Speech

Speech by SFST at Center for Accounting Research and Education Conference (English only)

Monday, June 9, 2014

Following is the speech by the Secretary for Financial Services and the Treasury, Professor K C Chan, at the Center for Accounting Research and Education Conference today (June 9):

Distinguished guests, ladies and gentlemen,

In view of the academic audience we have here today, I hope to learn something from you and gain some insights on the important topic of corporate governance. Corporate governance is a broad issue and there are many experts here today to speak on the various aspects of it. I think I would like to focus on one issue that our market has been confronted with recently: the case of Alibaba.

Those of you who have been following the case would have noticed that Alibaba was exploring a listing in Hong Kong and have ultimately opted to apply for a listing in the United States. Since the deliberations were not public, the market could only suggest that the decision had to do with the issue of corporate control, and how much control the management could have in particular.

Alibaba's decision to pass over Hong Kong for New York has caused a lot of discussions. There are generally two lines of argument. On one hand commentators celebrate Hong Kong's adherence to the high standard of one share, one vote, and believe Hong Kong should be very proud as we are not letting our standards slip just because Alibaba is a big company. On the other hand, many practitioners argue that Hong Kong must be innovative, or we will be losing all the potential deals to the American market. Hong Kong cannot lag behind and should keep pace with the market. If I try to gauge the general sentiment, the majority view seems to be that Hong Kong should uphold its governance standards.

The debate on corporate governance and the one share, one vote standard is not new, but is an ongoing one with a long history. In the United States, corporate governance is a matter of state law. There is no federal law on corporate governance. At the beginning of the last century, the one share, one vote model had become popular but not compulsory, as each state had its own

incorporation statute and adopted different models. However, in the decades that followed, non-voting common stock became popular as a way for founders and management to retain corporate control. A vocal movement advocating equal voting rights emerged in response. In 1926, the NYSE began to discourage unequal voting rights in its listing process. In 1940, the NYSE banned non-voting common stock, and disparate voting rights plans became rare in that market. Interestingly, NASDAQ and AMEX chose not to follow, and competed with the NYSE by attracting companies with dual class shares.

In the 1980s, a lot of battles for corporate control were waged and many corporate managements issued share classes with differential voting rights as defence against hostile takeovers. In 1988, the Securities and Exchange Commission (SEC) promulgated new rules in an attempt to limit room for corporations to adopt share structures with differential voting rights, but they were struck down by the courts. In 1990, the DC Circuit ruled in Business Roundtable v. SEC that corporate governance regulation is primarily a matter for state law. The role of the SEC, established under the Securities Exchange Act of 1934, is limited to the regulation of the trading of securities and the requirement of suitable disclosures. It has no authority to adopt rules affecting substantive aspects of corporate voting rights.

Today, share classes with disparate voting rights are popular among media and technology companies in the United States. However, as we have seen, the US regulatory system based on disclosure is not the result of conscious design by regulators, but the result of the US political system.

The US courts recognise the role of states in corporate governance as an opportunity for experimentation with alternative solutions to the difficult problems arising from corporate law. As Justice Brandeis put it, "It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."

Therefore, it is the result of US federalism that states adopted different corporate governance laws. But in the present day, we may wonder what effect this competition among states will bring about when commerce and investor participation have extended way beyond the borders of one state or one country. We need to think about if the competition among states has brought about a race to the top or a race to the bottom.

In the other countries, the debate over the one share, one vote standard is also very much alive. Across the Atlantic, the active market for hostile takeover that emerged in the 1960s had led to a rise in the use of dual class share structures in the UK. Opposition from institutional investors arose as a result. While not outlawed, investing institutions and the London Stock Exchange discouraged the limitation of voting rights, leading to the one share, one vote standard as the norm in the market today. More recently, the Financial Conduct Authority has proposed rules that require each share to have equal voting power.

The situation is a bit different in continental Europe, where many countries allow shares with unequal voting rights, and their usage is particularly popular in France and Sweden. For example, as a way to encourage long-term investment, investors in France are awarded double voting rights if they keep the shares for two years. Still, according to one study, there was a decline in the fraction of dual class listed companies from 41 per cent in 1995 to 22 per cent in 2001, partly due to cost and other reasons.

In 2007, the European Commission published an impact assessment on the proportionality between capital and control in listed companies. They found no conclusive empirical evidence that unequal voting rights have positive or negative impact on firm value. The study was commissioned with a view to bringing the one share, one vote standard to the entire European Union (EU). But since no conclusive evidence was found, the EU ultimately decided that there is no need for action on the EU level. Interestingly, with a view to promoting long-term shareholding, the idea of giving long-term investors more votes was brought up again by the EU Commissioner Michel Barnier in 2013, but the issue was not followed up.

In Australia, a public consultation was launched in 2007 on the introduction of non-voting common shares. The matter was dropped as there was no conclusive response.

By giving you a quick review, the one conclusion we can draw is that the debate around the one share, one vote standard is a long-standing one, with lists of pro and con arguments. The pro argument is relatively simple. The one share, one vote standard is simple and transparent, with voting power proportional to shareholding. The argument against the one share, one vote standard seems be gaining traction lately because of the concern over short-termism of stock

markets. Some informed and impartial parties begin to wonder if differential voting rights should be allowed to encourage longer-term behaviour. At the same time, it is difficult to strike the right balance as we try to guard against the entrenchment of management and controlling shareholders at the same time.

It is also fair to say that institutional investors are never impressed by the argument against one share, one vote. They believe that as professionals they have the necessary knowledge, information and expertise, and prefer to retain the right to influence management by making full use of their votes.

So what are the policy choices? I believe that Hong Kong did not arrive at the current arrangement of one share, one vote for no reason. There is a history behind it, and if you are familiar with Hong Kong's market, you would probably understand why there is such a strong concern over corporate governance. It is not a good idea to transplant one policy from one market to another without understanding their respective historical backgrounds.

However, the debate is going to continue. With the US being the largest stock market in the world, it carries huge influence over the global market. The US approach to regulation matters because they are the big elephant in the room. The US standard of corporate governance also matters for competitive reasons, as companies will always shop around and decide where to get listed.

I am not optimistic about a global convergence of standards as different jurisdictions do approach the issue of corporate governance very differently. The Alibaba case has showcased instead the divergence in global standards in listing, pointing to some potential risks, such as a race to the bottom in regulatory standards. I do not detect that kind of race at the moment as global regulators are sticking to high governance standards, but the risk cannot be ignored.

At the same time, Hong Kong is not against changes to the one share, one vote standard. However, when I look at the various proposals, I realise that it is a very difficult task to come up with a justified variation. For example, should long-term investors or the management get more votes? And how many more votes? What about a sunset clause or other limitations? It is not easy to form a rational basis to support a particular deviation.

As a policymaker, it is my hope that the experts present here today would be able to shed further light on this matter. Once again I would like to thank the

organisers for holding this event to help solve some of the most challenging issues related to corporate governance.

Thank you.

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