CFA Institute

23/F Man Yee Building
68 Des Voeux Road
Central, Hong Kong SAR

+852 2868 2700 tel
+852 2868 9912 fax
info@cfainstitute.org
www.cfainstitute.org

28 February 2018

Research
Hang Seng Indexes Company Limited
22/F Hang Seng Bank Headquarters
83 Des Voeux Road
Central, Hong Kong

Re: Consultation on the eligibility of foreign companies, stapled securities and weighted voting right companies for inclusion in the Hang Seng Composite Index ("HSCI")

Dear Sir,

We are responding to the above consultation conducted by the Hang Seng Indexes Company Limited ("HSI").

CFA Institute[1] appreciates the opportunity to offer comments to HSI on the eligibility of foreign companies, stapled securities and weighted voting right ("WVR") companies for inclusion in the HSCI. CFA Institute represents the views of those investment professionals who are its members before standard setters, regulatory authorities, and legislative bodies worldwide about issues affecting the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues affecting the efficiency, integrity and accountability of global financial markets.

Before setting out our position on your consultation, we would like to highlight that, in principle, CFA Institute believes that there should not be any unequal voting rights. An introduction of a structure that permits disproportionate votes to one group of shareowners would allow a minority shareowner to override the desires of most owners for personal interest. We consider that unequal voting rights would weaken the checks and balances between shareholders and management, and immunize management against stakeholders' critics and accountability, leading to potential entrenchment issues. It is, therefore, our position that Hong Kong retains the corporate governance gold standard of one-share one-vote.

<u>Question 1</u>

> *Given that the role of the HSCI is to be a comprehensive Hong Kong market benchmark, do you think Foreign Companies should be eligible for inclusion in the HSCI?*
>
> *☑ Yes, I think Foreign Companies should be eligible.*
>
> *☐ No, Foreign Companies should not be eligible.*
>
> *<u>Please provide your comments / suggestions</u>*
>
> We consider it appropriate for foreign companies to be included in the HSCI as constituents.
>
> Under its current framework, the HSCI is intended for representing domestic companies whose principle place of business is Hong Kong and/or Mainland China, and it is, therefore, interpreted that foreign companies should not be included in the Index.

[1] CFA Institute is a global, not-for-profit professional association of more than 150,000 investment analysts, advisers, portfolio managers, and other investment professionals in 165+ countries and territories. The CFA Institute membership also includes 151 member societies in 70+ countries and territories.

However, if the HSCI is meant to represent the externally-oriented nature of the Hong Kong economy – with two-way trade flows represented about 386% of Hong Kong's real GDP in 2016[2] – the inclusion of foreign companies in the Index should be encouraged. In fact, as an international financial and commercial center, Hong Kong is home to 1,413 setups of regional headquarters with parent companies located outside the city.[3] Therefore, it is counter-intuitive to not consider international companies as a part of the Hong Kong community.

Having foreign companies included in the main index may also boost the attractiveness of the listing market (i.e. Hong Kong Stock Exchange). As these companies can attract capital from the increasingly popular passive investment funds,[4] the inclusion of foreign companies in the HSCI may attract more foreign listings to the Hong Kong Stock Exchange ("HKEx").

Meanwhile, foreign companies represent an increasingly significant number of listed companies in Hong Kong. Comparing to 2010 when the previous consultation on this subject was conducted, there has been a marked increase (from 14 to 29) of foreign companies listed on the HKEx, whose aggregate market capitalization now represents some 7% of the total market capitalization. Assuming that the HSI is correct with its projection that there would be more listings of international companies in the city, such companies will have a growing share in the Hong Kong market.

On the back of these observations, we consider it appropriate for the HSI to include foreign companies in the HSCI so long as these international companies are **primarily listed on, and conforming to the Listing Rules of, the HKEx**.

Since companies with secondary listings in Hong Kong are subject to regulations set by other stock exchanges and securities regulators that may have different standards compared to the HKEx and the Securities and Futures Commission, **we only recommend companies that have their primary listing on the HKEx to be considered for inclusion in the HSCI**.

We would also note that if and when foreign companies are allowed into HSCI, it should be as an expansion of the number of constituents to avoid crowding out of local companies.

Last in order but not of importance, since the inclusion of foreign companies in the HSCI could have explicit and broad-based implications on index users, serious consideration should be given to opinions of these users.

Question 2

Given that the role of HSCI is to be a comprehensive Hong Kong market benchmark, do you think Stapled Securities with the existing legal structure should be eligible for inclusion in the HSCI?

☐ Yes, I think Stapled Securities with the existing legal structure should be eligible.

☑ No, Stapled Securities should not be eligible.

Please provide your comments / suggestions

A stapled security is an investment vehicle made up of at least two components, contractually-bounded, as a security. Stapled securities are available in Hong Kong and other markets, such as Australia, typically comprising of i) a share in a company, and ii) a unit in a unit trust.[5]

[2] Census and Statistics Department.
[3] Census and Statistics Department.
[4] According to HKEx, the turnover of HKEx-listed ETFs accounted for 28% of total equity market turnover on HKEx in the first eight months of 2017.
[5] Australia Securities & Investments Commission.

While the four listed stapled securities currently available in the Hong Kong do have the same legal structure, it was highlighted in the consultation paper that the structure of stapled securities could change *widely* going forward.[6] Such variations may add complexity to the structure of the staple security if it involves investment components in different jurisdictions, given that different sets of laws and regulations applied to the involved jurisdictions will have to be complied.[7]

Comparing to traditional equities, the structure of stapled securities is relatively new and more complex to investors. Currently only ordinary shares are included in the Hang Seng indexes and commingling instruments with different legal structures into an index may reduce its representativeness. At the same time, there are only a handful of such securities listed on the HKEx.

Hence, we recommend a prudent approach to be adopted when the HSI contemplates the eligibility of stapled securities in the HSCI. As and when the number of listed stapled securities in Hong Kong rises and the sector as a whole becomes representative, HSI may consider establishing a brand-new index dedicated to such securities, similar to the Hang Sang REIT Index.

To be clear, while we recognize index inclusion should not depend solely on the legal structure chosen by a business, we recommend the inclusion of these equities in the HSCI to be put on hold for the time being as they are still relatively new to investors and could potentially add uncertainty to the protection of shareholders. Over the medium- to long-term, however, the eligibility for inclusion of equities listed with such structures should be revisited.

<u>Question 3</u>

Given that WVR Companies will be listed on the Main Board of the SEHK, do you think Hang Seng Indexes should consider including such companies in the HSCI universe?

☐ Yes, I think Hang Seng Indexes should consider including WVR Companies in the HSCI universe.

☑ No, WVR Companies should not be eligible for inclusion.

<u>Please provide your comments / suggestions</u>

Shareholders are entitled to voting right as a tool to illustrate their views on important, and at times debatable, matters related to invested companies. According to the Legislative Council, in Hong Kong,

> *the right of a shareholder to vote should be proportional to the size of his or her shareholdings, and this is reflected by the "one-share, one-vote" standard. Contrary to the "one-share, one-vote" structure are the governance structures which give certain persons voting power or other related rights that are disproportionate to their shareholdings. Such governance structures are referred to as "weighted voting right structures"…*

Legislative Council Secretariat, 2015[8]

In the hypothetical case where companies with WVR structures are introduced to the Hong Kong market, **CFA Institute recommends such shares to be excluded from HSCI**. This is

[6] Paragraph 3.4.
[7] Chiu, J. (June 2011) The Emergence of Stapled Securities and Business Trusts in Hong Kong. *Mayer Brown JSM Legal Update.*
[8] Ng, T (January 2015) Understanding "weighted voting right structures". Legislative Council.

consistent with the reasoning underlying our position with stapled securities: given the differences between shares with WVR and ordinary shares, we believe commingling the two will send confusing market signals. If benchmark indexes include such shares, passive funds have no choice but to buy them, thus creating market inefficiencies by under-pricing the risks associated with inferior or no voting rights.

Over the last few months, index compilers around the world, including S&P Dow Jones, FTSE Russell and MSCI all undertook extensive consultations on the inclusion of non-voting and/or dual class shares in indexes. S&P Dow Jones stated that it would not allow companies with dual-class share structures to be part of some of their high-profile indexes, such as the S&P 500 Index and its small cap and midcap brethren.[9] FTSE Russell concluded that new constituents of all FTSE Russell indexes in developed markets would be required to have no less than 5% of the company's aggregate voting rights owned by unrestricted shareholders.[10] In its consultation paper released in January 2018, MSCI suggested that it would consider the inclusion of equities with unequal voting rights, but would adjust the weights of such stocks so as to reflect the unequal voting rights structures.[11]

These developments signified investors' concerns over the inclusion of shares with a WVR structure in an index. HSI should be mindful of the fact that the inclusion of equities with weak corporate governance structure in HSCI and other sub-indexes will have negative implications for investor protection.

Concluding Remarks

CFA Institute welcomes the opportunity to offer comments on the issues of the eligibility of foreign companies, stapled securities and WVR companies for inclusion in the HSCI. Please do not hesitate to contact us should you have any questions concerning our comments.

Yours faithfully,

/s/ Mary Leung, CFA
Head, Advocacy, Asia Pacific
CFA Institute
+852 3103-9353
mary.leung@cfainstitute.org

/s/ Rocky Tung
Director, Capital Markets Policy
CFA Institute
+852 3103-9334
rocky.tung@cfainstitute.org

[9] S&P Dow Jones Indices (July 2017) S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rules. Press release.
[10] FTSE Russell (July 2017) Voting Rights Consultation – Next Steps.
[11] MSCI (January 2018) Should Equity Indexes Include Stocks of Companies with Share Classes Having Unequal Voting Rights?