

**Speech**  
**Speech by Acting FS at Conference on Business Ethics**  
**for Listed Companies 2017 (English only) (with photos/video)**

Friday, September 1, 2017

Following is the speech by the Acting Financial Secretary, Mr James Lau, at the Conference on Business Ethics for Listed Companies 2017 today (September 1):

Simon (Commissioner of the Independent Commission Against Corruption (ICAC), Mr Simon Peh), and honourable guests,

Good morning everyone. For me it's a very exciting time because it's the first time I've been to an ICAC symposium or conference and actually I was told that the last one organised was in 2007 – so on the 20th anniversary of Hong Kong's return to China, I think this is a very apt time to take stock of what is happening in terms of corporate governance and compliance and beyond.

I would want to touch on a somewhat sensitive subject, weighted voting rights (WVR), because there have been very busy discussions and debates, mainly because the Hong Kong Exchange (HKEX) recently closed the consultation on August 18 on the treatment, in loose terms, of the new board and various issues. I would just have a kind of generic discussion.

Let me first make a disclaimer. I'm not going to comment on the outcomes of the consultation paper because there are several hundreds of them and the HKEX is still analysing them, busy doing so. For me I'm just looking at this as a kind of generic issue. The second point, disclaimer I would say is that this issue was also recently discussed by the Financial Leaders Forum, which was set up by the Chief Executive to discuss with a group of core advisers and also regulators. There has been media interest in the outcome of this discussion announced by the Financial Secretary, Mr Paul Chan, two days ago. On the fact that this subject was exhaustively discussed, there was considerable importance attached to the review of this particular topic, and it's for the Securities and Futures Commission (SFC) and the HKEX to go on to do further hard work and study the analyses and assessment on the implications of such direction. So that's the disclaimer that I'd just like to put on record for the moment.

Now, coming back to my address. We are all of course familiar with corporate governance, risk management of all sorts, and in the more recent days we have the ESG – the environmental, social and governance reporting. Green finance, a main initiative espoused by the Chief Executive in her manifesto, comes also under this one. We also have the board composition, the functioning of the board of directors, executive compensation, some of these so-called run-of-the-mill or more traditional issues. But of course we also have responsible ownership and how they exercise the shareholders' rights, transparency, accountability, and when we talk about shareholders' rights, this comes to the point where the topic of weighted voting rights comes right in.

Hong Kong for historical reasons has some experience with listed companies with dual class structure. In today's world the subject comes alive again – or it has come alive in the last few years particularly because there are new economy companies. It used to be more family-owned or particular kinds of companies which had the weighted voting rights, but the new economy means that there are now new gurus coming around with new ideas and a novel way of dealing with all sorts of what we see here, on the mobile device or otherwise. The argument that we see is that new economy gurus, they need time to focus on the development of the company, so they should not be distracted by short-term debate on the corporate development, or maybe boardroom politics. The weighted voting rights usually give the new economy companies, their shareholders or usually the founders, or maybe some of the senior executives and the like, a voting right which militates against the traditionally long-held value of equal say. In crude terms it will be said "one share, one vote".

When we see today around the world, there are different exchanges, jurisdictions, all looking at this issue. And when we look around, particularly in the US (United States), of course we see quite a few examples, some are mega corporations, some have a very large share of certain indices. The question then is, why is this sparking such a heated debate? We see the debate not just in Hong Kong or London or Singapore, but even also in the US. The US of course is the leading capital, in terms of financial capital, where you have WVR companies. Now, in the US the Council of Institutional Investors, and for them their members oversee about US\$23 trillion of assets, they have come out very strongly, if I'm not mistaken I think I saw in the press that they have also

written in response to our consultation in Hong Kong. Given all that background, why are investors or the buy side so concerned about WVR?

I think I can summarise it with one phrase I borrowed from the American colonial days. They had this argument back then when there was this battle on what I will quote as "no taxation without representation". In the American colonial days there were 13 states, they resisted the imposition of colonial taxes by the British Parliament and their argument was they were not represented in the British Parliament so they had no say on which taxes should be levied and to what extent, yet they were at the receiving end of the taxes. So the outcome, and some historians say that precipitated the American Revolution, the 13 states were the first ones to rise, and the rest is history.

Now, when I look at the weighted voting rights I thought some might see this as "taxation without representation", or maybe taxation with minimal representation, depending on how weighted voting rights are cast. Earlier this year in March, there was a US company that went for an IPO and it went very well, though the shares went up 40-something per cent and it's come down three months later to the same IPO level. But that was quite a sensational IPO, for what reason? That particular IPO caught the market by surprise because they announced that the publicly-traded shares would carry zero voting rights.

When we look at this "taxation without representation", that particular IPO in March actually generated a lot of debate. There was concern from the buy side and from managers of index funds in particular that they have no choice but to passively follow equity indices, because that particular company, if I'm not mistaken, they are in about 24, at least two dozen indices, large and small. So, if there were funds going after, or indexed, to some of these indices, then they will have to follow and purchase these shares, that being index funds. It's been suggested that if a particular group of investors, particularly the buy side, if they don't like that particular share, then just don't invest in these shares with weighted voting rights. But the point is, in the investment world today, in recent years according to Blackrock research, about a third of the global stock market are controlled by index funds. That means about a third of these investments have to follow the index. So, when the index brings in a particular company, of whatever nature, whatever industry, or whatever weighted voting rights, they just go ahead and then have to buy it.

This particular float in March this year generated a very major debate in the world of S&P Dow Jones and FTSE Russell. In April this year S&P Dow Jones announced a consultation on the eligibility of non-voting share classes in their indices. Following the consultation, S&P Dow Jones announced the decision that they would no longer add new companies with multiple share class structures to its S&P Composite 1500 and its component indices, and those components are S&P 500, S&P MidCap 400 and S&P SmallCap 600. So, it's very clear on the S&P front, even though it's a leading light in the US in this area, it has decided that there will be no more new additions.

Similarly, a month later in May, FTSE Russell issued a consultation paper on the same issue, suggesting that the criterion for index inclusion should be a minimum percentage of voting rights that are held in the hands of non-restricted, free float shareholders. So, it is no more the case that there will be unrestricted access to the market with zero voting rights without any commitment on the so-called public float portion. FTSE Russell has proposed to set a minimum threshold of 5 per cent for companies to be eligible for inclusion in its standard indices for these WVR companies.

As a respondent, a major sovereign wealth fund in Europe, usually cited as the largest sovereign fund from Europe, proposed scaling index weightings based on the voting power given to shareholders. So they are saying when you bring in WVR companies, you have to scale it in order to adjust for the fact that these companies do not have equal say in their voting structure. Specifically, this sovereign fund suggested that any constituent failing to clear the minimum threshold should have its investability weight reduced, and that voteless companies should have zero investability weighting. So, this is a very clear statement from a US\$1 trillion sovereign wealth fund.

This actually suggests that if you look at the market, the buy side and sell side, and if you look at the world of index providers, they see this as a very major development. When we talk about the new economy we talk about the disruptive effect, we talk about the disintermediation and so forth, but here we can see that the WVR, even though it's been in existence in the US for quite a while, is a very disruptive issue. Now of course, while we have these concerns over index inclusion, even critics acknowledge that zero voting rights is rather rare. My colleagues checked for me, there are a few in the London market, obviously not in the premium listing. When we have other new economy firms

coming along and they offer voting rights for trading, even though individual investors might have fewer votes, or zero votes, the question then is what should the listing regulator and what should these major financial centres, these jurisdictions, what is the stance that they should take in response to these offers?

In fact, financial centres around the world, we all face the issue of whether weighted voting rights should be allowed, and if so, the parameters and appropriate safeguards, since actually they are often touted as a preferred structure for these founders of new economies, gurus and so forth. What we've seen so far on these mega issues, some have done very well. If I'm not mistaken there is a particular one where the founder has less than 1 per cent of the publicly traded stock, and that particular person holds 60 per cent voting right. Now, if the investors are prepared to concede this sort of boardroom to these guru founders, I think that's in a way their choice but as I mentioned just now, index funds means that others have no choice but to follow. That's why the inclusion or otherwise, subject to safeguards, is a very key issue to be debated. So, let me now take you through with a few arguments for and against the weighted voting rights.

One of the main arguments as I mentioned just now is to actually give the company founders the ability or the room to focus on long-term performance and less on short-term market pressures. Supporters of the initiative often claim that they allow founders to maintain control over the strategic direction of the company and prevent unwanted takeover attempts. Others may also believe that these founders and gurus are capable of generating value, or maybe astronomical value for all investors, including individual investors. So that's all jolly good, all the investors, big and small, will be very happy that the founders are with them and everybody is coasting along.

In contrast, those against weighted voting rights argue that these structures increase the risk that those with superior voting rights will not be held accountable, that's the corporate governance, for their behaviour, and may even pursue projects that are not in the best interests of the company but for their own good. That challenge may not be so obvious, but what if the founder engages or goes for an M&A, or maybe an acquisition, or maybe privatisation? What if they take those sorts of moves, if I can use the word, steamrolling through the boardroom because they have the superior voting rights, the

majority or controlling say on the stock.

That's why several stock exchanges around the world, including London and Singapore, are looking at this issue. The Financial Conduct Authority of the United Kingdom (UKFCA) came out with a consultation paper in March and concluded in May but so far they have not published their findings. So obviously they are taking time to take a considered assessment on which direction it should be. Singapore also launched a consultation in February and again so far they have not come out with the conclusion. Ours is just a few days old, ended on August 18. So we will all have to put our thinking cap on, or rather the Stock Exchange or the SFC would have to evaluate very carefully the pros and cons and what should be done in here.

As I said, I am not going to devote myself to the HKEX consultation because this is more of a generic discussion. What I would like to conclude is that, after this conceptual discussion, from what we have seen in the reports so far, the discussion has focused a lot on the structure, whether there should be a new board PRO, a new board PREMIUM, a graduation ceremony or is there a path up the scale so that they can move from one board to another.

One major issue here in that CP (concept paper) is this question of weighted voting rights. I would emphasise that when we go for this WVR examination, one key question is what are the safeguards that should be included or the conditions, like what the UKFCA and others are looking at, and also what we should be looking at in Hong Kong. I will just sum up with a few key questions, kind of food for thought. Not that they are very new, but sometimes they are forgotten because when we see the economy going well and there are others so-called knocking on our door, we almost usher them in, bring them in and put them on our listing platform.

So the key questions here, the first one of course is the basic question: should weighted voting rights itself be allowed at all? The equal say, the corporate governance and the enhanced corporate governance would suggest that this is not something we should easily succumb to, if I use that word. But if we do consider weighted voting rights as a question to be addressed, then what conditions or what safeguards should be put on the table and thoroughly thrashed out? Where should the weighted voting rights be accommodated in Hong Kong's context, in the main board? In the United Kingdom so far, the

premium board is not for the weighted voting rights or what they call the "dual class structure".

The second question is should weighted voting rights be restricted to "new economy" companies? How do you define "new economy" companies? How should they then be allowed in? Should there be sunset clauses? Should there be conditions on when the founders' rights should be taken away? For example, when they are no longer actively involved in business, should they not be deprived of what the WVR gave them? Some might see this as kind of an unlikely situation, but we know for a fact that even recently, we see in the press, that a particular "new economy" company which we should be quite familiar with even it is not operating very legally in Hong Kong, the founder had a lot of problems with the shareholders. And in fact, in that case, the founder was removed but then he still got the power to appoint a few directors to the board. And that particular case means that he can still have a lot of sway over the board's decision. So, this is a quite real situation, not hypothetical.

And another question is should we allow companies with weighted voting rights already listed elsewhere to seek secondary listing. This is also a heavily debated issue and some jurisdictions have recently announced they will accept secondary listing. The thing is can you rely on the primary market regulators, even though they have been primarily listed elsewhere in a particular jurisdiction, but if the trading should shift, the preponderant trading of that particular WVR company's shares should come to our market, our market becomes the major market trading that particular WVR company's shares. In that case, will that change the equation when you look at reliance on the primary market, or relying on the price discovery in both markets to do the trick.

The final question for me from here, what would be the safeguards required in terms of ring-fencing. How do you ring-fence the eligibility? Who are the eligible persons? Who are the gurus who can have these super voting rights? Is this transferable? If he transfers to another guru, should that be perpetuated? Or even without transfer, should there be a sunset requirement so that after so many years, there will be a phased alignment of the multiple dual class or whatever class with a voting differential to be brought down to a more reasonable level? What is a more reasonable level? What are the disclosure requirements? And how do they together impact on corporate governance?

So, in my final word, while we see the weighted voting rights as a very important development which we have to give serious attention to, we also have to know that some see the WVR, if introduced in Hong Kong, would mean a sea change in Hong Kong and a lot of these new economy companies would be coming to Hong Kong. But, will they? We also have to look at other factors. As you are in the market, you are very familiar with the fact that valuation, for example, is a major issue. When they come for a particular financial market, it is not just that they allow WVR, they look at the valuation, political and economic stability, the reputation and the international recognition of that particular exchange, the trading and clearing settlement infrastructure, the regulatory framework, the ability to attract foreign and institutional investors, the rule of law and independent judiciary. When you have issues like these, some say that class action is a major kind of lever. But would class action really do the trick, given all the issues we cited?

Ladies and gentlemen, as I mentioned, given the key importance of this particular subject for market development on the one hand, and market quality and integrity on the other, we can see why the financial centres around the world are now having this tough balancing act to do when it comes to the issue of weighted voting rights or dual class structure or triple class or quadruple class structure.

Thank you very much.

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