RESPONSE TO CONSULTATION PAPER "POSSIBLE LISTING FRAMEWORK FOR DUAL CLASS SHARE STRUCTURES"

Thank you for the opportunity to provide feedback on the consultation paper.

I am an associate professor of accounting at the NUS Business School, National University of Singapore. I specialise in corporate governance and have been involved in this area for 20 years, and am also a retail investor.

I have studied the use of dual class shares (DCS) in various overseas jurisdictions and companies, discussed the subject with experts in some countries where they are used, spoken to institutional and retail investors, and written extensively on the topic. Some of my commentaries on this subject are attached at the end of this document.

The views in this response to the consultation paper are my personal views, and not necessarily the views of NUS.

Summary

I am <u>against</u> the introduction of DCS for SGX-listed issuers <u>under all circumstances</u>. My key reasons are summarised below:

1. It will undermine Singapore's reputation as a capital market with high standards of corporate governance.

2. SGX should not start or participate in a "race to the bottom" in this region. Any "benefits" from additional listings through DCS may be unsustainable while the damage to Singapore's reputation may be substantial.

3. Most institutional investors are against DCS and major investor groups are lobbying regulators and companies in developed markets to unwind DCS structures.

4. Should DCS be introduced, there is likely to be continuing negative spotlight on Singapore each time a major DCS listing is contemplated. This will continually chip away at Singapore's reputation.

5. Singapore's main source of competitive advantage is its reputation. Institutional investors may downgrade Singapore as an attractive investment market, which can affect not just DCS companies but also non-DCS companies.

6. DCS will undermine other initiatives to improve corporate governance, such as the Code of Corporate Governance and the Singapore Stewardship Principles.

7. DCS will lead to inconsistencies with our regulatory framework, including company law, listing rules and the takeover code.

8. DCS will render existing corporate governance mechanisms largely ineffective.

9. Countries that allow DCS have unique legal, institutional and cultural features in their environment which minimise risks of DCS. Introducing DCS into an environment without these features is likely to lead to abuse.

10. DCS does not address the root causes of lack of listings in Singapore - structural issues and low valuations. SGX may attract DCS companies that exploit our weaker regulatory and shareholder enforcement compared to other markets that allow DCS, such as US. This may further erode investor confidence and adversely affect valuations, and worsen the problem of attracting high-quality listings.

11. Companies already have other financing options that allow founders and controlling shareholders to raise capital without diluting voting rights, such as preference shares and debt financing.

12. There is strong evidence based on rigorous academic research that DCS companies underperform non-DCS companies.

13. Contrary to assertions that DCS structures facilitate innovation and long-term perspectives in running businesses, there is a lack of strong empirical evidence supporting this.

14. The Committee on the Future Economy (CFE) has argued for using DCS as a public financing option for start-up companies in their incubation stage. Venture capital and not public equity financing is the appropriate financing option for such companies.

15. Many of the proposed safeguards in the consultation paper are unlikely to be effective or are arbitrary. Extensive safeguards that reduce the power of founders and controlling shareholders in making key decisions are likely to reduce the attraction of DCS.

COMMENTS ON QUESTIONS RAISED IN CONSULTATION PAPER

Question 1: DCS Framework

Do you think that the introduction of the DCS Framework will be beneficial to companies, investors and the Singapore economy? Please give reasons for your views.

My answer is an **emphatic "no"**.

A. No proven benefits to companies, with potential for harming long-term performance

i. Arguably the most comprehensive academic study on dual class shares published in 2010 by three professors from Harvard, Stanford and Yale found that dual class shares reduce firm value in US companies.[1] Another U.S. study of family firms by two professors from Harvard and Wharton found that dual class shares have a negative impact on firm value in family firms.[2]

ii. There is a lack of strong empirical evidence that DCS promote innovation and long-term decision-making. Anecdotally, while tech companies such as Alphabet (Google), Facebook, Groupon and LinkedIn have DCS (or three classes of shares), other equally innovative companies such as Amazon, Apple, Microsoft, Netflix and Twitter do not. This suggests that innovation is not dependent on having DCS. There are other measures that can be explored to promote innovation and long-term thinking, and accountability should not be sacrificed based on tenuous links between DCS and innovation.

iii. Companies already have other financing options that allow founders and controlling shareholders to raise capital without diluting voting rights, such as preference shares and debt financing. It is an important discipline for companies to make trade-offs between giving equal voting rights and giving dividend, interest or liquidation preferences to suppliers of capital. DCS significantly reduce the exposure of management to market discipline and from having to make trade-offs, and does not support the development of strong management who believe in accountability.

iv. Interestingly, Li Ka-Shing has publicly stated his preference for one-share-one-vote. Of course, this may be because DCS will affect his ability to acquire other companies. Nevertheless, shielding companies from market discipline, including the market for corporate control (which is already weak in Singapore), will result in weaker companies and management.

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[1] Paul A. Gompers, Joy Ishii and Andrew Metrick, Extreme Governance: An Analysis of Dual-Class Firms in the United States, The Review of Financial Studies, March 2010, pp. 1051-1088.

[2] Belen Villalonga and Raphael Amit, How are U.S. Family Firms Controlled?, The Review of Financial Studies, August 2009, pp. 3047-3091.

v. DCS will render traditional corporate governance mechanisms largely ineffective. As pointed out by Professor Charles Elson, Director of the Weinberg Center for Corporate Governance at the University of Delaware, when you have DCS, what you are doing is exporting the monitoring function to third parties — to the government, the courts, the regulators.[3] This is because DCS will severely inhibit the role of directors, shareholders and markets in corporate governance. This is likely to affect the long-term performance of DCS companies, as the research suggests.

B. Harmful to investors, many of whom are opposed to it

i. Control should be aligned to economic interest. By breaking the link between control and economic interest, DCS create entrenchment and expropriation risks that harm non-controlling shareholders. For this reason, most institutional investors are against DCS.

ii. Some institutional investors investing in DCS companies are doing so not by choice, but because passive investment strategies such as indexed funds cause them to invest in all stocks in a market or sector. Some are now calling for DCS companies to be excluded from market indices so that they have a choice to not invest in DCS companies. The ultimate beneficial owners in institutional investors are ordinary investors and they stand to lose from poor corporate governance and underperformance of DCS companies.

iii. When HKEx consulted on the issue, large global investment managers like Blackrock and Fidelity opposed it under all circumstances. The Asian Corporate Governance Association (ACGA) survey of 54 of its institutional investor members showed "overwhelming opposition" to it.

iv. Two influential institutional investor bodies, the Council of Institutional Investors and International Corporate Governance Network, have called for companies going public to adopt a "one share one vote" structure and for existing companies to end their DCS structures if they have them.

v. We cannot rely solely on caveat emptor and investor education to protect the interests of ordinary retail investors. Given the complexities and nuances of DCS and the limited access to justice for retail shareholders in Singapore, strict restrictions should be placed on retail investors using their CPF funds to buy shares of DCS companies, if DCS are allowed.

vi. Venture capital and private equity investors put in place a variety of measures to protect their own interests when they invest. These may include liquidation preference, restrictive covenants (which essentially amount to voting or veto rights in key decisions), board representation and put options. These investors may support DCS at the time of IPO because the IPO provides an opportunity for them to cash out their investment and they stand to realise a significant return on their initial investment. Even if DCS results in a discounted IPO price, their gain is likely to be still substantial and the discount a small price for them to pay in order for founders wanting to retain control to agree to go public.

[3] Dual Class Shares: Governance at the Edge, Directors & Boards, Third Quarter, 2012.

C. Harmful to Singapore's reputation as a reputable financial centre and capital market

i. DCS will undermine Singapore's hard-earned reputation as a capital market with high standards of corporate governance and strong investor protection. A consequence is an expected drop in Singapore's top ranking by the Asian Corporate Governance Association. We can expect strong opposition from global institutional investors, broadcast around the world.

ii. DCS will also undermine efforts to improve corporate governance, such as the Code of Corporate Governance and the Singapore Stewardship Principles. Claims of improving shareholder participation and encouraging institutional shareholders to exercise stewardship over their investee companies will ring hollow if we allow DCS that does exactly the opposite. Worse, it may make us look hypocritical.

iii. Once the DCS Pandora's box is opened, it is difficult to close it. Any benefits from additional listings through its introduction may be unsustainable as other exchanges also allow them in a "race to the bottom", while the damage to Singapore's reputation may be substantial.

iv. There will also likely be continuing negative spotlight on Singapore each time a major DCS listing is contemplated. This will continually chip away at Singapore's reputation.

v. Singapore is a small market. While large markets may be able to attract global institutional investors despite questionable corporate governance standards, Singapore's main source of competitive advantage is her reputation. Institutional investors may downgrade Singapore as an attractive investment market, which can affect not just DCS companies but also non-DCS companies.

vi. DCS continues to be highly contentious in markets where they are prominent, such as US and Canada. Notwithstanding that a number of tech companies have recently used DCS, the tide is arguably turning against, not towards, DCS. Singapore will be swimming against the tide on DCS and will be seen as out of touch, rather than progressive.

i. While there have not been widespread scandals involving DCS companies, countries that allow DCS have certain legal and institutional features in their environment which minimise risks of DCS – such as fiduciary duty of controlling shareholders, and contingency-fee class action. This is how two lawyers from a US law firm explain it in the context of dual class shares in The Corporate & Securities Law Advisor: "Corporate law provides shareholders with protections against abuses by those in control of the corporation. Directors and controlling shareholders owe shareholders a fiduciary duty of loyalty. The duty of loyalty requires that directors and controlling shareholders act in the best interests of the company and its shareholders, and without regard to personal motivations not shared by shareholders generally. Directors or controlling shareholders may be found to have violated the duty of loyalty if they approve transactions in which they have a conflict of interest because they or someone with whom they are aligned will benefit from the transaction. Such conflict of interest transactions are subject to an entire fairness review unless procedural protections, including an independent committee and minority shareholder approval, are used. To survive the stringent entire fairness review, the transaction must be the result of fair dealing and must be at a fair price. Any breach of the duty of loyalty entitles shareholders to seek judicial relief and remedies. There have been

several judicial actions where the control group in a dual class company has been successfully challenged by shareholders."[4]

vii. The consultation paper mentions other countries where DCS are allowed, including Canada, UK (except for premium-listed issuers) and Sweden. Canada allows contingency-fee class actions, as does UK since 2013. I understand that countries like Sweden, Switzerland and several other European countries where DCS are allowed have voting caps. Under a system of voting caps, articles of association may limit the number of votes each shareholder has at general meetings, with no distinction for different classes of shares, In Switzerland, where there was a major dispute at Sika AG involving the controlling shareholder's attempt to sell its multi-vote shares to an external party at a significant premium, the board was able to pass a resolution which restricted the controlling shareholder's voting power to just 5%, even though it actually controlled 52.4% of the voting rights. But voting caps are a double-edged sword that can be used to disenfranchise large shareholders, so there must be other safeguards to prevent abuse. Continental European countries may also have other societal factors, such as egalitarianism, which may help control expropriation risks, such as excessive remuneration and abusive related party transactions.

viii. In other words, there are legal, institutional and possibly cultural factors in countries which permit DCS that may help curb rampant abuse. Importing DCS into Singapore without these "macro safeguards" may be a recipe for disaster.

ix. Given that DCS are available in much larger markets such as the US, we are likely to attract the poorer quality companies. This will further affect valuations in our market. DCS will accentuate existing weaknesses in corporate governance, shareholders' rights and enforcement.

x. The lack of listings in Singapore is due to structural issues (such as small domestic economy and lack of a "hinterland" providing a supply of listings) and low valuations (caused partly by S-chip and penny stock scandals, and lack of effective enforcement). These are not addressed by DCS.

D. No clear benefits to the economy

i. Foreign companies listing here with DCS will not benefit Singapore in any significant way in terms of employment in the real economy since most of their operations will remain overseas.

ii. DCS are likely to benefit mainly the SGX in terms of its profitability from more listings if they eventuate, and market participants such as banks, law firms and accounting firms in terms of fee income – and of course the founders and management who want control with minimum economic investment. Indeed, those who responded positively to the HKEx consultation paper on DCS are generally accountancy firms, sponsor firms/banks, law firms and listed company staff.

[4] Stephen I. Glover and Aarthy S. Thamodaran, Capital Formation: Debating the Pros and Cons of Dual Class Capital Structures, The Corporate & Securities Law Advisor, March 2013, pp. 1-9

iii. The Committee on the Future Economy (CFE) envisages DCS as a way of promoting Singapore as a hub for tech and biomedical start-ups. It has argued for using DCS as a public financing option for start-up companies in their incubation stage. Venture capital is the traditional financing option for such companies and remains the appropriate financing option for such companies. Venture capital investors put in place numerous safeguards to protect their interests. It is ill-advised to expose public investors to such investments without the safeguards available to venture capital investors.

iv. It is speculative to assume that DCS will contribute to Singapore becoming a hotbed for innovation or that they will spur growth in number of listings or the economy.

E. Other comments

i. I am concerned that SGX risks repeating the mistake it made with S-chips. In my view, SGX pursued a strategy of attracting Chinese companies to list here without a proper consideration of the differences in legal frameworks and business practices in China, and the unique governance, regulatory and enforcement challenges. When problems arose, it found that existing rules and regulations and enforcement mechanisms were of limited usefulness to hold these companies accountable. DCS companies will likewise pose unique governance and regulatory challenges.

ii. The SGX board should ensure that there is a proper risk assessment before it makes a decision on whether to allow DCS. This should involve a comprehensive assessment of the impact of introducing DCS on its reputation and the governance risks of DCS companies and how they can be mitigated. As an operator of a listing platform for companies, it should also assess how the introduction of DCS will affect different stakeholders, including non-DCS issuers and investors in the market as a whole. It should also assess whether any benefits that may be derived from DCS are sustainable.

iii. SGX seems to believe that it is possible to develop its own Singapore-style DCS, with enhanced corporate governance arrangements and an array of safeguards (that cumulatively reduce the attractiveness of DCS) to mitigate the governance risks of DCS. For example, it proposes to mandate certain provisions in the Code on independence and to require a risk committee, even though experts have said that conventional corporate governance mechanisms will not work in DCS companies. Indeed, in the US, DCS companies generally qualify as "controlled companies" which are exempted from corporate governance rules relating to majority of independent directors, corporate governance/nominating committee and compensation committee. Investment in such companies is based on caveat emptor, and redress for abuse can be sought through contingency-fee class actions. Similarly, in the UK, single-class shares go hand-in-hand with strict corporate governance requirements for premium-listed companies. DCS companies are only allowed for standard listings (but it is understood are nevertheless rare) which also have lower corporate governance requirements. UK now also has contingency fee class actions.

iii. With the heightened governance risks for DCS companies, monitoring and enforcement resources will surely have to be beefed up. Yet, there is only a cursory discussion of enforcement in the consultation paper and this discussion is about the existing enforcement framework - statutory derivative actions by shareholders (which are still costly without contingency fee arrangements) and the enhanced listings enforcement framework - neither of which have proven to be particularly effective thus far in addressing serious governance

infractions. One gets the impression that SGX believes that it can introduce DCS without significantly beefing up its monitoring and enforcement resources. Lunch break may be back but there is still no free lunch!

iv. The introduction of DCS will require an examination of existing laws, regulations and rules, including the Companies Act, Listing Rules and Takeover Code, as these rules are drawn up on the basis of a one-share-one-vote system. For example, DCS will have implications for rights of shareholders to requisition or call for meetings and to propose resolutions, approve major business decisions such as large acquisitions and divestments, approve takeovers, and so on. Some lawyers I have spoken to have even suggested that separate corporate legislation may be necessary for DCS companies.

v. There have been comments that some form of DCS already exists in Singapore in the form of management shares at SPH and are therefore not new. The management shares at SPH were introduced for a very specific objective and the superior voting rights are only exercisable in the very limited circumstances of key appointments and are not carte blanche. Those superior voting rights have not been exercised in shareholder meetings in the last few years – and possibly have never been. In any case, a single exception is a poor excuse for a broad shift in policy.

vi. It has also been argued that founders and management already control many companies and that DCS does not change this in our market. Where control is aligned with economic interest, governance risks are less severe. Mechanisms such as pyramids and cross ownership that can be used to create a wedge between control and economic interest are harmful and should be discouraged. Corporate governance scorecards, such as the ASEAN CG Scorecard, identify such structures as bad for governance and discourage their use. SGX and regulators should focus on discouraging and eradicating such bad governance practices rather than use them as a justification for introducing DCS. Further, the earlier-cited study by Professors Villalonga and Amit found that dual class shares and disproportionate board representation are particularly damaging for firm value in U.S. family firms, compared to other mechanisms that create de-link control and economic interest.

Questions 2 to 10

Note: As I am against DCS under all circumstances, my views on the following questions are not a conditional endorsement of DCS under certain situations.

Question 2: Additional Admission Criteria

Do you think there should be additional listing criteria for issuers using DCS structures? If the answer is yes, SGX seeks views on the following possible listing criteria for issuers using DCS structures: (a) a minimum market capitalisation of S$500 million; (b) the level of participation by sophisticated investors (i.e. 90% of the public float requirement), taking into account the existing public float and distribution requirements under Rule 210(1)(a) of the Mainboard Rules; and (c) a compelling reason based on holistic assessment of various factors such as industry and operating track record.

(a) Minimum market capitalisation of $500 million:

There appears to be a lack of clarity as to what kind of companies DCS are intended for. The initial conversations following the LAC's recommendation seem to be that DCS would be allowed only sparingly to attract some large foreign listings which may otherwise choose to list elsewhere. If so, then a minimum market capitalisation such as $500 million, or even higher, makes sense.

However, the CFE, whose views are cited in the consultation paper, seems to envisage different target companies – tech and biomedical start-ups in their incubation stage. If these are the target companies, then a $500 million threshold will be far too high. As mentioned earlier, venture capital financing is the appropriate form of financing for such start-ups, not public markets using DCS.

(b) Level of participation by sophisticated investors:

Given that participation of sophisticated investors is intended to provide a stamp of quality of a listing, it is important to be clear as to what is meant by sophisticated investors. There should be significant participation by "sophisticated investors" who are unrelated investors and who are not pre-IPO investors selling most of their shares at the IPO. The pre-IPO investors would already be expected to realise a substantial return if a company goes IPO and would likely be prepared to retain some stake. They should also not be investors who have entered into other arrangements with the company or its founders such that they stand to gain from other private benefits for supporting a DCS structure.

These sophisticated investors should also be subject to appropriate moratoriums.

(c) Compelling reasons

DCS are used by companies in many different industries in other markets. It is arbitrary to limit to certain industries if DCS is allowed. However, limiting to certain industries may make sense if the objective is to grow a specific sector (like technology) or to develop expertise in assessing certain sectors.

DCS applicants with an operating track record or founders/management with strong track records and who have proven themselves to be responsible stewards are likely to have lower risks [Warren Buffet and Berkshire Hathaway come to mind, but they are not coming.]

Many DCS companies that list are not true start-ups at all. Google was founded 6 years before listing, while Facebook was founded 8 years before listing. By the time of listing, they were already well known companies with proven technologies, sizeable customers'/users' bases, and reasonably well-established business models. Ford Motor operated as a private company for many years, with several generations of automobiles already commercially sold, before it went public with DCS.

In assessing DCS listing applicants, the above factors can be considered. However, what constitutes "compelling reasons" is somewhat subjective. If the LAC is tasked with advising on whether there are compelling reasons and on the governance risks of a specific applicant given any mandatory and voluntary safeguards, then its composition needs to be carefully considered to avoid perception of vested interests and to ensure that its members are competent in making such assessments.

Question 3: Maximum Voting Differential

SGX seeks views on the following: (a) whether there should be a maximum voting differential between each MV share and OV share or a fixed ratio applied to all issuers; and (b) the appropriate maximum or fixed ratio (as the case may be) of voting differential between each MV share and OV share.

Yes, there should be a maximum voting differential. The greater the voting differential, the greater the entrenchment and expropriation risks.

Although the US and other markets generally allow for ratios of 10:1 or higher, the maximum voting differential needs to be calibrated according to the legal and institutional environment and the governance risks of companies that are likely to list here.

In order to ensure some minimum alignment between control and economic interest, the maximum voting differential ratio should be no more than 4:1, which has also been proposed by the Canadian Coalition of Good Governance.

Question 4: Restriction on Issuance of MV Shares Post-listing

SGX seeks views on the following: (a) whether issuance of MV shares post-listing should be prohibited; and (b) whether a rights issue should be an exception to such prohibition. For Question 4(b), you may also propose, in substitution or in addition, other exceptional events where issuance of MV shares should be permitted, and provide reasons for your proposals.

Prohibiting issuance of MV shares post-listing is consistent with similar prohibitions in markets such as the US and predicated on the lack of investor choice at the time of listing. In theory, investors still have a choice if a company proposes to convert from single-class shares to DCS,

through shareholder meetings and special voting procedures to approve changes. That being said, the more stringent the rules the better, so (a) is preferred. However, SGX needs to watch out for companies that delist, convert to a DCS structure, and then re-list as another entity later; or spin off and list another company with DCS and then delisting the single-class share company.

In terms of (b), the proposed exception is predicated on rights issues not altering the relative rights of different shareholders as long as they subscribe for their entitlement for new shares. However, shareholders holding MV shares who wish to raise additional capital should have to cede some of their control. Therefore, I do not support a general exception for rights issues.

Question 5: Automatic Conversion of MV Shares

SGX seeks views on the following:
(a) Who should be eligible to hold MV shares (e.g. executive officers or executive directors)?
(b) Do you think that it should be a mandatory requirement that MV shares will be automatically converted into OV shares upon the occurrence of certain events or should such conversion provision be left to issuers to adopt on a voluntary basis, bearing in mind that the Take-over Code will continue to apply if there is a change in control of the DCS company?48
(c) If you are in favour of a mandatory automatic conversion requirement:
(i) Do you agree with the possible conversion events listed in paragraph 3.6 of this Part IV? Please indicate your preferred form and combination of the conversion events, and provide reasons for your views.
(ii) Do you agree that there should be flexibility for shareholders to waive such automatic conversion requirement?

(a) These would typically be the founders and those closely involved in day to day management (executive directors and key officers). Even pre-IPO investors such as venture capitalists often are not entitled to the same MV shares. For example, in the recent Snap Inc. listing with three classes of shares, the shares with 10 votes were limited to just the two founders. Other pre-IPO investors got shares with 1 vote each, while public investors got shares with no votes. In Alibaba, there are arrangements in place that give Softbank and Yahoo some influence compared to public investors, but they are not in the "partnership group" that makes key decisions.

(b) and (c) Regardless of who are eligible for MV shares, they should all have a mandatory conversion feature. The proposed conversion events in the consultation paper are too complicated. Transfers to the original founders, executive directors and key officers should require approval of OV shares. All other transfers should trigger auto conversion.

Question 6: Sunset Clause

SGX seeks views on the following: (a) Do you think it should be mandatory for a DCS issuer to adopt a sunset clause? (b) Should a sunset provision always be based on duration? If so, what length of time do you consider an appropriate duration? Should the issuer be allowed to continue having a DCS structure if shareholders allow the issuer to do so at a particular future date? (c) Would other factors, such as change of principal business or ownership makeup (for example, where MV shares will be converted into OV shares upon the total number of MV shares falling below certain percentage), be considered appropriate as a sunset provision?

Yes, a sunset clause should be mandatory. It should be for an initial period of 5 years, renewable if approved by OV shares. The sunset clause should also be triggered if there is a significant change in business, ownership or management.

Question 7: Independence Element on the Board

SGX seeks views on the possible safeguard to enhance the independence element on the Board by mandating certain recommendations of the Code as set out in paragraph 1.2 of this Part V.

I do not agree with this. With DCS, conventional corporate governance mechanisms are unlikely to be effective. Enhancing the independence element on the Board by mandating certain recommendations of the Code is unlikely to improve the governance of DCS companies. In DCS companies, independent directors are likely to be even less effective than for other companies. Therefore, this is likely to be just additional compliance cost with minimal benefits. In the US, DCS companies would generally qualify as "controlled companies" and would be exempt from requirements such as a majority of independent directors, corporate governance/nominating committee and compensation committee. We should not pretend that corporate governance would really work in DCS companies!

Question 8: Enhanced Voting Process on Appointment of Independent Directors

SGX seeks views on the possible safeguard of requiring the implementation of the Enhanced Voting Process for the appointment of independent directors.

Under this proposal, independent directors will essentially be appointed by OV shareholders, since MV shares will only have one vote and OV shares are likely to outnumber MV shares. While this can potentially improve the corporate governance of DCS companies, it is very unlikely that companies seeking to list with DCS will agree to it as it will undermine the control of MV shareholders. There is also the issue of whether OV shares can propose and remove independent directors, or whether they can only vote for directors chosen by management/MV shareholders.

Given the lack of regulatory and shareholder enforcement against independent directors, I am not confident that this will help address the governance risks in DCS companies.

Question 9: Risk Committee

SGX seeks views on the possible safeguard of requiring a risk committee and the composition of such committee.

I do not support this proposal. A risk committee is unlikely to be effective in mitigating governance risks from entrenchment and expropriation. It will likely be just additional compliance costs with minimum benefits. If DCS are intended for start-ups during their incubation stage (which I have stated should not be the case), then imposing additional committees such as this is counter-intuitive.

Question 10: Coat-tail Provision

SGX seeks views on the possible safeguard of a coat-tail provision in a take-over situation. Do you think that a coat-tail provision is necessary in addition to the Take-over Code which will likely apply if there is a change in control of the DCS company?

Yes, there should be appropriate coat-tail provisions, which may depend on the mandatory conversion features governing transfers of MV shares.

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ATTACHMENTS

SAY 'NO' TO DUAL CLASS SHARES

Mak Yuen Teen

Business Times, November 27, 2015

FROM the first quarter of 2016, public companies in Singapore can issue ordinary shares with different voting rights. The Singapore Exchange (SGX) and Monetary Authority of Singapore (MAS) are currently reviewing whether to allow dual class shares for listed companies.

Hong Kong recently shut the door on dual class shares after the Hong Kong Securities and Futures Commission (SFC) rejected it. The Australian Securities Exchange does not allow it (with minor exceptions for cooperatives and mutuals), and the Financial Conduct Authority (FCA) in the UK has also recently banned dual class shares for companies listing on the Main Market of the London Stock Exchange.

In the US, the recent popularity of dual class shares among technology companies going public has re-ignited the debate about its merits. Dual class shares were largely disallowed by the New York Stock Exchange (NYSE) from 1940 until the takeover era in the 1980s, when the NYSE suspended the restriction as some companies seeking to shield themselves from takeovers started to convert from one-share-one-vote to dual class shares and moved to other US exchanges. The Securities and Exchange Commission (SEC) eventually adopted a rule prohibiting companies that were already listed with a single class of shares from converting into dual class shares, which remains the position in the US today.

Recently, a number of commentators here have expressed support for dual class shares for listed companies. The pros and cons of dual class shares have been extensively discussed, and I shall not repeat them. Perhaps Financial Times columnist Andrew Hill best summed up the conundrum as follows: "The advantage of a dual-class share structure is that it protects entrepreneurial management from the demands of ordinary shareholders. The disadvantage of a dual-class share structure is that it protects entrepreneurial management from the demands of shareholders."

Founders and management who wish to protect themselves from the demands of outside shareholders have options such as retaining sufficient shares in a one-share-one-vote structure, issuing preference shares with no voting rights, or using debt financing. Using dual class shares is a case of wanting to have the cake and eating it too.

The empirical evidence supporting dual class shares is at best mixed. Arguably the most comprehensive academic study on dual class shares published in 2010 by three professors from Harvard, Stanford and Yale found evidence indicating that dual class shares reduce firm value in US companies.

However, we cannot reduce the question as to whether we should introduce dual class shares here to a matter of statistics – and even if dual class shares work in the US and other markets, we cannot assume that they will work here. As Geoff Colvin, senior editor-at-large of Fortune magazine said in Directors & Boards magazine: "The founders of the United States didn't survey types of government around the world and then run a regression analysis to figure out which was going to be the most effective. They set up a governance system according to the principles that they thought made the most sense."

It would be imprudent for us to allow dual class shares without considering our legal and institutional environment, and our approach to corporate governance. We should ask ourselves some fundamental questions, including:

- Does our legal system provide sufficient safeguards against abuse and practical means for shareholders to seek redress?
- Are dual class shares consistent with our legal and institutional environment, and with our philosophy about shareholders' rights and corporate governance generally?

When HKEx consulted on the issue earlier this year, the respondents were highly divided, largely in accordance with their backgrounds. Accountancy firms, sponsor firms/banks, law firms and listed company staff overwhelmingly supported dual class shares under certain circumstances.

Large global investment managers such as Blackrock and Fidelity opposed it under all circumstances. The Asian Corporate Governance Association (ACGA) survey of 54 of its institutional investor members showed "overwhelming opposition" to it. Most broker-dealers, retail investors and HKEx staff responding in their individual capacity opposed it. Those respondents who support it do not believe that they should be allowed under all circumstances.

Some commentators have suggested limiting dual class shares to certain companies, such as technology companies. This appears to be based on the recent trend of technology companies using dual class shares, rather than the potential merits of dual class shares only applying to such companies as one can just as easily make a case for other types of companies. It may be technology companies today and space travel companies tomorrow that favour dual class shares.

Dual class shares are also used by US companies in industries such as media and communications, fashion and home goods. Some well-known companies that are not in the technology sector that have dual class shares include Berkshire Hathaway, News Corp and Nike.

Among technology companies in the US, Facebook, Google, Groupon and LinkedIn are examples that have dual class shares. However, many others do not have them, including Amazon, Apple, Microsoft, Netflix and Twitter. Some have argued that dual class shares encourage innovation. Are the latter companies really lacking in innovation? Others have argued that hostile takeovers encourage short-term thinking or threaten founder control and therefore founders and management need to be shielded from them through dual class shares. So, should we also relax our takeover rules to allow boards to take actions to frustrate takeover offers?

RESTRICTIONS AND SAFEGUARDS

Another suggestion is to restrict dual class shares to large listings that attract institutional investors and fund managers. However, as the responses to the HKEx consultation indicate, these investors tend to object to dual class shares. They may still invest in companies with dual class shares not because of fondness for them, but because their passive investment strategies lead them to index some portion of their funds' portfolios.

It has also been proposed that the number of independent directors on the board or nominating committee can be increased to improve oversight and monitoring. As it currently stands, many independent directors are already beholden to controlling shareholders. Having more independent directors who are appointed by those with superior voting rights is unlikely to do much good.

To counter this, it has been suggested that superior voting rights should not extend to the voting for independent directors or that ordinary voting shares should be able to approve or veto certain major corporate actions, such as changes to the core business or constitution of the company. Since one of the main reasons that founders and management want dual class shares is to have more control over key corporate decisions and actions, excluding or limiting the superior voting rights in such situations would miss the main point of such shares. Companies are unlikely to accept dual class shares with major exclusions and may soon be asking the SGX for waivers.

Another suggestion is that superior voting rights should be suspended when certain trigger events occur, such as insolvency or qualified accounts. There may be practical difficulties in prescribing the situations under which such rights should be suspended, and when these trigger events occur, the horse may have already bolted.

Finally, other proposed safeguards include "sunset" clauses requiring shareholder vote every few years or automatic conversion of superior voting shares to ordinary voting shares when the former are sold to outside investors. In the US, some of these restrictions do exist. For example, in Facebook and Google, the superior voting shares convert to ordinary voting shares when the founders sell their superior voting shares to outside investors. However, these are voluntary restrictions adopted by individual companies, and blanket rules around these will further limit the popularity of dual class shares.

There are two key safeguards in the US that provide protection for minority shareholders against abusive conduct by those who control companies through dual class shares.

First, controlling shareholders, like directors, owe fiduciary duty of loyalty to the company and shareholders. This is different from the UK approach, followed by Singapore, which imposes fiduciary duty on directors but not on controlling shareholders. This is how two lawyers from a US law firm explain it in the context of dual class shares in The Corporate & Securities Law Advisor:

"Corporate law provides shareholders with protections against abuses by those in control of the corporation. Directors and controlling shareholders owe shareholders a fiduciary duty of loyalty. The duty of loyalty requires that directors and controlling shareholders act in the best interests of the company and its shareholders, and without regard to personal motivations not shared by shareholders generally. Directors or controlling shareholders may be found to have violated the duty of loyalty if they approve transactions in which they have a conflict of interest because they or someone with whom they are aligned will benefit from the transaction. Such conflict of interest transactions are subject to an entire fairness review unless procedural protections, including an independent committee and minority shareholder approval, are used. To survive the stringent entire fairness review, the transaction must be the result of fair dealing and must be at a fair price. Any breach of the duty of loyalty entitles shareholders to seek judicial relief and remedies. There have been several judicial actions where the control group in a dual class company has been successfully challenged by shareholders."

It seems clear that the protection that minority shareholders have in the US against abusive actions by controlling shareholders is far more extensive than what is provided by section 216 of the Singapore Companies Act dealing with oppression of minority shareholders.

Second, the contingency fee-based class action system in the US gives minority shareholders a viable means for taking actions to seek redress, something that is clearly lacking in Singapore.

Investor rights and protection should not be sacrificed at the altar of attracting listings. The MAS must make the call on this in the same way that the SFC in Hong Kong and the FCA in UK made the decision.

I would urge MAS to bear in mind a comment from Charles Elson, director of the Weinberg Center for Corporate Governance at the University of Delaware, who is also a lawyer and an independent director, that when you have dual class shares, what you are doing is exporting the monitoring function to third parties – to the government, the courts, the regulators. This is because dual class shares will severely inhibit the role of directors, shareholders and markets in corporate governance. Are our regulators up to the task and prepared to shoulder this responsibility?

MAS SHOULD SAY NO TO DUAL-CLASS SHARES

Mak Yuen Teen

Business Times, Aug 25, 2016

WHEN the Companies Act was amended to allow public companies to have dual-class shares, there was a sense of inevitability about the Singapore Exchange (SGX) opening its doors to listed companies with dual-class shares. I am therefore not at all surprised that the report "SGX close to allowing exceptions for dual-class share listings" (BT, Aug 23) now tells us that the Listings Advisory Committee (LAC) is set to propose that dual-class shares be allowed for companies listed on the SGX. What did surprise me was that David Gerald, president and CEO of the Securities Investors Association (Singapore) (SIAS), speaking on behalf of the association, expressed support for dual-class shares - because they are "well established in the United States and Europe" and necessary to attract companies to list here. What about investor rights and protection, which is the core mission of SIAS?

I have already written extensively on this subject. In my commentary "Say 'no' to dual class shares" (BT, Nov 27, 2015), I laid out in some detail the historical context of dual class shares in the US, the empirical evidence against them, the dangers of importing dual class shares into our market without considering the differences in legal and institutional environments, and the difficulty of implementing meaningful safeguards without defeating the raison d'etre for them. Those who cite Google and Facebook as examples of companies with dual-class shares do not cite Amazon, Apple, Microsoft and other technology companies as counter-examples of those that do not. Citing companies like Google to make the business case for dual-class shares is a bit like citing Warren Buffett to make the business case for appointing octogenarians to run companies. Hugh Young and David Smith of Aberdeen Asia have recently written a compelling piece "Dual class shares are double trouble" in their July 2016 newsletter, setting out an institutional investor's perspective. Most institutional investors are against dual-class shares, and we should brace ourselves for criticism if we allow it.

While proponents of dual-class shares may point to Google, Alibaba or Facebook, we may wish to remind ourselves that when we opened our doors to foreign listings, particularly S-chips, we did not end up with companies like Ping An or Bank of China. Instead, we got China Gaoxian, China Sky, Eratat Lifestyle, Sino-Environment and well over a hundred of others, many that we would rather not mention. Scandals in these listings have undoubtedly contributed to a loss of confidence in our market, impacting liquidity and valuations. We risk allowing history to repeat itself. Investors do not want to feel like they are victims of "bait and switch", with promises of bluechip dual-class shares only to be burnt by those that are only using dual-class shares to entrench and enrich themselves.

Danger of compelling reasons

In the BT report, it was stated that the LAC is expected to allow dual-class structures only when there are compelling reasons to do so, and that such reasons would include whether there are certain individuals who play indispensable roles in the company or when an uneven ownership structure is long-standing practice. The danger is that the case can be easily made, especially in founder-controlled companies, that certain individuals play indispensable roles. Many people think they are indispensable until they are gone. Over time, the list of "compelling reasons" may get longer.

In my earlier commentary, I had also highlighted that in a dual-class share structure, the monitoring function will effectively be outsourced to the government, the courts and the regulators, imposing a greater expectation and burden on them. This is because corporate

governance mechanisms such as board of directors and shareholder meetings would be rendered largely ineffective. With dual-class shares, it will be even easier to control the appointment of independent directors and to pass resolutions at AGMs. Investors would rightly expect regulators to step in to protect their rights if things go wrong in companies with dual-class shares, with other corporate governance mechanisms being ineffective, and shareholder enforcement being costly and largely impractical in Singapore.

In the forthcoming volume of the Corporate Governance Case Studies published by CPA Australia which I edit, there is a case on a Swiss company called Sika AG about the founding family exiting the business by selling their shares with superior voting rights to an outside investor at a huge premium to the existing market price. The family owned 16.1 per cent of the shares but controlled 52.4 per cent of the voting rights. The company had a provision in its articles that allowed the outside investor to circumvent a mandatory takeover offer even though it was acquiring a majority of the voting rights. Minority investors' rights were trampled over.

Before the LAC makes its recommendation, it would be well advised to carefully study and understand the features of dual-class share structures and their different nuances, their impact on corporate governance mechanisms such as independent directors, and the legal and institutional environments in countries where they are allowed. Allowing dual-class shares just because some other countries do so is simply not good enough.

Finally, while the LAC should be accountable when it allows a company to list with dual-class shares, the buck ultimately stops with the SGX and the Monetary Authority of Singapore (MAS), which supervises SGX and our capital market. Calling the LAC "autonomous" or "independent" does not change this fact because ultimately, SGX and MAS must agree to them. The Hong Kong Securities and Futures Commission firmly rejected dual-class shares when the Hong Kong exchange was considering allowing them, and I would urge MAS to do the same.

DUAL CLASS SHARES: SAFEGUARDS OR MINEFIELDS?

Mak Yuen Teen

Business Times, Sep 1, 2016

THE Singapore Exchange (SGX) has now moved one step closer to allowing companies to list with dual class shares (DCS), with the Listings Advisory Committee (LAC) endorsing it with certain "safeguards". The SGX has given assurance that there will be a public consultation before it makes its decision. I would urge all investors and other stakeholders who feel strongly against DCS to make their voices heard in this consultation - even if they feel that this may be to no avail.

It is good that the LAC understands that there are entrenchment and expropriation risks that come with DCS. However, even though the LAC is stacked with "practitioner experience", I wonder whether they fully understand how these risks may actually play out in a DCS company and the usefulness and practicality of the safeguards they are proposing.

According to the LAC, the SGX has proposed certain measures to mitigate against the risks of poor quality companies with a DCS structure. These measures are admission of companies based on a holistic assessment and the SGX referring potential listings with a DCS structure to the LAC for advice for an initial period, until the SGX becomes more familiar with such listings (which may be about the time that we have the sequel to the "S-chip" listing frenzy). The "holistic assessment" would include consideration of factors such as industry, size, operating track record and raising of funds from sophisticated investors.

Those who have been burnt by the slew of S-chip scandals would not have much confidence in the ability or incentive of the SGX to differentiate poor-quality companies from good ones. And what does "sophisticated investors" mean? Investors such as Aberdeen, BlackRock and Fidelity, who would presumably be considered sophisticated investors, have already publicly voiced opposition to DCS. Wouldn't such sophisticated investors avoiding DCS companies be considered a negative in a "holistic assessment"?

In my commentary "Misadventures of Alibaba, JD.com" (BT, June 4, 2014), I had pointed out that Softbank and Yahoo, two major investors in Alibaba, had conflicts of interest because they stood to benefit from commercial arrangements, and had a number of related-party transactions, with Alibaba. Therefore, it is important to assess whether such "sophisticated investors" stand to gain private benefits from supporting a company with a DCS structure.

We seem to be reverting to a "merit-based" approach to listing and herein lies the first danger - investors believing that DCS companies that list have already passed the scrutiny of all those involved in the IPO process, the SGX and the LAC.

Entrenchment risks

Let's now consider the proposed "safeguards" to minimise entrenchment and expropriation risks. For entrenchment risks, the first safeguard is a maximum voting differential of 10:1, which is the commonly adopted voting differential in other jurisdictions. A 10:1 ratio is the problem, not a safeguard. Consider a founder who holds only Class B shares with 10 votes each and public shareholders hold Class A shares with one vote each, and there are one million total issued shares. If the founder owns just 10 per cent of the total issued shares, he will have one million votes - or 52.6 per cent of the voting rights - while the public shareholders will

have 900,000 votes. This will allow him to pass all ordinary resolutions. If he wants to be able to pass all special resolutions requiring 75 per cent support, he only needs to own about 23.5 per cent of the shares. And this is assuming all shares are voted at general meetings.

While the LAC considers this as a "safeguard" against entrenchment risks, such a voting differential creates expropriation risks too. Assume that the founder who owns 10 per cent of the total shares controls the company with DCS. If he "expropriates" $100 million from the company, for example through excessive remuneration or related party transactions, the company value should fall by $100 million but his share of the loss in company value is just $10 million - and meanwhile, his private benefit is $100 million. This is why expropriation risks are higher when there is a larger "wedge" between beneficial ownership of shares ("cash flow rights") and voting power in the company ("control rights").

If the LAC is really interested in providing a safeguard through the voting differential, it should have proposed limiting the voting differential to something much lower than 10:1 - which, although still not ideal, would be better from the anti-entrenchment and anti-expropriation standpoint. Of course, this will make DCS less attractive, as any real safeguard would.

The second proposed safeguard against entrenchment risks is that existing companies with a one-share-one-vote structure would not be permitted to convert to a DCS structure post-listing. The LAC explains that this is because shareholders did not invest with knowledge of the risks of a DCS structure. This is the rule in the US and it is easy to copy on paper, but has the LAC considered how it will be implemented in practice? How about an existing company with a one-share-one-vote structure delisting and then later relisting with a DCS structure? Wouldn't investors now be able to invest with knowledge of the risks of a DCS structure?

Perhaps the SGX and LAC will scrutinise such opportunistic behaviour and reject blatant abuse. But where do they draw the line? If the company delists and relists with a new name and a slight change in business, with the same controlling shareholder, would that be permitted? If the answer is yes, it is easy to beat the safeguard. If the answer is no, does it mean that a controlling shareholder who has delisted a company with a one-share-one-vote structure can never list another company with a DCS structure? The point I am making is that there are practical difficulties in such a safeguard.

The third "safeguard" against expropriation risks is the auto-conversion of multi-vote (MV) shares into one-vote shares when MV shares are sold or transferred to parties other than "permitted holders", or when the owner-manager relinquishes his executive chairman or chief executive officer role unless there is a "compelling reason". Auto-conversion of MV shares is practised in companies such as Alphabet (Google) and Facebook. In its public consultation, the SGX should explain what "permitted holders" and "compelling reasons" would be considered acceptable for MV shares to be transferred without auto-conversion. However, I suspect there will be a bit of a "making it up as we go along" approach in operationalising this in practice. It will be down to the wise men and women on the LAC again.

Expropriation risks

I will now turn to the proposed "safeguards" against expropriation risks. Essentially, the LAC suggests making recommendations in the Code of Corporate Governance on independence of boards and the different committees mandatory, and having the election of independent directors voted on a one-share-one-vote basis. As many of those who follow closely the corporate governance of listed companies here would know, independent directors here can be classified into "good", "bad" or "ugly". Just as the "good" often avoid the S-chips, they may also avoid the DCS companies that seek to list here.

Further, we very rarely hold our independent directors accountable for failing to discharge their duties. Are we going to hold them accountable for failing to discharge their duties when the odds are stacked against them? If not, how then can independent directors really be a safeguard? This is why specialists such as Charles Elson have said that when you have DCS, you are essentially outsourcing the monitoring function to third parties - to the government, the courts and the regulators. Under a DCS structure, investors need to look to these third parties to protect their interests.

Finally, the LAC has proposed safeguards to increase investor awareness. These involve clear disclosure of shareholder rights, distinctive identification of DCS companies and investor education initiatives. Here we are back to a disclosure-based approach and "caveat emptor" again.

If the SGX does proceed with DCS, perhaps it should only make such shares available to institutional investors and certain prequalified retail investors. If DCS shares can be bought by ordinary retail investors through ATMs and Internet banking, I would suggest that a danger sign flashes on the screen, accompanied by a skull, before the investor can proceed. If, as a recent study suggests, less educated retail investors are less likely to consider a modified audit opinion as important when making investment decisions, would such investors be able to tell the difference between DCS and one-share-one-vote companies?

Finally, I would like to remind the SGX board about its role under the Singapore Code of Corporate Governance. In particular, they are expected to "identify key stakeholder groups and recognise that their perceptions affect the company's reputation", "ensure that their obligations to shareholders and other stakeholders are understood and met", and "consider sustainability issues as part of its strategic formulation".

All companies must consider wider stakeholders' interest in enhancing long-term value, but this is even more important for a company such as the SGX, for which investors in other companies listed on the exchange are a key stakeholder group whose views must be seriously considered. The board should also consider if DCS are the way to build a sustainable exchange.

DUAL CLASS SHARES – MYOPIA OR OPPORTUNISM?

Mak Yuen Teen

Blog published on October 3, 2016 at www.governanceforstakeholders.com

I have written extensively on the subject of dual class shares (DCS) and would have preferred to wait until the public consultation before saying any more. However, in recent days, I have seen the lobbying continue for DCS, with one describing those opposed to it as myopic. To be fair, the word "opportunistic" has also been used to describe the Listings Advisory Committee (LAC) decision to greenlight it (although not by me). It is not difficult to understand that with more listings, there will be more business for various intermediaries such as bankers, lawyers and accountants.

Recently, I had a chat with a senior audit partner of a major accounting firm. He said he is against it. When I said other parts of his firm may be for it, he agrees that I may be right. A lawyer who supported my stance against DCS when I first wrote about it a couple of years ago has changed tune. I do not know whether it is business considerations that have caused this or a better understanding of the issues.

I recall a forum I attended a few years ago about REITs and business trusts. When someone proposed that the rules should be strengthened, a legal firm representative was very vocal arguing against it. He mentioned that his client, which he named, would be reluctant to list here if we strengthened the rules. That client's share price has now been decimated, along with accusations of lack of transparency. Of course, most intermediaries owe their duties to the client, which tends to be management and founders. They generally do not owe fiduciary duties to the company and its investors. It's very easy for them to support something that brings fees to their firm, without thinking of investors' or the wider public interest. The investing world will be a much safer place if intermediaries have fiduciary duties to the company and its shareholders.

It is interesting to read a recent newsletter from a law firm which argued the case for DCS. The fact that US has a contingency-fee class action system which enhances shareholder protection was briefly mentioned. The article then proceeded to argue that dual class shares may be useful and show various "safeguards" adopted by some US companies with DCS, such as auto-conversion into ordinary voting shares upon sale to outside investors or sunset clauses.

In the US, where the article draws examples from, those safeguards exist in the context of other safeguards such as a contingency-fee class action system, fiduciary duties of controlling shareholders, a very prescriptive approach to regulating corporate governance, and a very legalistic approach to resolving corporate governance issues (e.g., takeovers are governed by courts rather than an industry-based takeover panel). It is disappointing that we somehow think that we can just transplant something from the US into our environment, by adding the odd safeguard, but then ignoring many other aspects of the corporate governance eco-system which provides the real safeguards.

Although not a lawyer by training, I have tried to understand some of the unique features of the US legal system that helps ensure that DCS work – or at least generally do not lead to rampant abuse. Last year, I spoke at an overseas corporate governance conference where fellow speakers include a Justice of the Delaware Supreme Court (many US companies are incorporated in Delaware), and a former chairman of a securities commission in a major market. I asked the chairman of the securities commission and he was straightforward: "Don't

introduce dual class shares". I asked the Justice about the duty of controlling shareholders in the US. He confirmed to me that controlling shareholders owe fiduciary duties to the company in the US. His view is consistent what I had read in an article discussing duties of controlling shareholders in a DCS company. It helps explain why in companies with DCS in the US, the risk of rampant abuse is minimised. This is not the case here. I wonder how much the LAC has dived into understanding the different environments where DCS exist before arriving at its recommendation. Differences in environment can be legal or even cultural. For example, in many European countries where DCS exist, society is egalitarian. In such a society, human greed may be less of a concern.

In terms of myopia, I wonder who is being myopic – those who oppose it or those who are for it. We have been told that we will still have 99.8% of companies with single class shares. So, the LAC is supposed to choose the 0.2%? On what basis? And how will that 0.2% improve the number of listings and volume of trading in our market? In the US, despite all its sophistication, they do not try to pick and choose which companies can list with DCS. Here, we are trying to marry a merit-based approach (with the LAC determining merit) to a disclosure-based caveat emptor approach when it comes to DCS.

Those safeguards that are being proposed by the LAC are generally voluntary safeguards adopted by US companies, not mandated by the regulators as we are proposing (except for the one that companies cannot convert to DCS after listing). The true safeguards are those in the broader institutional environment I have alluded to earlier – contingency-fee class action, fiduciary duties of controlling shareholders, and a prescriptive and highly legalistic approach to corporate governance. I have not seen the LAC proposing these safeguards – because they will totally change our environment. Plucking DCS and just plonking it here is like buying the frame without the picture.

Are we looking for a quick fix rather than a longer-term more sustainable solution to building a stronger exchange with better valuations and liquidity? While it is good to be ambitious, are we setting our sights too far and high by trying to court listings with unusual structures from all around the world, when ASEAN and our own SMEs should be the centre of our attention?

Finally, I see an attempt to link DCS with innovation and long-term thinking. There are plenty of innovative companies without DCS. Companies like Microsoft do not have DCS and did not pay dividends for many many years as it focused on growth and investing in R&D. Jeff Bezos did not get thrown out even though Amazon does not have DCS and Amazon was burning through cash and losing money as it built its business in its early years. A recent analysis has shown that investors in Amazon have done better than those in many of the regularly-cited DCS companies. Truly innovative and entrepreneurial companies do not need financial engineering such as DCS to entrench their founders and to thrive and attract long-term investors.

My suggestion to investors here is this. If you are prepared to invest in companies with DCS, invest in those in the US where the legal protection is much stronger. If there is abuse, you can be sure that there will be class action lawsuits, and you may be able to join such lawsuits. If you lose, there is nothing to pay. In fact, from what I know, you may even be paid to join such lawsuits. At the very least, you know that there are US shareholders who will keep management and founders in check. If DCS companies list here from overseas, do you think that you or the regulators will be able to do much if there is abuse? Has anyone who has suffered from the S-chip scandals being able to enforce their rights? If you have, I would be most interested to hear your story.

MISADVENTURES OF ALIBABA, JD.COM

Mak Yuen Teen

Business Times, June 4, 2014

WHEN the corporate governance of News Corp came under scrutiny after the phone hacking scandal in 2011, Nell Minow of GovernanceMetrics International (GMI), which rates the corporate governance of companies, was quoted (Financial Times, July 12, 2011) as saying: "We've consistently given News Corp an F, only because there is no lower grade."

A key objection to News Corp's corporate governance is its dual class share structure, which allows Rupert Murdoch and his family to control 40 per cent of the votes while owning only about 12 per cent of the total outstanding shares. Such a share structure translates into board control by the Murdochs as they pretty much can decide who are appointed to the board, even though they own nowhere near a majority of the shares. This, in turn, is likely to lead to weak board oversight over management, which may, in turn, explain its corporate culture which has been described by one commentator as "corrupt" (http://mediamatters.org). Dual-class shares are not just a matter of shareholder rights – they make companies more susceptible to other problems in corporate governance.

GMI and other governance ratings agencies may soon have to introduce a lower grade than "F" for corporate governance of companies listed in the United States, with two China-based companies, Alibaba and JD.com, trying to outdo each other in terms of poor corporate governance practices.

Alibaba

After trying unsuccessfully to list on the Hong Kong exchange, Alibaba filed its preliminary prospectus with the US Securities and Exchange Commission (SEC) on May 6.

Alibaba certainly comes with a strong business case based on potential growth in online commerce in China. According to its filing, it is the "largest online and mobile commerce company in the world in terms of growth merchandise volume in 2013". Unlike many technology-based companies at the time of IPO, Alibaba is already profitable, with net income attributable to shareholders of 4.2 billion yuan (S$844 million) for FY2012, 8.4 billion yuan for FY2013, and 17.5 billion yuan for the nine months ended Dec 31, 2013. Its rather colourful charts in the first few pages of the prospectus trot out statistic after statistic about its huge future potential in China and its nice growth story.

Then the colourful charts stop and the rather bland discussion of its risks starts. Every company has business risks, but what sets Alibaba apart from many others are the business and governance risks associated with its corporate governance arrangements and corporate structure. A more balanced presentation of its risks might have included a picture of a fast car hurtling down a road with no brakes – with a cliff up ahead.

Governance risks

Although most of the attention on the corporate governance of Alibaba has focused on its unusual arrangement which allows a partnership made up of 28 founders/managers to nominate a simple majority of the board of directors – in effect allowing management to control the board – this is just the tip of the governance iceberg.

Softbank and Yahoo, which currently own 34.4 per cent and 22.6 per cent respectively of the shares of Alibaba, have entered into agreements to vote their shares in favour of the Alibaba Partnership director nominees. In turn, Yahoo, Jack Ma (Alibaba founder and executive chairman who owns 8.9 per cent) and Joe Tsai (executive vice-chairman who owns 3.6 per cent) have agreed to vote in favour of the single Softbank director nominee. Softbank has also agreed to grant the voting power of its shares exceeding 30 per cent to a voting trust to be voted at the direction of Mr Ma and Mr Tsai.

Softbank and Yahoo have come out publicly voicing strong support for the governance arrangements in Alibaba. Their acquiescence may be because they truly believe that the unorthodox governance arrangements are good for the company and all shareholders, but it should also be pointed out that they stand to benefit from other commercial arrangements with Alibaba – something not available to other shareholders.

Any changes to the articles of association of Alibaba must be approved by 95 per cent of shares voted at a shareholders' meeting, well beyond the 75 per cent in our Companies Act. This suggests that the existing shareholders, founders and managers are ensuring that they continue to control the company even if they divest substantial amounts of their shares. Further, the articles of association contain a number of antitakeover provisions involving poison pills and board entrenchment that do not require shareholders' approval. These provisions are designed to frustrate any hostile takeover again, something not permitted under Singapore rules.

The preliminary prospectus also contains six pages describing related party transactions, mainly with Mr Ma, Mr Tsai, Yahoo and Softbank and associates, and numerous warnings about conflicts of interests.

The financial statements in Alibaba's preliminary prospectus are also audited by auditors who are not inspected fully by the Public Company Accounting Oversight Board (PCAOB) in the US, because PCAOB currently cannot conduct inspections without the approval of the Chinese authorities. The SEC has also initiated proceedings against the China-based affiliate of the independent auditor for failure to produce audit work papers and other documents, which may result in financial statements audited by it being deemed to be noncompliant with US requirements. Given that Alibaba has substantial operations in China and the arguably weaker oversight of the work of the auditors, this may raise questions about the veracity of its financial statements in the preliminary prospectus.

Other corporate structure-related risks

Restrictions on foreign ownership in certain industries imposed by Beijing mean that Chinese companies listed overseas often have in place fairly convoluted corporate structures, essentially to get around these rules. Alibaba is no exception.

Alibaba is incorporated in the Cayman Islands and, therefore, subject to the Companies Law of the Cayman Islands. It conducts its business through wholly owned foreign enterprises, majority-owned entities and variable interest entities (VIEs). The VIEs hold the licences for the Internet service providers and operate the websites for Alibaba's business. They are generally majority-owned by Mr Ma and minority-ownedby another founder-manager, Simon Xie. Alibaba enters into contractual arrangements with these VIEs to secure the benefits and risks of ownership, and consolidates their results into their financial statements. As the prospectus points out, China laws state that directors and executive officers owe fiduciary duty to the company they direct or manage. This puts Mr Ma in a conflict, as he also owes fiduciary duty to Alibaba as one of its directors.

Although VIEs have been used for many years by foreign companies as a backdoor way to invest in restricted sectors in China with apparent tacit approval from the Chinese authorities, many commentators have pointed out that this may change and these VIEs may have to be unwound. Further, these commentators have also pointed out possible problems with the enforceability of VIE agreements and the ability to exercise effective control over these VIEs.

Of course, all these risks are fully disclosed in Alibaba's 342-page preliminary prospectus.

JD.com

While Alibaba has received a lot of attention, another Chinese ecommerce firm, JD.com, had earlier filed its registration statement with the SEC on Jan 30 and debuted on Nasdaq on May 22, opening 10 per cent above its IPO price. Again, it has a strong China story.

According to the company, it is the largest online direct sales company in China in terms of transaction volume. However, unlike Alibaba, it has been incurring losses, with net loss attributable to ordinary shareholders of 2.9 billion yuan for FY2011, 3.3 billion for FY2012 and 2.1 billion for the nine months to Sept 30, 2013.

It has a similar corporate structure to Alibaba in terms of incorporation in the Cayman Islands and operating through various entities, including VIEs, and therefore similar risks associated with its corporate structure. Its business risks, many of which relate to operating in China, are also similar to Alibaba.

However, the governance arrangements used by JD.com to entrench control by the founder are different from Alibaba's. JD.com has a dual-class share structure, with Class A shares having one vote per share and Class B shares having 20 votes. Founder Richard Liu, who is also the chairman and CEO, owns 20 per cent of the shares but has more than 80 per cent of the voting rights.

Further, under the company's articles, the board of directors will not be able to form a quorum without Mr Liu as long as he remains a director. Therefore, he controls the board. As JD.com acknowledged, the control that he has is a significant deterrent against any potential hostile takeover.

As Reuters (May22) reported, JD.com awarded Mr Liu 93.78 million "immediately vesting restricted share units" as a oneoff bonus "in consideration of his past and future services", and booked a US$891 million share-based expense. It is unclear what restrictions are applicable to these share units.

Other governance issues in Alibaba such as potential conflict of interests of the founder and other key executives, the inability of the PCAOB to fully inspect the work of the auditor, and SEC action against the China-based affiliate of the auditor also apply to JD.com.

Race to the bottom

The listing of Alibaba and JD.com in the US should lay to rest any argument that America is an example for others to follow when it comes to good corporate governance – even if these companies are foreign companies.

JD.com has had a successful debut on Nasdaq and Alibaba may follow suit. Given their governance arrangements, I believe their China stories will not have a fairy tale ending for minority investors.