Part B Consultation Questions

Question 18: If, in addition, you believe that the Exchange should impose mandatory safeguards for companies that list on the New Board with a WVR structure, what safeguards should we apply? Should the same safeguards apply to both segments of the New Board?

Please give reasons for your views.

Response: (The detailed explanation of most of my opinions below can be found in my article *The Anatomy of Dual Class Share Structures: A Comparative Perspective* (2016) 46 Hong Kong Law Journal 477, available at <https://ssrn.com/abstract=2836788>.)

WVR structures have many merits and demerits which are too complex to explain in detail here. I believe that WVR structures per se are not evil and that they can enhance corporate performance and economic efficiency if they are used for proper business purposes. The question is how we can control the demerits of WVR structures. Some of them, e.g. the exacerbation of 'tunnelling',[1] should be dealt with by the general shareholder protection regime, including the enforcement of corporate controllers' fiduciary duties; while some other demerits of WVR structures can be dealt with by relatively simple rules which can be in the form of listing rules.

Compared to other control-enhancing mechanisms, e.g. pyramidal and cross-ownership structures, WVR structures have two disadvantages. First, WVR structures may decouple voting rights from cash flow rights infinitely. Imagine that a company issues voting shares to its insiders and non-voting ordinary shares to the public. The voting shares may represent little economic ownership of the company. One may argue that this problem is subject to market scrutiny: investors will simply not buy the shares of such a company whose controllers have only negligible cash flow rights. However, anecdotal evidence suggests that this may not be the case.[2] The Exchange should particularly consider the high-level participation of retail investors in the HK securities markets.[3]

A related problem is that non-voting ordinary shares may be used to circumvent the application of some shareholder protection rules which is founded on the existence of voting rights.[4] For example, SEC Rule 14a-8 entitles a shareholder to put his proposal in the company's proxy statement. To take advantage of the rule, a shareholder must have continuously held for a specific period at least US$2,000 in market value, or 1%, of the

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[1] "Tunnelling" refers to the misconduct that corporate controllers divert corporate resources to their own pockets at the expense of shareholders.

[2] Two well-known examples were Dodge Brothers, Inc. and Industrial Rayon Corporation.

[3] HKEx, 'Retail Investor Survey 2011' (April 2012) p 1.

[4] The application of various US securities laws will be affected by non-voting ordinary shares. See pages 57–58 of Form 10-Q filed by the Snap Inc. to the SEC (for the quarterly period ended 31 March 2017).

company's *voting* securities. The rule is hence unavailable to a holder of non-voting ordinary shares who also has residual claims to corporate assets. The Exchange needs to check whether HK has rules whose application would be affected by non-voting ordinary shares; alternatively, the Exchange may regulate WVR structures' voting-cash flow rights divergence to avoid this problem.

When regulating the voting-cash flow rights divergence in classic dual class companies which issue plural / multiple classes of shares with unequal votes, overseas policy-makers generally place limits on the maximum votes attached to a superior voting share. It is worth noting that the basis for calculating a superior voting share's votes does matter. For example, in Swedish companies, no share may carry voting rights more than 10 times greater than the voting rights of any other share.[5] Assume that a company issues two classes of shares: "A" and "B" shares carry one vote per share, but the par value and dividend rights of "B" shares are less than one-tenth of those of "A" shares.[6] The company thereby decouples voting rights from cash flow rights to an extent exceeding what the Swedish rule actually allows but is technically in compliance.

An effective solution to the above problem is to connect the calculation basis to superior voting shares' economic elements. The Exchange may stipulate that the voting rights of any share should not exceed 10 times the votes per unit of its dividend rights as compared to the votes held by the class of shares with the least voting rights per unit of their dividend rights. Of course, the Exchange may choose another voting ratio and calculation basis it thinks fit. Note that under this rule, non-voting ordinary shares are automatically prohibited. In addition, the Exchange should limit decision rights that can be assigned to priority shares and particular persons by a company's articles.[7]

The second disadvantage of WVR structures, compared to other control-enhancing mechanisms, is about dual class recapitalizations: a listed company may alter its articles to adopt a dual class (WVR) structure after its equity has been issued to the public. Due to the collective action problems in shareholders' actions, certain dual class recapitalization mechanisms may be used to deprive existing shareholders of their voting rights, regardless of their true wills and without due compensations.

To begin with, dual class recapitalization proposals, whether increasing or reducing shareholder wealth, are rarely voted down by public shareholders because of their collective action problems. An individual shareholder has little incentive to do the research necessary for an informed vote, because the cost exceeds the expected return, owing to his small cash flow rights. Moreover, even when a shareholder confirms that a recapitalization proposal will diminish shareholder wealth, he does not have much

[5] Swedish Companies Act 2005 (SCA 2005), cap 4, s 5.
[6] This kind of practice once took place in HK. HKEx, "Concept Paper on Weighted Voting Rights" (August 2014) paras 83–84.
[7] Swedish companies are allowed to issue priority shares and their articles can confer special decision rights on particular persons, but in public companies, more than 50% of the board of directors should be appointed through general shareholder elections. SCA 2005, cap 8, ss 8, 47.

incentive to organize opposition, because he would bear all the costs but enjoy a small part of the benefits. In addition, corporate insiders may bundle recapitalization proposals with unrelated proposals that public shareholders like and threaten not to pursue valuable investment projects without dual class equity financing.

Then the difference of various recapitalization mechanisms comes into play. Two of them are compared here: "exchange offers" and "pro rata dividends". In an exchange offer, shareholders are given a time limit to choose either to keep their existing shares with inferior voting rights or to exchange them for newly-issued shares with superior voting rights. In most cases, increased dividend rights are granted to existing shares. Due to collective action problems, even a shareholder who knows that the consolidation of corporate control is harmful will choose to keep inferior voting shares. If enough public shareholders opt for superior voting shares and corporate insiders cannot entrench their control, the shareholder gains more by refusing the exchange. He can thereby obtain the increased dividend rights and free-ride on other shareholders' efforts against managerial opportunism. If too few public shareholders choose superior voting shares, he is still better off refusing the exchange. Despite the increased agency risks, he at least gets a dividend preference. If all or most shareholders follow this strategy, corporate insiders can acquire an immediate voting majority. It should also be noted that the value of increased dividend rights attached to inferior voting shares is unlikely to correspond with the value of superior voting rights,[8] owing to the absence of market pricing in exchange offer recapitalizations.

In a pro rata dividend recapitalization, the company distributes superior voting shares to all shareholders on a pro rata basis: the number of superior voting shares a shareholder receives is proportionate to his shareholding at the time of distribution.[9] As long as no restrictions are imposed on transfers of superior voting shares, such a recapitalization does not vary the original distribution of voting power in the company, and shifts in the control distribution can only occur as a result of market transactions conducted by individual shareholders after the completion of the recapitalization.

Pursuant to the Voting Rights Policy of the NYSE, WVR structures are generally permitted with one qualification: existing shareholders' voting rights cannot be disparately reduced or restricted through any corporate action or issuance.[10] Therefore, the NYSE will permit dual class IPOs and pro rata dividends without restrictions on transfers of superior voting shares, but will prohibit exchange offers.

In its earlier market consultation, the Exchange proposed to confine WVR structures to new listing applicants.[11] This means all dual class recapitalizations would be prohibited.

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[8] It is a general practice that superior voting shares have 10 votes each, and inferior voting shares have an extra 10% of dividend rights.

[9] Pro rata dividend recapitalizations are often implemented through share splits. For example, a company may issue one superior voting share and one inferior voting share in exchange for each of its outstanding ordinary shares.

[10] NYSE Listed Company Manual, s 313(A).

[11] HKEx, "Consultation Conclusions to Concept Paper on Weighted Voting Rights" (June 2015) para 111.

This approach is, of course, much better than no regulation, but I think it interferes somewhat too far in market freedom.

Firstly, the mere fact that collective action problems may, in effect, compel shareholders to approve recapitalization proposals is not sufficient to justify a total ban on dual class recapitalizations. Shareholder approval of all sorts of fundamental corporate changes is susceptible to collective action problems, while these changes are generally not forbidden by law, e.g. mergers, reincorporation and the sale of core business. Dual class recapitalizations are not so special that should be treated differently. Moreover, the Exchange may make stringent shareholder approval requirements for recapitalization proposals to reduce the difficulty of organizing opposition.

Secondly, an important rationale behind the permission for dual class IPOs is that investors can discount the price of inferior voting shares for increased agency risks when purchasing such shares. In fact, shareholders in a dual class recapitalization will obtain similar compensation if the recapitalization does not reduce their voting rights and does not impose restrictions on transfers of superior voting shares. Market pricing functions in the sale of superior voting shares by public shareholders just as it does in the purchase of inferior voting shares in a dual class IPO. Both the premium for superior voting rights and the discount for inferior voting rights act as compensations for increased agency risks, and both compensations are priced by securities markets.

Thirdly, prohibition of all kinds of dual class recapitalizations may overkill value-increasing ones proposed by existing listed companies that need to adjust their governance structures to changes of market conditions.

In the current market consultation, the Exchange needs to consider whether to allow a company listed on the New Board to adopt a WVR structure after its listing. I suggest this be allowed, but only if existing shareholders' voting rights are not impaired. That is to say, I suggest the Exchange make a rule like the Voting Rights Policy of the NYSE.

I suggest the proposed rules above apply to both segments of the New Board since the difference between the two segments has no significant impacts upon my views and reasoning above. If the Exchange considers otherwise, one acceptable adjustment is to remove the constraints on WVR structures' voting-cash flow rights divergence in New Board PRO because this market would be open only to professional investors who might have the ability to make informed and rational decisions in respect of extreme voting-cash flow rights divergence and non-voting ordinary shares.

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