New Consultation on Corporate WVR Beneficiaries and Updated Guidance to Listing Rules for Biotech Companies

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As reported in our previous client update on the subject, the Hong Kong Stock Exchange ("HKEx") introduced a new listing regime on April 30, 2018 allowing high-growth and innovative companies with weighted voting right ("WVR") structures, and biotech companies that do not yet meet the pre-existing financial eligibility criteria, to list on the main board of the HKEx ("Main Board"). Following up on this reform, the HKEx published the Consultation Paper on Corporate WVR Beneficiaries on January 31, 2020, soliciting feedback on a new proposal allowing corporate entities to benefit from the WVR structure, which is enjoyed only by individuals under the current regime. Having reviewed the operation of Chapter 18A of the Main Board listing rules ("Chapter 18A") governing the listing of biotech companies, the HKEx also provided further guidance concerning the listing suitability criteria and updated disclosure requirements through the guidance letters.

This memorandum provides a brief summary on the consultation proposal on corporate WVR beneficiaries and the new guidance for biotech companies.

Consultation on Corporate WVR Beneficiaries

The consultation on corporate WVR beneficiaries came after the HKEx received feedback from various parties suggesting that corporate entities should also be allowed to benefit from WVR structures. There are various reasons put forward in support of such proposal:

Business Ecosystem of Innovative Companies

Innovative companies typically operate in a broader "ecosystem" that includes other companies within the same corporate group as well as independent companies, as seen in the case of a large number of sizeable, unlisted Mainland companies from emerging and innovative sectors. The companies in these ecosystems have often made material contributions to and shaped the growth of the innovative companies. Furthermore, when these innovative companies seek to list, they would likely continue to be materially influenced by the strategy and vision of the ecosystem leader, and it would therefore be in their interest to continue to evolve together with other companies in their ecosystems. As such, granting WVR to a corporate shareholder who is the ecosystem leader would encourage it to include the listing applicant in its common vision for the ecosystem, thereby providing the listing applicant with a competitive advantage as well as reinforcing its position within the ecosystem. In the long run, this would allow the listing applicant to gain access to material intangible benefits such as users and data that may not be otherwise easily replicable, and would in turn give it a significant competitive advantage over its peers.

Corporate Shareholders

An ecosystem leader that has invested in a unicorn company typically will have its ownership stake diluted over time after the company has conducted multiple rounds of financing from other investors. As a result, upon an IPO, the ecosystem leader as a corporate shareholder, like any individual entrepreneurial founder, may seek to use WVR structures to maintain its level of voting rights. In addition, WVR could be a way to retain the balance of control or consolidate control where the listing applicant's business forms a crucial part of the corporate shareholder's ecosystem or to gain more than 50% voting power and consolidate the WVR issuer into the corporate shareholder's financial results.

Diversifying the Hong Kong Market

In the HKEx's New Board Concept Paper published in June 2017, it was noted that there is a lack of diversity and high sector concentrations in the Hong Kong equity markets. As of November 2019, financial and property sectors accounted for 38% of HKEx's total market capitalization, while companies from innovative and emerging sectors accounted for 10% of the total market capitalization.[1] The HKEx further observed that this lack of exposure to high growth sectors may lead to stagnation and a lack of investor interest. Given that WVR structures are features of many emerging and innovative companies, allowing corporate shareholders to hold WVR may help diversify the market and incentivize more companies to choose Hong Kong as their IPO destination.

The proposed suitability and eligibility criteria and ongoing requirements are as follows:

Suitability	1. The corporate WVR beneficiary must: i. be an innovative company or have a track record of

1 Excluding the market capitalization of Alibaba Group, which obtained a secondary listing on the HKEx in November 2019.

	investments in, and contributions to, innovative companies; ii. have held an economic interest of 10%, and been materially involved in the listing applicant's business, for at least two financial years prior to the date of the listing application; and iii. have an economic interest of 30% in the listing applicant at the date of listing. 2. The corporate WVR beneficiary must have made contribution to the listing applicant of a type that is not easily replicated or substituted. The HKEx specifically noted that financial investments or non-financial contributions (such as know-how or strategic advice) are not sufficient to allow a corporate shareholder to avail itself of the WVR structure. 3. A prospective corporate WVR holder must also demonstrate that it owns and operates an "ecosystem" at listing (and on an ongoing basis) that benefits the listing applicant. Key requirements for the ecosystem are that: • it comprises a community of companies, including the listing applicant and other components (which may be non-legal entities such as business units of the corporate shareholder, user or customer bases, applications, programs or other technological applications), that has grown and co-evolved around a technology or know-how platform or a set of core products or services owned or operated by the corporate WVR beneficiary; • its components, including the listing applicant, benefit from, and contribute to, the ecosystem by sharing data, users, and/or technology (e.g., software, applications, proprietary know-how or patents); • the ecosystem must have attained a meaningful scale, which will normally be measured by reference to indicators such as the number and technological sophistication of its components, size of its (combined) user base, extent and frequency of cross-interaction between the users or customers of different components; • its core components and the listing applicant are, in substance, controlled by the corporate WVR beneficiary; and • the listing applicant's growth and success were materially attributable to its participation in and co-evolvement with

	the ecosystem, and the listing applicant is expected to continue to benefit materially from being part of that ecosystem.
Eligibility	A corporate WVR beneficiary: i. must have its primary listing on the HKEx or on a Qualifying Exchange;[2] ii. must have a minimum market capitalization of HK$200 billion; and iii. must not have the listing applicant represent more than 30% of the corporate WVR beneficiary in terms of market capitalization at the time of listing.
Continuing Requirements	1. A corporate WVR beneficiary must: i. have at least one corporate representative on the board of directors of the listed company; ii. remain listed on the HKEx or a qualifying exchange; iii. have WVRs that carry no more than five times the voting power of the listed company's ordinary shares; and iv. continue to own at least a 30% economic interest in the listed company. 2. The WVRs will lapse after a "sunset" period of no more than 10 years, renewable for successive periods of no more than five years with the approval of independent shareholders. 3. The WVRs will lapse permanently if its contribution to the WVR issuer is substantially terminated, or materially disrupted or suspended for 12 months or more.

The consultation paper also discussed the risks associated with corporate WVR beneficiaries. One argument was that as the controlling shareholders' economic interest in the company drops, they may become more tempted to extract benefits from the company at the expense of the other shareholders. As a result, granting them WVRs may aggravate these risks by providing for control to be maintained with only a minority ownership stake in the company. Moreover, the situation could worsen if the corporate WVR beneficiary has a controlling shareholder with a WVR structure, as the controlling shareholders would be able to exercise majority voting power in a listing applicant despite only holding a small and indirect stake in the company, causing a

2 "Qualifying Exchange" means the NYSE, NASDAQ or the Main Market of the London Stock Exchange plc (and belonging to the UK Financial Conduct Authority's "Premium Listing" segment).

misalignment of interests between the ultimate controlling shareholder and other shareholders.

Another risk noted was that allowing corporate shareholders to benefit from WVR may cause WVR structures to become more commonplace, which would be contrary to the intention of granting them in the first place as special rights to recognize the material contribution and intangible benefits that such corporate shareholders bring to the listing applicant in the ecosystem, similar to the manner in which individual WVR beneficiaries have contributed invaluable skills, knowledge and/or strategic direction to the company. The HKEx has therefore proposed certain “ring-fencing” solutions in the consultation paper to address this issue.

The consultation paper also recognized that unlike individual WVR beneficiaries, corporate WVR beneficiaries cannot act as directors and consequently will not owe fiduciary duties to the listing applicant, nor would their senior management or board owe any fiduciary duty or other responsibility to the listing applicant or its shareholders. Moreover, the senior management and/or the board of a corporate WVR beneficiary will change over time, which means the persons in such senior management or board positions may not have made the material contributions which form the very basis of the granting of WVRs. This concern is noteworthy because whereas WVRs held by individuals would lapse at some point in time, WVRs held by corporate shareholders potentially could be exercised indefinitely.

The consultation period will close on May 31, 2020 and it remains to be seen what will be the industry consensus on corporate WVR beneficiaries, how the proposal would be balanced with additional conditions and investor safeguards and whether these proposals would eventually be adopted by the HKEx.

New Guidance on Listing Suitability Criteria of Biotech Companies

Since the launch of the Chapter 18A listing framework, the HKEx has also conducted a review of such framework’s operation and identified certain new suitability criteria relating to biotech company listings. The new criteria have been reflected in two existing HKEx guidance letters (i.e., HKEX-GL92-18 and HKEX-GL85-16), and some of the key items are set forth below:

Existing Shareholders’ Participation in an IPO

Biotech companies often require significant ongoing funding needs to develop their core product commercialization. At the same time, existing shareholders typically wish to be able to continue participating in future fundraisings to prevent a dilution to their shareholding. As a result, the HKEx now allows existing shareholders to participate in the IPO of a biotech company, provided that the listing applicant complies with Main Board listing rules 8.08(1) and 18A.07. Specifically, the "Existing Shareholders Conditions" in HKEX-GL85-16 would not apply to biotech companies.

Pursuant to this change, an existing shareholder of a listing applicant holding less than 10% of the shares may subscribe for shares in the IPO either as a cornerstone investor or as a placee in a share placement. In addition, an existing shareholder with a contractual anti-dilution right may exercise such right and subscribe for shares in the IPO in accordance with the existing listing rule requirements. Where allocations will be made to "core connected persons",[3] the biotech company must apply for, and the HKEx will ordinarily grant, a related Main Board listing rule 9.09 waiver (relating to, among others, dealing in securities by a "core connected person"), if applicable.

Clawback Mechanism

Conscious of the additional investment risks that biotech companies potentially pose to retail investors, the HKEx indicated that it is prepared to consider proposals for modifying the minimum public/retail subscription requirement under Practice Note 18 of the listing rules in a Chapter 18A IPO and adjusting the clawback mechanism on a case-by-case basis, provided that compelling reasons for such modification are given. Although the HKEx has not set out an exhaustive list of factors for consideration, it would exercise its discretion carefully and flexibly to accommodate such requests.

Core Products

In respect of the core products developed by a biotech company, specifically in relation to in-licensed or acquired products, commercialized products, medical device products, and products that do not fit into any regulatory regime on external milestones, the HKEx also has set out their expectations on the various factors they will look at to assess the biotech company's suitability for listing. These include research and development progress, technological preparation and/or market and clinical value with reference to the corresponding pharmaceutical journals, guidelines and pre-clinical and clinical results. The HKEx has emphasized that these factors are neither exhaustive nor binding, and all relevant circumstances will be taken into account in assessing a biotech company's listing suitability.

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[3] "Core connected person" means (a) for a company other than a PRC issuer, or any subsidiary of a PRC issuer, a director, chief executive or substantial shareholder of the company or any of its subsidiaries or a close associate of any of them; and (b) for a PRC issuer, a director, supervisor, chief executive or substantial shareholder of the PRC issuer or any of its subsidiaries or close associate of any of them.

Updated Disclosure Requirements for Biotech Company IPOs

In a new guidance letter, HKEX-GL107-20, the HKEx suggested key areas in listing documents where disclosure could be enhanced. In addition to the general principle of disclosure set forth in Rule 11.07 of the Main Board listing rules and requirements for biotech companies set forth in Chapter 18A thereunder, the HKEx notes that the following items, among others, should also be disclosed in the listing documents:

Valuation of pre-IPO Investments and Material Fluctuations

The biotech company should disclose the valuation of each pre-IPO financing round and explain any material fluctuation in valuation with the immediate previous financing round with reference to key development of products, business milestones and competitive advantage over its peers.

Sophisticated Investors

Material information on sophisticated investors, such as the background and track record of such investors in the relevant biotech or healthcare industries, should be disclosed.

Net Liabilities

In the “Summary” and “Risk Factors” sections of the IPO prospectus, if the biotech company has incurred net liabilities during the track record period from significant fair value change of convertible financial instruments which will be fully converted upon listing (and as a result will turn into a net assets position), they should be disclosed.

Burn Rate

In the “Summary” section or other relevant sections of the IPO prospectus, the biotech company should disclose a reasonable period of time in which it can maintain its viability using its existing cash resources with and without the IPO proceeds, as well as when it expects to raise its next round of financing based on its burn rate.

Competitive Landscape and Addressable Market

The biotech company should disclose the competitive landscape of its core products and other key pipeline products to be commercialized in targeted markets, including (i) competitors’ current pipeline products targeting the same indication and their development stages; (ii) the name, price and reimbursement coverage of such available products, if applicable; and (iii) expiration dates of competing products’ key patents, etc., as the case may be and if available. Any other material information on the relevant addressable market of the core products and other key pipeline products rather than the overall market (and the potential addressable market size should be consistent with the potential competitive landscape presented by the biotech company) should also be disclosed. In addition, there should be a comparison between its products and direct competing products in major areas such as technologies, indications and targeting market.

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Please do not hesitate to contact us with any questions.

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