shareholders
  - time-defined sunset clause is **not** required
- limits on WVR
  - WVR to be attached to specific class(es) of shares – the rights attached to the WVR shares must be the same as other classes except only as to voting rights
  - the rules may require that where prescribed majorities are set for shareholders’ resolutions, in the event that a holder of WVR shares casts his / her votes in circumstances that the holder should not, such resolutions (sic. – presumably the Exchange means such votes) shall not be counted
  - WVR to be capped to not more than 10 times the voting power of ordinary shares, and non-WVR holders must hold at least 10% of the votes eligible to be cast at general meeting and this same percentage (10%) of one-share-one-vote shares must be able to convene a general meeting
  - a number of matters must be decided on a one-share one-vote basis – e.g. material changes to constitutional document, variation of class rights, etc.

Enhanced disclosure will be required in relation to WVR, including the use of a unique stock code or marker, and appropriate warnings in the prospectus. Enhanced corporate governance will also be required (basically mandatory requirements for a corporate governance committee comprising independent non-executive directors and the engagement of compliance advisers). The prescribed safeguards must be entrenched in the articles.

## Biotech companies

Biotech companies are defined as companies engaged in the research and development, application and commercialisation of products, processes or technologies in the biotech sphere. The Exchange has identified this as a key target group for what in essence is a class exemption for pre-revenue companies.

The focus on the biotech sector is based on the fact that these companies tend to be highly regulated (e.g. by the US Food and Drug Administration) under a regime that sets external milestones on development progress, and that these companies make up the majority of listing candidates in the pre-revenue stage.

The Exchange has drawn out the parameters around the biotech companies that will qualify for this reform. These features are highlighted in the box below:

#### **Biotech company entry requirements**

- minimum expected market capitalisation of HK\$1.5b
- engaged in R&D
- has unique features of innovation / IP reasonably expected to give rise to commercialisable patents, copyrights, etc.
- has at least one product beyond the concept stage
- has as primary reason for listing the raising of funds for R&D
- has a portfolio of durable patents, registered patents, etc. demonstrating rights to the new technologies
- has previously received investment from at least one sophisticated investor (including financial institutions)
- meets enhanced working capital requirements (125% of requirement for next 12 months)
- has two years' record of operations in the current business

The company will be required to make enhanced disclosures in its prospectus to inform the market appropriately of the nature of the business and the R&D risks involved. To ensure liquidity in these companies, cornerstone investments will be allowed but will not count towards the public float.

#### **Concessional route to secondary listing**

In the same package, the Exchange proposes also to modify the secondary listing requirements, most recently set out in the 2013 Joint Policy Statement (JPS), to open up the market to candidates that are of the right nature and quality, and that have been listed on an acceptable overseas exchange.

One important aspect of reform is removing the “centre of gravity” test – i.e. allowing companies with a Greater China business focus to secondary-list in Hong Kong. In addition, provided they meet the requisite business and historical profile, both Greater China companies already listed on an acceptable exchange, and non-Greater China companies with a WVR structure will be able to secondary-list in Hong Kong without complying with the WVR safeguards mentioned above, nor change their WVR structure to meet primary listing requirements. This should be an attractive prospect for a number of Chinese technology enterprises already listed in New York or London, as well as new economy enterprises with non-China businesses.

The key requirements and processes of the new concessional route are set out in the box below:

<b>Concessional secondary listing route – an overview</b>	
<ul style="list-style-type: none"> <li>▪ emerging and innovative sector, namely:                             <ul style="list-style-type: none"> <li>▪ has been successful due to the application of new technologies, innovations, business models, etc. in the core business</li> <li>▪ has R&amp;D as a significant contributor to value and cause of expense</li> <li>▪ has had its success demonstrably attributable to unique features of innovation / IP</li> <li>▪ has an outsized market cap or intangible asset value</li> </ul> </li> </ul>	
<ul style="list-style-type: none"> <li>▪ primary-listed on NYSE, Nasdaq, or LSE Main Market Premium Listing segment                             <ul style="list-style-type: none"> <li>▪ grandfathering procedure: for “grandfathered” companies (i.e. those that were already listed on those exchanges as of 15 December 2017), there is no need to demonstrate HK-equivalent shareholders protection standards</li> <li>▪ to prevent companies listing overseas first and coming back to HK to circumvent HK’s primary listing requirement, Greater China companies listed overseas after 15 Dec 2017 cannot take the concessional secondary listing route but must comply with the new requirements for WVR / biotech primary listings if they want or need to take advantage of the revised framework</li> </ul> </li> </ul>	
<ul style="list-style-type: none"> <li>▪ expected market cap of at least HK\$10b</li> <li>▪ two years’ good compliance record</li> <li>▪ companies with WVR / centre of gravity in Greater China must meet revenue test for WVR applicants if the market cap is below HK\$40b</li> <li>▪ automatic waivers will be given to these concessional listings – the waivers will fall away after a 12-month grace period if the bulk (taken to be 55%) of their trading volume migrates to HK on a permanent basis</li> <li>▪ the Takeovers Code will not apply to secondary listings of Great China companies, but if the bulk of trading migrates to HK, the company will be treated as having a dual primary listing here and the Takeovers Code will apply to them</li> </ul>	

The roadmap for the three types of potential candidates for the concessional secondary listing route (again, companies are regarded as “grandfathered” if they were listed one of the acceptable exchanges in New York or London as at 15 December 2017) is as follows:

	<b>Grandfathered Greater China Companies</b>	<b>Non-Grandfathered Greater China Companies</b>	<b>Non-Greater China Companies</b>
<b>Automatic waivers</b>	Apply		
<b>JPS shareholder protection standards</b>	Required to comply with the standards (to be written into the listing rules)	Required to change constitutional documents (as necessary) to meet equivalent standards	Required to comply with the standards (to be written into the listing rules)
<b>WVR structures (if applicable)</b>	No need to meet WVR safeguards nor change WVR structure to meet primary listing requirements	Must meet WVR safeguards and WVR structure must conform with primary listing requirements	No need to meet WVR safeguards nor change WVR structure to meet primary listing requirements

## GEM and Main Board rule amendments

A consultation paper on proposed GEM and Main Board rule amendments was issued on the same day as the New Board Concept Paper. The two were specifically stated to complement each other, comprising a “holistic” review of the market structure. Notably, the former consultation focuses on repositioning GEM as a standalone board and to the extent possible reversing some of the undesirable market practices relating to it.

The **consultation conclusions** to that paper also came out on 15 December with the following key decisions:

### Key conclusions on GEM and Main Board listing rules

- “Streamlined” transfer of GEM companies to the Main Board will be abolished. Transfer applicants will have to appoint a sponsor to carry out due diligence and prepare a listing document.
  - However, there will be some “facilitation measures” – e.g. dispensation with certain documentary requirements, lockup requirements, appointment of compliance adviser, etc.
- The cash flow requirement will increase from HK\$20m to HK\$30m.
- The minimum capitalisation requirement will increase from HK\$100m to HK\$150m.
- The post-listing lockup on controlling shareholders will increase to one year (non-disposal) + one year (no disposal that results in shareholding dropping to below 30%)
- No more “placing only” GEM listings
  - mandatory public offering of at least 10% of the offer size
- The GEM requirements on placing to connected persons / connected clients / existing shareholders / associates will be aligned with that of the Main Board and GL85-16.
- The GEM requirements on allocation / clawback will be aligned with that of the Main Board.
- The GEM minimum public float value will increase from HK\$30m to HK\$45m.
- The Main Board minimum market capitalisation will increase from HK\$200m to HK\$500m, and the minimum public float value will likewise increase from HK\$50m to HK\$125m.
- Changes will take effect on 15 February 2018. There will be transitional arrangements.

## Timing and further consultation

A key question for the market is “is this the final word?”

The New Board consultation conclusions indicate the general direction the Exchange expects to take at this stage in opening up the market. The paper states (in paragraphs 244 and 247) that, while the Exchange is determined to proceed as set out, the revised rules are in preparation and will be subject to further consultation. The Exchange also states that it will discuss with stakeholders and take the benefit of their views.

The intention is that some of the issues will be written into the listing rules while others will be provided by way of guidance letters. Technically only listing rule amendments are subject to public consultation, but we note that some matters (e.g. the key indicators of an “innovative company”) intended to be dealt with by way of guidance letter (see paragraph 32 of the paper) will nevertheless be put out for further consultation (see paragraph 249 read in the light of paragraph 247). We are therefore expecting some measure of flexibility in the market engaging further with the Exchange on most of the important details.

In this regard, the Exchange's intention is to start discussion with market stakeholders soon and launch the formal consultation on the rule amendments in the first quarter of 2018. According to Mr Charles Li, the Exchange's CEO, the rules are expected to be in place by mid-2018.

## Conclusion

The question of dual class shares and the prospect of losing out to other exchanges some of the most attractive listing candidates have haunted our market for months if not years. Indeed, many among us have wished that our regulators could have led the market to a broad consensus sooner rather than later. Nevertheless, the blueprint just released is a good beginning and in many ways a commendable effort.

The Exchange has taken a measured approach in drawing out the parameters of the initial target companies, which is appropriate, as balancing market development and shareholders' protection has always been a challenge in Hong Kong.

A consensual framework that works to make Hong Kong a realistic listing venue for new economy companies while giving the regulators a suitably firm grip on the reins is not easy to build. With this encouraging first step towards liberalisation, we look forward to seeing our market grow in prosperity and diversity.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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