Hong Kong's dilemma

The HKSE released a concept paper on dual-class share structures only weeks before Alibaba's US IPO. Must it allow these structures to remain competitive?

The Hong Kong market has long anticipated a consultation on listed companies that have shares with dual-class structures or, as the Hong Kong Stock Exchange (HKSE) refers to them in its recent concept paper, weighted voting right (WVR) structures.

The concept paper was published on August 29 2014, in the aftermath of the city-state losing the world's largest initial public offering (IPO) to the US in the guise of Jack Ma's Alibaba. We may as well refer to it as Jack Ma's Alibaba as he, together with a small group of minority shareholders, retain the right to appoint a majority of Alibaba's board – notwithstanding their small equity shareholding. WVR structures refer to a number of different structures under which minority shareholders somehow retain the decision-making capacity over certain reserved matters, such as who is elected or appointed to the board.

The concept paper is intended to promote the debate on whether WVR companies should be allowed to list at all. If there is enough support, this will be followed by a consultation on rule changes. A soft approach has been adopted owing to the fundamental importance attached to the principle that all shareholders must be treated equally, as set out in the Listing Rules. They also outlaw, in the absence of exceptional circumstances as agreed with the stock exchange, the existence, in the share capital of a listed company, of a class of shares whose voting power does not bear a reasonable relationship to their equity interest.

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The idea of having a minority shareholder base controlling a majority of the board may at first seem offensive, but global exchanges no longer operate on a one-size-fits-all principle. Markets have evolved over time, while many investors would welcome the opportunity to invest in and trade the securities of WVR companies in Hong Kong.

WVR evolution

The evolution of WVR structures is seen most prominently in the US where numerous such companies are listed, including the likes of Facebook and Groupon. While Nasdaq did not introduce any restrictions on the listing of WVR companies, the New York Stock Exchange (NYSE) has only allowed listings of such companies since 1990, after the Securities and Exchange Commission (SEC) sought to ban such listings following a prolonged debate which went so far as the Court of Appeals for the District of Columbia Circuit. The NYSE indicated that it would only place restrictions on WVR companies if other exchanges were required to do so, as a matter of law, highlighting that its main rationale for allowing such listings was to prevent unfair competition.

The concept paper also highlights that the UK recently reinforced the one-share-one-vote principle, although companies that apply for a standard as opposed to a premium listing would not be subject to such restrictions. It has, however, been noted that institutional investors in the UK may shy away from WVR companies.

The concept paper also cites studies that show a discount is typically applied to WVR companies. This would seem to indicate that capital markets are sophisticated enough to price-in associated risks. Moreover, the studies also show that there is no evidence that WVR structures negatively impact performance.

There is no doubt that the global perception of, and investors' attitudes towards, WVR structures, have changed over time. A look at some of the largest publicly listed WVR companies, which happen to be in the technology sector, is a firm testament to this. Google, Facebook, LinkedIn and Groupon – probably the most renowned international brands – all have such structures.

In fairness, Hong Kong probably did not even have a shot at securing the above listings. It is the listings of Chinese enterprises that propels Hong Kong up the rankings in IPO funds raised on a global scale. However, Hong Kong laments not only the loss of Alibaba but others including JD.com, Baidu, and Weibo. It has Tencent, of course, but it seems that others may have flocked to Hong Kong if its exchange were able to list WVR companies. Regardless of the history and given the significant number of companies that are publicly listed, if the HKSE is to attract more listings and evolve into a new era, it seems it has no choice but to allow companies with WVR structures to list. Given this is an evolving position, it should however only apply to new listing applicants and not all listed companies.

This prompts the question of whether and what conditions should be attached to such listings. Out of respect, the shareholder protection concerns voiced in protest to any compromises on the one-share-one-vote principle should also be addressed.

Protecting shareholders

It is widely accepted that when private shareholders take a company public and seek funds from global investors, they must be willing to give up a certain amount of control.

The fact of the matter is that initial shareholders have not necessarily given up control for many HKSE-listed companies. A group of aligned shareholders that collectively have over 50% control over a listed company would be able to carry most resolutions. This is common in Hong Kong, where you have many tightly controlled businesses and controlling shareholders (defined in the Listing Rules as those with holdings above 30%) who are supported by other shareholders sympathetic to their vision of how business should be progressed. This element of retained control also gives rise to the perception that directors of listed companies may abuse their position of power.

Regulators and lawmakers are not blind to concerns on retained control. There are safeguards in place to deal with the most offensive abuses of power. The Companies Ordinance, as with most company law provisions in common law jurisdictions,

provides for redress where minority shareholders' rights are unfairly prejudiced. Moreover, a rigid set of rules on connected transactions in the Listing Rules ensure that founders with controlling stakes and their associates must disclose and obtain shareholder approval (subject to materiality) on transactions where they may personally profit from dealings with a listed company. Finally, common law fiduciary duties pertain to directors of companies incorporated in common law jurisdictions, which seek to ensure that they act in the best interests of a company.

On a completely level playing field, one could take the view that a controlling shareholder or founder that sold down all its major stakes in a business should no longer be entitled to have a greater say than others in the running of a listed company. However, the reality is that companies, particularly in the technology sector, go through rounds of funding before they get to the public markets by which time the founding shareholder's interest has been watered down significantly. Investors may nevertheless still be interested in such a company as they believe in the vision of its founder. There is also no longer a level playing field, hence the NYSE's reluctant move in the direction of allowing the listing of WVR companies. However, this should not be a free for all to the complete detriment of shareholder protection.

A paternalistic culture exists in Hong Kong and retail investors expect its Securities and Futures Commission (SFC) to protect them from evil in the securities world. This was made clear by the demonstrations outside the SFC's offices in the wake of the so-called Lehman mini-bonds scandal. We should therefore acknowledge that a public consultation on additional measures that may or should be attached WVR companies is necessary, as is an element of discretion on the part of the stock exchange.

Conditions attached to WVR companies

It has been suggested that Hong Kong should only allow WVR companies to list once shareholders are empowered to take class actions in securities litigation.

We must however be very careful not to encourage a litigious society. One of the side effects will be frivolous litigation, which would not only disable company management from doing business as usual, but also potentially bring companies to their knees and result in significant losses for shareholders. For example, a US judge recently criticised a law firm over an action that was brought against Boeing for delays in producing the 787 Dreamliner. Judge Suzanne Conlon described the claim as "at best unreliable and at worst fraudulent". The law firm in question was ordered to pay Boeing's legal fees and other costs.

We could do without such actions in Hong Kong. The SFC has had several victories on behalf of shareholders and may be relied upon to take enforcement action on behalf of shareholders. This was seen prominently in the instance of Hontex International Holdings where the SFC used its powers under the Securities and Futures Ordinance to freeze the assets of the company and obtain a further order for a shareholder-approved share buy-back scheme.

The greatest fear with companies that are controlled or influenced by a powerful shareholder is that they may detract value from the company and its minority shareholders to their own advantage and possibly that of their associates. The Listing Rules have some of the tightest regulations on connected party transactions (or related party transactions) on a global scale. Such rules ensure that where there is a possibility for influence from a director or controlling shareholder, relevant transactions will be subject to an independent shareholders' vote and reviews by independent board committees and financial advisers. Directors, chief executives and substantial shareholders – and their associates – are caught by the definition of connected persons under the Listing Rules.

Not that Alibaba deserves yet another mention, but it is an interesting case in point. Alipay was removed from the Alibaba group in 2011 to another company that is ultimately controlled by Jack Ma, prompting intense criticism from Alibaba's largest shareholders. This was done without the consent of Alibaba's other shareholders because foreign investors were not apparently allowed to be involved with a company providing third-party payment services in China. However the rules that would have forbidden this were reportedly never promulgated. Jack Ma says that shareholders should trust its management to act in their best interests. From a regulatory perspective, however, it seems likely that the Alipay disposal would have been required to be subject to an independent shareholder vote if Alibaba was listed on the HKSE at the relevant time.

There are some variations around WVR structures, the most offensive of which may be a minority shareholding base having the ability to appoint a majority of the board. They would therefore make most corporate decisions, with the exception of those that would be subject to shareholder approval. Interestingly, the concept paper highlights that there are only two companies with such provisions in their articles listed in the US: Autohome and now Alibaba.

In Hong Kong, a greater number of transactions by listed companies are potentially caught by requirements for shareholder approval than their counterparts in the US, for example. But a much more palatable manner in which a minority founding shareholder or group of shareholders may influence a board is the ability to elect representatives to the board, subject to a general vote amongst shareholders.

Most US-listed WVR companies place voluntary restrictions on shares with weighted rights. These must all be considered as part of a consultation on the subject so that we can evolve in a manner that does not disregard relevant methods to protect the interests of minority or retail shareholders. Many WVR companies stipulate that weighted shares will convert to ordinary shares when sold, which seems entirely appropriate as most structures exist largely to enable founding visionaries to continue to have a somewhat free reign.

Some WVR companies similarly incorporate provisions into their articles to stipulate that if founders are not able to participate in management affairs, the WVR shares will revert to ordinary shares. Facebook and Groupon even have provisions to say that WVR shares must convert to ordinary shares if a majority of ordinary shareholders vote for it. In the case of Groupon, the WVR shares will mandatorily convert into ordinary shares after the lapse of a certain period of time.

Market participants must also consider carefully how the rights of WVR shareholders will interact with the Hong Kong Codes on Takeovers and Mergers and Share Buy-Backs, which apply to listed companies. It is a longstanding principle of the Takeovers Code that there can be no frustrating action over a bona fide offer to all shareholders, which is a compelling argument to say that weighted rights must not be invoked on a bona fide offer for a listed company.

A full consultation on this important subject to Hong Kong's capital markets is most welcome – hopefully sooner rather than later. Most WVR companies, if not all, happen to be in the technology sector, which may be consistent with such companies being heavily reliant on a visionary. However, limiting WVR structures to a particular sector does not seem appropriate in the context of development in the interests of the market as a whole, which must be the focus.

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