

Investment and Innovation: Corporate Governance on the Stock Exchange of Hong Kong

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Abstract: This paper analyzes corporate governance in Hong Kong, within the context of the Hong Kong Securities and Futures Commission's (SFC) new rules for the sponsor regime governing initial public offerings (IPO). The focus is on examining the financial ecosystem prior to the reform, with special attention on changes to 1) prospectus liability 2) application proof and 3) sponsors' roles. However, despite these changes, the Hong Kong Stock Exchange remains wary of the alternative share structures American and English markets have adopted. As a result, companies such as Alibaba Group chose to list elsewhere, in markets that are more investor-friendly. Indeed, while the SFC's reforms have improved the ethical posture of the Hong Kong market, the long-term consequences of those reforms remain to be seen.

Hong Kong has enjoyed a strong reputation as a center for capital-raising amongst major global financial markets.¹ From 2009 to 2011, Hong Kong was the frontrunner in total funds raised through initial public offerings (“IPOs”), significantly bolstering its market.² Last year alone, The Stock Exchange of Hong Kong, Limited (“the Exchange”) saw a record HK\$449.5 billion (US\$57.7

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¹ Securities and Futures Commission, “Market & Industries Statistics Q1 2014,” available at <http://www.sfc.hk/web/EN/regulatory-functions/market-infrastructure-and-trading/market-infrastructure/market-statistics/>

² Securities and Futures Commission, “Consultation Paper on the Regulation of Sponsors” (May 2012), available at [http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=12CPI](http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=12CPI;); see also Hong Kong Exchanges and Clearing Limited, “Hong Kong Leads World in IPO Fundraising for Three Consecutive Years and Attracts More International Listings” Exchange (January 2012), 2, available at <http://www.hkex.com.hk/eng/newsconsul/newsltr/2012/documents/2012-01-02-e.pdf>.

billion) worth of IPOs.³ By March 2014, Hong Kong ranked sixth worldwide – and second in Asia – in total market capitalization of all listed companies.⁴

Much of Hong Kong's financial success results from branding itself as a gateway for foreign companies seeking access to capital funding in Asia. This has benefitted industries, such as luxury retail and natural resources, which have experienced an increase in branding power throughout the greater Asia-Pacific regions. Moreover, the Exchange offers various advantages when listing on the Hong Kong market, such as low tax rates, currency convertibility, unrestricted capital flows, and freedom of information.⁵ These advantages are backed up by a strong regulatory framework based on English common law and the International Financial Reporting Standards.⁶ For example, Hong Kong's *Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited* ("Listing Rules") require that new applicants appoint a sponsor to assist it with its initial application for listing.⁷ These sponsors are usually financial entities licensed to counsel clients on listing documents, undertaking due diligence, and addressing regulatory concerns. Upon approval of the listing application, the prospectus is required to be authorized by the Exchange for registration before publication by the issuer. Today, the principal rules governing the marketing of new issues in Hong Kong are the Companies Ordinance,⁸ the Securities and Futures Ordinance,⁹ the Listing Rules,¹⁰ and the Securities and Futures Rules.¹¹ Historically, such

³ Hui, Bei and Fox Hu, "Hong Kong IPO Sponsor Due Diligence 'Inadequate,' Securities Watchdog Says," Bloomberg News, March 2011, available at <http://www.bloomberg.com/news/2011-03-29/hong-kong-initial-public-offer-sponsor-diligence-inadequate-wheatley-says.html>

⁴ Securities and Futures Commission, "Market & Industries Statistics Q1 2014," available at <http://www.sfc.hk/web/EN/regulatory-functions/market-infrastructure-and-trading/market-infrastructure/market-statistics/>

⁵ Hong Kong Financial Services Development Council, "Positioning Hong Kong as an International IPO Centre of Choice," available at [http://www.fsd.org.hk/sites/default/files/IPO4-2%20\(Final%2017-6-2014\).pdf](http://www.fsd.org.hk/sites/default/files/IPO4-2%20(Final%2017-6-2014).pdf)

⁶ *Ibid.*

⁷ The Stock Exchange of Hong Kong, "Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited," available at <http://www.hkex.com.hk/eng/rulesreg/listrules/rulesandguidelines.htm>

⁸ Hong Kong Companies Ordinance (Cap. 32), available at [http://www.legislation.gov.hk/blis_pdf.nsf/4f0db701c6c25d4a4825755c00352e35/BFBC0BDE18CA0665482575EE0030D882/\\$FILE/CAP_32_e_b5.pdf](http://www.legislation.gov.hk/blis_pdf.nsf/4f0db701c6c25d4a4825755c00352e35/BFBC0BDE18CA0665482575EE0030D882/$FILE/CAP_32_e_b5.pdf)

⁹ Hong Kong Securities and Futures Ordinance (Cap. 571), available at [http://www.legislation.gov.hk/blis_pdf.nsf/6799165D2FEE3FA94825755E0033E532/5167961DDC96C3B7482575EF001C7C2D/\\$FILE/CAP_571_e_b5.pdf](http://www.legislation.gov.hk/blis_pdf.nsf/6799165D2FEE3FA94825755E0033E532/5167961DDC96C3B7482575EF001C7C2D/$FILE/CAP_571_e_b5.pdf)

¹⁰ The Stock Exchange of Hong Kong, "Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited," available at <http://www.hkex.com.hk/eng/rulesreg/listrules/rulesandguidelines.htm>

clarity and enforceability have drawn investors from across the world, who seek comparability and reliability in the financial information made available to them.¹² Hong Kong's success is evidenced by the success of high profile companies like Prada (1913.HK), L'Occitane (973.HK), and Samsonite (1910.HK).¹³

FOREIGN INVESTMENT

Throughout the past decade, the Hong Kong market has experienced a rapid influx of foreign companies. In 2007, foreign companies accounted for only 4% of Hong Kong's total capitalization fund, and by 2011, that number had increased to 52%.¹⁴ However, in 2012, fundraising dropped to only 15%, prompting critics to question the sustainability of this growth.¹⁵ Examining the breakdown of listing companies reveals that, presently, those from the People's Republic of China account for much of the Exchange's success as a top global performer. In 2014, H share,¹⁶ red chip,¹⁷ and Mainland Private Enterprises accounted for 55.8% of Hong Kong's market capitalization and 70.2% of the equity turnover value in all Hong Kong listings.¹⁸ By 2013, there were 721 Chinese companies listed on the Exchange, representing 47% of all listed companies in Hong Kong.^{19,20}

While certainly a boon, this influx of Chinese companies has posed considerable challenges to Hong Kong's regulatory system.²¹ Because Mainland China's

¹¹ Hong Kong Securities and Futures Rule, available at <http://en-rules.sfc.hk/>

¹² *Ibid.*

¹³ Hong Kong Financial Services Development Council, "Positioning Hong Kong as an International IPO Centre of Choice," available at [http://www.fsd.org.hk/sites/default/files/IPO4-2%20\(Final%2017-6-2014\).pdf](http://www.fsd.org.hk/sites/default/files/IPO4-2%20(Final%2017-6-2014).pdf)

¹⁴ KPMG Global China Practice, "Hong Kong – Asia's Global Market, A Destination for International Listings," September 2012, available at <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/HK-global-IPO-destination-201209-v3.pdf>

¹⁵ *Ibid.*

¹⁶ H shares are shares of companies that are traded on the Hong Kong Stock Exchange, but are incorporated in Mainland China

¹⁷ Red chip shares are shares of Chinese companies that are traded on the Hong Kong Stock Exchange, but incorporated outside of Mainland China

¹⁸ The Stock Exchange of Hong Kong, "HKEx Monthly Market Highlights," April 2014, available at <https://www.hkex.com.hk/eng/stat/statrpt/mkthl/mkthl201404.htm>

¹⁹ The Stock Exchange of Hong Kong, "Market Statistics 2012," available at <http://www.hkex.com.hk/eng/newsconsul/hkexnews/2013/Documents/130115news.pdf>

²⁰ Levin, Ned, "Panel Takes on Hong Kong's IPO Rules," *The Wall Street Journal*, June 2014, available at <http://blogs.wsj.com/moneybeat/2014/06/19/panel-takes-on-hong-kongs-ipo-rules/>

²¹ The Stock Exchange of Hong Kong, "Market Statistics 2012," available at

corporate governance standards are generally less developed than their Hong Kong counterparts, Mainland companies are oftentimes considered less legally sound.²² More pressing, however, is the fact that many Chinese companies operate outside of Hong Kong, outside of the enforcement power of Hong Kong regulators. Although the Hong Kong market has traditionally listed companies incorporated elsewhere,²³ many overseas companies that listed on the Exchange conducted their principal activities in Hong Kong.²⁴ In comparison, Mainland companies conduct business on the Mainland, where their assets and personnel are also located. This places significant strain on Hong Kong regulators to enforce their rules across the border. Matt Stewart, of the Hong Kong Securities and Futures Commission's Enforcement Division, warns that "in an IPO, if a company, its directors and some of its advisors are all based offshore, the only part of the chain the regulator has the power to influence is the investment banks who underwrite and sell deals to investors."²⁵ Similarly, Paul Chow, former Chief Executive of Hong Kong Exchanges and Clearing Limited, writes:

“. . . [We] have to recognize that from time to time there are unscrupulous operators who seek to use the market to raise money from investors, such money then being channeled to purposes other than those stated in the offering document. This is not appropriate and may at times be criminal, but it can happen in any market. If it happens in a company based in Hong Kong, there is the apparatus to deal with it. But if the misdemeanors are perpetrated by Mainland [Chinese] enterprises, there is a potential problem because of current legal arrangements. Directors who disappear back to the Mainland, money transferred to the Mainland, and any remaining

²² <http://www.hkex.com.hk/eng/newsconsul/hkexnews/2013/Documents/130115news.pdf>
Ferguson, Michael, Kevin Lam and Grace Menia Lee, "Voluntary Disclosure by State-owned Enterprises Listed in the Stock Exchange of Hong Kong", *Journal of International Financial Management and Accounting*, 2002; de Jonge, Alice, "Corporate Governance and China's H-share Market," 2008; Mar, Pamela and Michael N. Young, "Corporate Governance in Transition Economies: A Case Study of Two Chinese Airlines", *Journal of World Business* 2001; Sun, Laixiang and Damian Tobin, "International Listing as a Mechanism of Commitment to More Credible Corporate Governance Practices: The Case of the Bank of China (Hong Kong)," *Corporate Governance: An International Review*, 2005.

²³ The Hong Kong Stock Exchange, "HKEx Factbook 2012," available at <http://www.hkex.com.hk/eng/stat/statrpt/factbook/factbook2012/fb2012.htm>

²⁴ The Hong Kong Stock Exchange, "HKEx Factbook 2011," available at <http://www.hkex.com.hk/eng/stat/statrpt/factbook/factbook2011/Documents/03.pdf>

²⁵ Davies, Paul and Brooke Masters, "HK Crackdown on Trading Misconduct," *Financial Times*, May 2012, available at <http://www.ft.com/cms/s/0/4e6a41e2-a0db-11e1-851f-00144feabdc0.html#axzz2c0mcyipia>.

assets which are in the Mainland may be beyond the reach of the Hong Kong authorities.”²⁶

Despite these challenges, however, Chinese companies still account for much of Hong Kong’s financial success. A report from the Hong Kong Financial Services Development Council, published earlier this year, warns that “the high level of reliance placed on [Chinese] companies may undermine [the Exchange’s] status as an ‘international’ market and its long-term development.”²⁷ The Exchange may potentially remedy this problem by reducing the regulatory burden for listed companies by streamlining the regulatory process and making structural changes to the market, seeking a balance between market efficiency and the high regulatory standards that Hong Kong is known for. In such an attempt, the Exchange published amendments to the Listing Rules and a suite of complementary guidance materials for IPO sponsors, issued by the Securities and Futures Commission (“SFC”) in July 2013, applicable in October 2013.²⁸ Broadly, these revisions affect prospectuses, application proof, expert data, and sponsors themselves. Proponents suggest that the reform makes broker and banks more accountable by setting firmer prospectus requirements.²⁹

I. PROSPECTUS LIABILITY

The Companies Ordinance structures the prospectus regime into a document-based approach, which focuses on the existence of a document containing an offer to the public. The Ordinance is especially concerned with the issuance of defective prospectuses³⁰ and incomplete application forms.³¹ Furthermore, the Securities and Futures Ordinance creates a mutually exclusive civil and criminal regime for market misconduct. Civil offenses are generally referred to the Market

²⁶ Chow, Paul, “Strengthening Corporate Governance in Hong Kong”, Exchange, October 2003, available at

<http://www.hkex.com.hk/eng/newsconsul/newsltr/2003/documents/2003-10-06-e.pdf>.

²⁷ Levin, Ned, "Panel Takes on Hong Kong's IPO Rules," The Wall Street Journal, June 2014, available at <http://blogs.wsj.com/moneybeat/2014/06/19/panel-takes-on-hong-kongs-ipo-rules/>

²⁸ *Ibid.*

²⁹ Barreto, Elizo, "Hong Kong IPO hopefuls get ready for 'name and shame' rule change," Reuters, March 2014, available at <http://www.reuters.com/article/2014/03/31/hongkong-listing-rules-idUSL3N0MH2UB20140331>

³⁰ Hong Kong Companies Ordinance 38(1B), 342(1), available at [http://www.legislation.gov.hk/blis_pdf.nsf/4f0db701c6c25d4a4825755c00352e35/BFBC0BDE18CA0665482575EE0030D882/\\$FILE/CAP_32_e_b5.pdf](http://www.legislation.gov.hk/blis_pdf.nsf/4f0db701c6c25d4a4825755c00352e35/BFBC0BDE18CA0665482575EE0030D882/$FILE/CAP_32_e_b5.pdf)

³¹ Hong Kong Companies Ordinance 38(3), 342(3), available at [http://www.legislation.gov.hk/blis_pdf.nsf/4f0db701c6c25d4a4825755c00352e35/BFBC0BDE18CA0665482575EE0030D882/\\$FILE/CAP_32_e_b5.pdf](http://www.legislation.gov.hk/blis_pdf.nsf/4f0db701c6c25d4a4825755c00352e35/BFBC0BDE18CA0665482575EE0030D882/$FILE/CAP_32_e_b5.pdf)

Misconduct Tribunal, and criminal offenses are generally referred to the criminal courts. Under the new regime, sponsors must be appointed at least two months before submitting the listing application form ("Form A1"), which initiates the application process.³² Moreover, the revised Listing Rules place three major requirements on sponsors: due diligence, additional documentation, and application proof.

A. The Sponsor must complete all reasonable due diligence on the applicant before submitting the Form A1

In finance, due diligence refers to the process of obtaining objective information about a person or company prior to a specific event, typically an acquisition or merger. It is categorically defined as a systematic research effort, which is used to gather the critical facts and descriptive information most relevant to making an informed decision about the event. In conducting its due diligence, sponsors are required to take reasonable efforts to ensure the information provided to the Exchange is materially true and without any material omissions. By doing so, sponsors vouch for an applicant's eligibility, the collective experience of its board, and the quality of experts appointed.³³

Securities market regulators have especially criticized sponsors' due diligence efforts in the past, claiming inadequacy relative to market activity. Martin Wheatley, the former chairman of the Securities and Futures Commission, claims "in many cases, sponsors are spread too thinly in terms of the number of deals they're bringing to the market at any one time."³⁴ Similarly, the Securities and Futures Commission has found deficiencies in both the due diligence work done by sponsors in the listing application process and internal workings of IPO sponsors.³⁵ This, the Commission warns, places the integrity of the market under threat.³⁶ Indeed, in 2012, the apparent failure to carry out adequate due diligence

³² Davis Polk & Wardwell LLP, "The Hong Kong Stock Exchange releases revised rules and procedures to implement new IPO sponsor regime," July 2013, available at <http://www.lexology.com/library/detail.aspx?g=46fe40b3-898d-4c65-ae4a-f13c045c4427>

³³ IFLR, "How to list in Hong Kong: The due diligence process," October 2012, available at <http://www.iflr.com/Article/3110339/How-to-list-in-Hong-Kong-the-due-diligence-process.html>

³⁴ Hui, Bei and Fox Hu, "Hong Kong IPO Sponsor Due Diligence 'Inadequate,' Securities Watchdog Says," Bloomberg News, March 2011, available at <http://www.bloomberg.com/news/2011-03-29/hong-kong-initial-public-offer-sponsor-diligence-inadequate-wheatley-says.html>

³⁵ *Ibid.*

³⁶ IFLR, "How to list in Hong Kong: The due diligence process," October 2012, available at <http://www.iflr.com/Article/3110339/How-to-list-in-Hong-Kong-the-due-diligence-process.html>

resulted in sponsor Mega Capital being fined HK\$42 million (US\$5.42 million) and having its license revoked.³⁷ This inadequacy highlights the risks applicants and potential investors face when dealing with irresponsible sponsors.

The recent revisions codify the Commission's proposals and clarify the expectation placed upon sponsors. Prior to 2013, the Exchange imposed non-exhaustive measures to help sponsors in conducting due diligence. For example, Practice Note 21 of the Listing Rules offered general guidelines on typical due diligence, including detailed reviews of group financial statements and interviews with major suppliers and customers, creditors and bankers.³⁸ That information was not required before submitting the Form A1, however, which oftentimes resulted in poor and incomplete prospectuses. Addressing that problem, the revised Listing Rules require due diligence before submitting the Form A1.

This revision marks a distinct change in the ethical posture of the Hong Kong market. Mandating due diligence before submission not only protects the market against inadequate or fraudulent applicants, but also provides more information to the Exchange. Providing a regulatory entity, such as the Exchange, with more information increases overall utility by maximizing benefits in allowing the Exchange to make more informed decisions. Additionally, making listing requirements more explicit reduces the risks that both the market and applicants face. Hong Kong's revised guidelines are more extensive than those of their counterparts in other markets, placing a greater onus upon IPO sponsors. By contrast, higher quality information will be provided to the Exchange, the applicant, and potential investors. These parties then enjoy greater utility.

B. Additional documentation must accompany the Form A1, including a draft prospectus (“Application Proof”)

Under the revised regime, companies must submit two draft disclosure documents relating to a listing applicant: 1) a substantially complete prospectus accompanying the listing application (“Application Proof”), and 2) a post-hearing information pack, after the Listing Committee hearing and before the “red-herring” prospectus or commencement of book-building, whichever is earlier. Those documents would then be disclosed to the public via online publication. These guidelines are especially important because failure to comply may render the Application Proof substantially incomplete and risks applications being returned. This all occurs under Hong Kong's unique two-step vetting framework – in addition to conducting due diligence work, companies wishing to list in Hong

³⁷ *Ibid.*

³⁸ *Ibid.*

Kong must also undergo verification. Verification involves a greater degree of scrutiny at all statements made within the prospectus, to ensure that they can be individually backed by a reliable source. This provides applicants with more leverage against sponsors, to ensure that sponsors perform due diligence satisfactorily. Should sponsors violate these terms, they risk fines and the revocation of licenses.

First, GL59-13 requires enhanced disclosure on an applicant's business details, in areas such as production and subcontracting, sales and marketing, product returns and warranty, health, safety, social and environmental matters, litigation and claims, hedging positions and exposure under derivative instruments, licenses and permits. Taken together, GL59-13 pushes towards transparency in the method the applicant's business is run. The emphasis on health, safety, social, and environmental matters appears to be an indirect response to critics of financial institutions' ethical posturing which resulted in the 2008 financial crisis, namely the headstrong approach towards profit and growth rather than sustainability or utility. With Hong Kong's two-step vetting process, GL59-13 places a greater onus on applicants to act in the best interests of its components.

Second, GL49-13 requires additional disclosure on the history and development of the company, for example, including information about the incorporation and commencement of members that contributed to the applicant's business. Additionally, applicants must disclose whether each acquisition, disposal, and merger was legally completed. Lastly, pre-IPO investments, outstanding options, and warrants or convertibles must all be disclosed. GL49-13 works in conjunction with GL43-12, which requires further disclosure on pre-IPO investments, such as investors' backgrounds and their relationship with the applicant. Taken together, these guidelines allow the Exchange to properly evaluate the applicant's background and track record, making the decision whether or not to list the applicant more clear-cut. These guidelines are especially important to the IPO sponsor regime because the character of the sponsors themselves is scrutinized, thereby safeguarding against unscrupulous sponsors and Mainland companies.

Lastly, GL37-12 requires detailed disclosures on financial resources, such as indebtedness, liquidity, and capital structures. Listing applicants must provide information about current liabilities, negative operative cash flows, and significant reclassifications of long-term debt to short-term debt.

C. The Application Proof must be a substantially complete document

Perhaps the most controversial of the Commission's reforms are Sections 40 and 40A(1) of the Companies Ordinance. Taken together, these sections impose civil and criminal liability upon sponsors where applicable. More specifically, Section 40 carves out categories of people who may be required to compensate investors who suffer losses attributable to untrue statements. Section 40A(1) requires that those persons who authorize fraudulent prospectuses may be fined and, if necessary, imprisoned. Sponsors may escape liability if they can show the statement is immaterial to the loss or that reasonable grounds to believe the statement's veracity existed. These changes make Hong Kong significantly stricter on investment bankers than in the United States; however, because Hong Kong has absorbed some of the world's largest deals in recent years, a greater degree of accountability is arguably necessary.

II. PUBLICATION OF APPLICATION PROOF

Starting on April 1, 2014, draft listing documents ("Application Proof") will be listed on the Exchange's website upon a Form A1 submission.³⁹ Should the Exchange determine that the Application Proof is not substantially complete, the Exchange will place a moratorium upon the applicant, preventing resubmission for eight weeks. Additionally, if a listing application is returned, both the applicant's and sponsor's name will be published on the Exchange's website. This change is a monumental development for the Hong Kong market. By publishing the names of applicants and sponsors whose Application Proofs were deemed incomplete, the Securities and Futures Commission has adopted a "name and shame" approach, with the intent of upgrading the quality of disclosure in the Application Proof.

Upon announcement, this provision was the subject of much controversy and debate. Potential investors were concerned the disclosure of such large volumes of information prior to any assurance of listing on the Hong Kong market is a strong disincentive to listing entities. Critics argue that although issuers may seek disclosure waivers from the Exchange, those waivers only apply to the Application Proof and not the post-hearing information pack. As is, the Exchange evaluates each case individually.⁴⁰ However, the publication of a substantially

³⁹ Davis Polk & Wardwell LLP, "The Hong Kong Stock Exchange releases revised rules and procedures to implement new IPO sponsor regime," July 2013, available at <http://www.lexology.com/library/detail.aspx?g=46fe40b3-898d-4c65-ae4a-f13c045c4427>

⁴⁰ Generally, GL-57-13 considers whether the information about the proposed listing is price-sensitive; whether the listing entity is required to disclose such information by

complete draft prospectus in the form of the AP is a significant development for the Hong Kong market. The SFC, after extensive consultation and numerous discussions with market stakeholders, has taken the view that public release of the AP and (subject to the suspension discussed below) “naming and shaming” by publishing the names of listing applicants and sponsors whose APs are returned by the regulators as being substantially incomplete, will be conducive to upgrading the quality of disclosure in the AP and the due diligence conducted by the sponsors.

III. INITIATIVES TO ENHANCE SPONSORS’ ROLES

The new rules expand upon the listing application process, paying special attention to instances of noncompliance and duties. The revised IPO regime is composed of enhanced conduct requirements, focusing on companies carrying out IPO sponsorship work in Hong Kong.

A. Sponsor’s Duties

The 2013 amendments revise Chapter 17 of the *Code of Conduct for Persons Likely Licensed by or Registered with the Securities and Futures Commission* (“Code of Conduct”), which imposes new and enhanced duties on an IPO sponsor.

Pursuant to the reforms, sponsors must deal with regulators in a truthful, cooperative, and prompt manner:

- Advise and guide the listing applicant in preparation for the listing
- Take reasonable due diligence steps in respect of a listing application and to complete all reasonable due diligence on a listing applicant by the time of submitting the Form A1
- Take reasonable steps to ensure that true, accurate and complete disclosure about a listing applicant is made to the public
- Deal with the regulators in a truthful, cooperative and prompt manner
- Fulfill the duty to maintain proper records and systems and controls for all sponsor’s assignments

Many of the Code of Conduct reforms are also present in the revised Listing Rules in a complementary nature. For example, the Code of Conduct sets out a number of guidelines when seeking assistance from third parties in carrying out due diligence. The Listing Rules serve a complementary function by requiring

statute; and whether the parent entity is able to keep its listing application confidential.

specific materials when dealing with expert advisers and declarations by sponsors when checking third parties' work. Additionally, the Commission and the Exchange both provide guidance on how to conduct management discussion, analyze financial information, and disclose it in the prospectus. The Code of Conduct sets out certain matters (e.g. obligation for the listing applicant to assist the sponsor, and to procure other parties to cooperate with the sponsor, in carrying out due diligence) as mandatory terms in a sponsor's engagement letter. The Listing Rules have been revised to incorporate these.

B. Sponsor's eligibility, record keeping, and notification requirements

New requirements promulgated by the Commission relate to the eligibility criteria, internal management, and systems specifically applicable to IPO sponsorship. Under the revised *Code of Conduct*,⁴¹ firms are required to maintain records of a sponsor's work for seven years after completion or termination of the assignment. This includes any transactions and due diligence work conducted. Similarly, Paragraphs 17.11 and 17.12 imposes specific requirements on overall management of IPO transactions, including resources, supervisory structures, and an annual systems assessment. Paragraph 17.10(b) requires that sponsors provide an updated list of work undertaken, upon request from the Commission. This list may include information such as the names of issuers and the composition of transaction teams, lending towards a greater degree of transparency from the Exchange's perspective. The *Code of Conduct* also affects sponsors after completion of a listing. Paragraph 17.11(f) requires that sponsors must submit a team structure chart two weeks after the first day of dealing. Pursuant to the *Code of Conduct*, this chart should report each of the licensed staff members, along with their titles and responsibilities. Taken together, Paragraph 17 simply asks that sponsors act with a greater degree of transparency, so that the Exchange may act in ways that maximize utility.

INNOVATION

While the efficacy and long-term ramifications of the Exchange's revised regulatory framework have yet to be seen, Hong Kong's rigorous standards have generated some friction. Earlier this year, Chinese internet giant Alibaba Group eschewed listing on the Hong Kong market, citing the bourse's refusal to relax its Listing Rules.⁴² Instead, Alibaba sought listing on the New York Stock Exchange

⁴¹ The Stock Exchange of Hong Kong, Code of Conduct 17.10(d), available at <https://www.mtr.com.hk/eng/publications/images/codeofconduct.pdf>

⁴² Fraser, Ian, "In spurning Alibaba's \$15bn IPO, Hong Kong puts principles before profit," QFinance, March 2014, available at <http://www.qfinance.com/blogs/ian->

(“NYSE”).⁴³ Presently, the Listing Rules are structured for businesses organized in a standard common law, corporate structure.⁴⁴ For example, the Listing Rules makes several distinct presumptions about capital structure, ownership, and rights.

Of contention, Alibaba disputes Listing Rules 2.03 and 8.11, which impose a “one share, one vote” structure, which is considered a shareholder safeguard under common law because it prevents minority shareholders from disproportionately affecting the majority shareholders’ interests.⁴⁵ Under Rule 8.11, for the Exchange to list a class of securities, the associated voting powers must bear a reasonable relationship to the equity interest of those shares when fully paid.⁴⁶ This predisposes the market against companies with weighted voting rights and other, unconventional governance structures.⁴⁷

By comparison, Alibaba sought to implement a dual-class structure, which would allow for such minority shareholder control. Specifically, Alibaba proposed a senior executive and founder primacy, where its 28 partners would retain control to nominate the majority of the board, despite holding less than 15% of the company.⁴⁸ However, Hong Kong categorically refuses such dual-class structures because its regulatory framework is premised upon a fundamental public policy that listed companies’ shareholders are treated fairly, the Exchange has categorically refused such dual-class structures.⁴⁹ As columnist James Saft writes, “. . . without the right to appoint board members or exert other forms of control, investors can only vote with their feet. That leaves executives free to pursue self-

⁴³ fraser/2014/03/21/in-spurning-alibabas-15bn-ipo-hong-kong-puts-principles-before-profit Hope, Bradley, "Alibaba to List on New York Stock Exchange," *The Wall Street Journal*, June 2014, available at <http://online.wsj.com/articles/alibaba-to-list-on-new-york-stock-exchange-1403802203>

⁴⁴ Hong Kong Financial Services Development Council, "Positioning Hong Kong as an International IPO Centre of Choice," FSDC Paper No. 9, June 2014, available at [http://www.fsd.org.hk/sites/default/files/IPO4-2%20\(Final%2017-6-2014\).pdf](http://www.fsd.org.hk/sites/default/files/IPO4-2%20(Final%2017-6-2014).pdf)

⁴⁵ The Stock Exchange of Hong Kong, "Listing Rules of the Stock Exchange of Hong Kong," § 2.03, 8.11, available at https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/Documents/consol_mb.pdf

⁴⁶ *Ibid.*

⁴⁷ *Ibid.*

⁴⁸ Lyons, James, "Alibaba vs corporate governance: Rules for listing around the world," *Growth Business*, November 2013, available at <http://www.growthbusiness.co.uk/growing-a-business/company-flotations/2430487/alibaba-vs-corporate-governance-rules-for-listing-around-the-world.shtml>

⁴⁹ *Ibid.*

serving policies, be they for reasons of self-enrichment, self-aggrandizement or caprice.”⁵⁰

This fundamental understanding differs in the United States, whose listing policies permit dual-class structures. Equity shareholders may nominate or remove directors “as a quid pro quo for ensuring compliance with more stringent reporting requirements.”⁵¹ Alibaba’s decision to eschew the Hong Kong market is not unique. In 2011, Manchester United similarly decided to list on the NYSE over the Exchange, citing preference to a dual-class equity ownership structure.⁵² Similarly, tech companies such as Google, Groupon, and Facebook have demonstrated a distinct preference to dual-class structures.⁵³

Although commentators have generally praised Hong Kong’s stringent corporate governance standards, losing Alibaba to the NYSE has prompted criticisms about the Exchange’s inflexibility in corporate governance. Critics worry Hong Kong’s regulatory framework is unnecessarily restrictive, more suited to internal investors and businesses, instead of larger institutional investors – oftentimes foreign companies – which contribute the lion’s share to Hong Kong’s IPO offerings.⁵⁴ As the Hong Kong Financial Services Development Council (“FSDC”) writes, “[b]y applying, in all cases, regulations which demand the highest investor protection standards (typically at increased compliance cost to the issuer), the Hong Kong IPO market as a whole risks losing flexibility and competitiveness.”⁵⁵

Hong Kong would benefit from further revising its IPO sponsorship regime, taking alternate corporate governance structures into consideration. Indeed, opening the market up to different legal entities carries a certain degree of risk;

⁵⁰ Saft, James, "Alibaba and the battle for financial supremacy," Reuters, March 2014, available at <http://www.reuters.com/article/2014/03/18/column-markets-saft-idUSL2N0ME0IN20140318>

⁵¹ Lyons, James, "Alibaba vs corporate governance: Rules for listing around the world," Growth Business, November 2013, available at <http://www.growthbusiness.co.uk/growing-a-business/company-flotations/2430487/alibaba-vs-corporate-governance-rules-for-listing-around-the-world.shtml>

⁵² *Ibid.*

⁵³ Orsagh, Matt, "Dual-Class Shares: From Google to Alibaba, Is It a Troubling Trend for Investors?," CFA Institute, April 2014, available at <http://blogs.cfainstitute.org/marketintegrity/2014/04/01/dual-class-shares-from-google-to-alibaba-is-it-a-troubling-trend-for-investors/>

⁵⁴ Levin, Ned, "Panel Takes on Hong Kong's IPO Rules," The Wall Street Journal, June 2014, available at <http://blogs.wsj.com/moneybeat/2014/06/19/panel-takes-on-hong-kongs-ipo-rules/>

⁵⁵ *Ibid.*

however, the innovation also brings about much-needed diversification to the Hong Kong market. Similarly, Hong Kong may benefit from reconsidering the “one share, one vote” rule. While Listing Rule 8.11 has undoubtedly been beneficial for the Hong Kong market, foreign companies and potential investors have avoided listing in Hong Kong precisely because of those stringent standards, much like Alibaba. Put simply, Hong Kong would benefit from reconsidering its regulatory posture. Such ardent, fundamental adherence to its regulatory posture has proven inefficient thus far.

Indeed, the FSDC has suggested that the Exchange may draw from the London Stock Exchange’s playbook and develop new board structures tailored to investors’ diverse needs, in an effort to attract a broader swath of companies and investors. As the Exchange’s chief executive, Charles Li, writes, “[the Exchange needs] to consider how to make changes to enhance our competitiveness. . . We will study if we can introduce a new board to meet special demands of any companies.”⁵⁶ Li elaborates that a multiple class share system works in the United States because of “a deeper institutional investor base and a litigious culture that can keep management in check and offer recourse for minority shareholders.”⁵⁷

By contrast, Asia does not have the same environment. Class action lawsuits do not exist in Hong Kong, and litigation to uphold investor rights are generally disfavored because of excessive costs.⁵⁸ Moreover, in addition to its fundraising function, stock markets in the United States also function as an accepted method for entrepreneurs to ‘cash out’ accumulated wealth.⁵⁹ In short, the financial culture in the United States permits the sort of dual-class share structure of which the Exchange is wary. Moving forward, how Hong Kong balances its corporate governance standards with its proposed flexibility will determine the trajectory of the market’s growth.

⁵⁶ Yiu, Enoch, "HKEx 'open' to new boards idea," South China Morning Post, June 2014, available at <http://www.scmp.com/business/money/markets-investing/article/1539231/hkex-open-new-boards-idea>

⁵⁷ Li, Charles, "Shanghai-Hong Kong Stock Connect is a big step in a long journey," May 2014, available at <http://www.hkex.com.hk/eng/newsconsul/blog/blog.htm>

⁵⁸ *Ibid.*

⁵⁹ *Ibid.*