wrongdoings, including window activities, internal control failures and IPO sponsor failures.[199]

2.208 The actions taken by the SFC confirm the SFC's stance of actively protecting investor rights and ensuring market transparency.

2.209 In summary, The SFC, as a "public protector", regulates both *ex ante* and *ex post*. *Ex ante* regulation consisting of comprehensive market monitoring, surveillance, inspections, analysis to detect illegal trading activities, authorisation of new products, investor education, and review of all listing applications for the exchange, which must be dually filed with both HKEx and the SFC. *Ex post* regulation includes criminal prosecution, enforcement actions, and some other disciplinary sanctions. This is an overall approach through which the SFC stretches its enforcement power to all types of misconduct for the benefit of the investing public: (i) penalising past misconduct through deterrent sanctions; (ii) stopping present misconduct through injunctions and quick remedies; and (iii) avoiding future misconduct through remedial orders, all of which is to make wrongdoers accountable for the financial costs of misconduct.

[199] *Securities and Futures Commission Annual Report 2013–2014.*

CHAPTER 3

REGULATION OF ISSUERS — INFORMATION DISCLOSURE ON THE SECURITIES MARKET

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1. Introduction

3.001 Hong Kong is one of few international capital markets in Asia. One mission of the SEHK is to promote the capital market system in Hong Kong by providing issuers and investors with a transparent, efficient and fair securities marketplace. In order to maintain the integrity of the market, the SEHK makes efforts to ensure the timely disclosure of corporate and financial information to all market players such as shareholders and investors. The purpose of the Listing Rules is consistent with the overall objective of the major Ordinances such as: (i) the Companies Ordinance (Cap.622); (ii) the retitled Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap.32); and (iii) the Securities and Finance Ordinance (Cap.571). The objective is to improve the transparency of listed companies by providing the investing public with information regarding shareholders and the holdings of directors and chief executive officers.

2. Key Governing Laws and Rules Concerning Information Disclosure

3.002 Of all the laws and regulations that impact upon listed issuers, their shareholders, and public investors, the Listing Rules have the greatest impact. Listing Rules discussed in this section refer to the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited ("Main Board Listing Rules") and the Rules Governing the Listing of Securities on the Growth Enterprise Market of the Stock Exchange of Hong Kong Limited ("GEM Listing Rules"), which, as pointed out in Chapter 2 of this book, are not of a statutory nature, but are drafted and applied by the SEHK with authority granted by the SFC under the SFO,[1] and on the basis of the contractual relationship between the SEHK and the listed companies.[2] Amendments to the Listing Rules designed to enhance corporate governance and market quality came into effect on March 31, 2004.[3] The Listing Rules set out the requirements which companies need to satisfy in order to list their securities on the SEHK, and the continuing obligations that listed companies are required to observe. The Listing Rules are intended to ensure that listed companies satisfy certain minimum governance standards and that investors and shareholders are kept informed of the issuers' activities. The Listing Rules also require that certain transactions be subject to prior shareholder approval.

3.003 The general principles which underpin the specific rules are set out in Chapter 2 of each of the Listing Rules. They also provide for disclosure. For instance, investors and the public must be kept fully informed by listed issuers. In particular, immediate disclosure is required of any information which might reasonably be expected to have

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[1] SFO, s.21.
[2] The underlying foundation of this entire system is arguably based on the contract between the listed companies and the SEHK by which the companies and their management voluntarily agree to abide by the Listing Rules in exchange for the SEHK making available to them its trading facilities.
[3] These amendments include revised requirements on the disclosure of directors' remuneration in annual reports.

a material effect on market activity, and the prices of listed securities.[4] Disclosure rules under the Listing Rules are evident in three respects, that is: (i) the content requirements for listing documents; (ii) the continuous disclosure obligations for listed companies; and (iii) special disclosure requirements for connected transactions. The SEHK may sanction a listed company and its directors for breach of the Listing Rules. This may take the form of suspension from listing, public censure and other non-statutory remedies. In order to enhance the disclosure regime, the proposal has been made to introduce statutory backing for selected Listing Rules that deal with disclosure. This would ensure that listed companies provide accurate, full and fair disclosure to their investors and the public.[5] The objective of such a proposal is "to build on the dual filing regime, codify the important requirements in the Listing Rules into subsidiary legislation, and make the SFC responsible for enforcing those provisions, while continuing to have SEHK receive applications at the frontline and administer the listing process".[6]

3.004 Takeovers and mergers affecting public companies in Hong Kong and companies with a primary equity listing in Hong Kong are subject to the provisions of the Hong Kong Code on Takeovers and Mergers (the "Code"). Although the Code does not have statutory backing, it applies, in practice, to all public takeovers and mergers in Hong Kong. The Code sets out procedures and standards that all parties involved in a takeover or merger, including the offeror, offeree and their respective boards and advisers, must observe. If control of a public company changes, is acquired or is consolidated, a general offer to all other shareholders is generally required. The threshold for triggering a mandatory offer is taking control of 30 percent or more of the voting right attaching to the listed company's shares.[7] During the course of an offer, or when an offer is under contemplation, all information relating to the offer should be made available to all (and not only some) shareholders. The Code on Share Repurchases adopts the same fundamental principle and sets out the standards of conduct required of market participants in the repurchase by a public company of

[4] The listing of PRC enterprises has been of critical importance to the SEHK in part because of the positive economic implications for the development of the Hong Kong capital market, and partly because of its mission to promote capital formation in Hong Kong and on the Mainland. By September 2004, there were 68 H share issuers listed on the Main Board and 37 H share issuers listed on GEM. SEHK also takes steps to review annual reports with respect to continuing disclosure by listing companies incorporated on the mainland China as part of its effort to increase investors' confidence in H share listings.

[5] See the *Consultation Paper on Proposed Amendments to the Securities and Futures Ordinance to Give Statutory Backing to Major Listing Requirements*, issued by the Financial Services and Treasury Bureau, and the *Consultation Paper on Proposed Amendments to the Securities and Futures (Stock Market Listing) Rules*, released by the SFC. Two consultation papers were issued in January 2005 and are available at www.fstb.gov.hk.

[6] See SFC, A Consultation Paper on Proposed Amendments to the Securities and Futures (Stock Market Listing) Rules (2005), para.7, available at www.sfc.hk.

[7] To take-private a Hong Kong-incorporated company by way of a scheme of arrangement, it is no longer necessary to satisfy the "headcount" test. A take-private transaction can be approved by members holding at least 75% of the voting rights of the company present and vote in favour of the scheme so long as the votes cast against the transaction do not exceed 10% of the total voting rights attached to all disinterested shares in the company. Part 13 of Cap.622. There is a requirement under the Code on Takeovers and Mergers that only disinterested members can vote at a general meeting to consider a scheme to take-private a company. For other schemes, the headcount test is retained, with a new discretion given to the court to dispense with the test for members' schemes in appropriate circumstances.

its own shares. The SFC is responsible for the administration and enforcement of the Codes on Takeovers and Mergers and Share Repurchases.

3.005 The latest step taken by the SEHK is to adopt the "comply or explain" approach as a new key component in regulating listed issuers. SEHK published conclusions to its 2010 Consultation Paper on Review of the Code on Corporate Governance Practices and Associated Listing Rules on October 28, 2011. The "comply or explain" approach, as a new principle, was introduced through the Corporate Governance Practice Code, which was modelled on the UK Corporate Governance Code and constitutes Appendix 14 of the Rules Governing the Listing of Securities of the Stock Exchange (the "Rules"). According to the "comply or explain" approach, issuers will be governed by a combination of Rules, code provisions and recommended best practices. Rules are standards of corporate governance requiring mandatory compliance by all issuers. Breach of any of the Rules by an issuer will result in sanctions. Code provisions provide issuers with the flexibility to either adopt them or not. If the issuer chooses not to adopt them, the issuer must give the reasons for its decision. Non-compliance with code provisions is not a breach of the Rules and will not trigger any sanction. Recommended best practices are desirable best practices that an issuer is encouraged to comply with even though the issuer is not required to explain its failure to comply. A new section is planned to be added into the Corporate Governance Practices Code offering an explanation of the rationale behind the "comply or explain" approach. A departure from code provisions is acceptable as long as the issuer finds more suitable ways to comply with such principles. Issuers may take into account their own circumstances, including the size and complexity of operations, and the nature of risks and challenges they face in formulating their corporate practices. In any event, deviations from code provisions and recommended best practices are not regarded as breaches of law.[8] Given the flexibility offered by the package of three-tiered norms, most changes adopted by the conclusions are not over-prescriptive, as good corporate governance cannot be imposed through a "one size fits all" approach. It is advisable that, based on the spirit of the "comply or explain" principle, the issuers formulate a corporate governance framework that is most suitable to themselves based on their own individual circumstances.

3.006 The pieces of legislation which regulate the offer of securities in Hong Kong include the: (i) Companies Ordinance (Cap.622); (ii) the retitled Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap.32); and (iii) the Securities and Finance Ordinance (Cap.571).[9]

3.007 The retitled Cap.32 remains the principal piece of legislation that affects corporate finance transactions in Hong Kong, and applies to offers of securities consisting of shares or debentures (that is, bonds, notes or other debt securities) issued by a company

[8] Details of new rules, code provisions and recommended best practices can be referred to in relevant sections below.

[9] In order to avoid spreading the relevant legislation governing public offers in two pieces of legislation, the SFC's new proposal is to move the prospectus regime which continue to remain from the retitled Cap.32 into the SFO and then to create a coherent approach to securities regulations. See SFC Consultation Paper on Possible Reforms to the Prospectus Regime in the CO, dated August 29, 2005. This is still under consideration as of this date.

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(whether incorporated in Hong Kong or not).[10] At the core of the retitled Cap.32 is the concept of the prospectus, which is a document offering shares or debentures to the public. The offer of securities to the public in Hong Kong is prohibited unless made by way of a prospectus complying with the requirements of the retitled Cap.32 and the prospectus is duly registered with the Companies Registry. Both the retitled Cap.32 and Companies Ordinance (Cap.622) contain different exceptions for local and overseas companies which propose to offer their shares or debentures in Hong Kong (e.g., offers to existing shareholders of the local/overseas offeror and offers made by an overseas offeror to institutional investors). In general, offers to the public for the sale of shares in Hong Kong will be subject to the prospectus requirements under the Ordinances.[11] These requirements are intended to ensure that sufficient information is provided to potential investors to enable them to make an informed decision about the issuer, its prospectus and the securities being offered. Any person who knowingly contravenes this prohibition may be summarily prosecuted and is subject to a fine of up to HK$100,000. These requirements are in addition to those prescribed under the Listing Rules. Under Cap.622, the failure to comply with certain administrative requirements may lead to the director facing offences with a lower burden of proof for establishing such offences.

3.008 The SFO sets out the general regulatory framework for the offering of securities, such as warrants, collective investment schemes, equity-linked instruments and certificates of deposit. Furthermore, the SFO establishes a framework for the regulation of financial intermediaries, including advisers on corporate finance mattes, to ensure that they meet the relevant standards both in financial terms and to establish that they are "fit and proper". The SFO also provides for mandatory disclosure of interests requirements of shareholders, directors and chief executives of listed companies in Pt.V of the SFO and disclosure of notifiable interests in listed companies in Pt.XV of the SFO, which are binding on all companies listed on the SEHK regardless of their place of incorporation. The SFO provides criminal sanctions in connection with the disclosure of any false or misleading information relating to securities. In addition, the SFO deals with the regulation of the offering of investment products and collective investment schemes to the public in Hong Kong. Breach of the provisions of the SFO may give rise to criminal liability.

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[10] All the provisions relating to debentures in the predecessor Companies Ordinance are put in one place in Cap.622. These provisions have been separated from, and aligned with, many of the equivalent provisions in respect of shares.

[11] Factors relevant for the consideration of whether an offer is of a private or public nature include the total number of offerees involved; whether there is a special nexus between the offeror and the offerees and whether or not the offer could be viewed as calculated to result directly or indirectly in the shares becoming available for subscription or purchase by persons other than those receiving the offer. The legislation is obscure as to what types of offers would clearly fall outside the public sphere (subject to any specific exception being available). Upon enforcement of the Companies (Amendment) Ordinance 2004, the prospectus regime will carve out from the definition of "prospectus" offering documentation in relation to specified types of offers for providing certainty as to the types of offers that can be made without triggering the prospectus regime. See the 17th Schedule contained in the Companies (Amendment) Ordinance 2004.

3. Information Disclosure in Relation to Public Offers

3.009 As part of the entry criteria, the issuer must comply with the contents requirements of disclosure rules when it applies to list on the Main Board. There are two main sources of the requirements relating to contents of listing documents. If the document is a prospectus as defined in the retitled Cap.32, it has to comply with the requirements of this Ordinance.[12] In addition, the listing document has to comply with the requirements of the Listing Rules regardless of whether the document constitutes a prospectus.

4. Prospectus Requirements under the Retitled Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap.32)

4.1 Contents requirements for a prospectus

3.010 The retitled Cap.32 sets out the contents requirements for a prospectus of a Hong Kong-incorporated company. A prospectus issued by or on behalf of a company must be dated.[13] The retitled Cap.32 provides that every prospectus issued by or on behalf of a company must set out certain information, including matters specified in Pt.I of the Third Schedule to this Ordinance and in Pt.II of the Third Schedule to this Ordinance.[14] Every prospectus must contain in a prominent position, a recommendation that the recipient of the prospectus should seek independent professional advice if the recipient is in doubt about any part of the content of the document.[15] It is unlawful to issue an application form for a company's shares or debentures unless it is accompanied by a prospectus that complies with the requirement of the amended s.38 of this retitled Cap.32.

4.2 Excluded offers under the Companies (Amendment) Ordinance 2004

3.011 There are 12 categories of excluded offers from the application of the prospectus requirement. These are:[16]

[12] The term "prospectus" is defined in s.2 of the retitled Cap.32. A prospectus must be in written form, and includes any prospectus, notice, circular, brochure, advertisement or other document. A prospectus must offer shares or debentures to the public or be calculated to invite offers for shares or debenture by the public. A prospectus can relate to new shares or debentures of the issuer or to shares or debentures already in issue. The consideration under the offer can be a cash or non-cash consideration.

[13] Retitled Cap.32, s.37. There is a rebuttable presumption that the date shown is the date of publication of the prospectus.

[14] Retitled Cap.32, s.38. Information shall be disclosed in both Chinese and English. The Third Schedule requirements do not apply to the issue of a prospectus relating to shares or debentures of the company to existing shareholders or debenture holders of that company, whether or not the applicant can renounce his rights in favour of a third party. A prospectus which relates to shares or debentures that are in all respects the same as shares or debentures issued previously and listed on the SEHK. A prospectus issued generally to the extent that the SFC has given a certificate of exemption pursuant to s.38A of the retitled Cap.32.

[15] An applicant for shares cannot waive compliance with these provisions.

[16] Companies (Amendment) Ordinance, 17th Schedule.

Chapter 6

REGULATION OF MARKETS

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6.001 The regulation of markets consists of two aspects: the *first* is the *ex ante* regulation of market-places such that those market-places that are allowed to operate must satisfy a certain standard of operational fitness and credibility; the *second* aspect is the regulation of abusive conduct in market-places so that investor confidence will not be diminished. Investor confidence is considered crucial for maintaining a vibrant capital market.[1] The loss of investor confidence would bring about serious consequences to market trading, liquidity and may lead to systemic effects on the Hong Kong economy. Furthermore, as investor behaviour unpredictable,[2] regulation of market misconduct has been given a serious upgrade in the new Securities and Futures Ordinance (Cap.571) (SFO) provisions.

1. Regulation of Market Misconduct

6.002 "Market misconduct" is defined under s.245 of the SFO to refer to insider dealing, false trading, price rigging, disclosure of information about prohibited transactions, disclosure of false or misleading information inducing transactions, and stock market manipulation. SFO is a great leap forward in Hong Kong's combat against abusive market behaviour, as Hong Kong had a relatively weak insider dealing laws until the SFO came into force.

6.003 All market misconduct would attract administrative sanctions before a Market Misconduct Tribunal (Pt.XIII of the SFO). The sanctions would be initiated by the Financial Secretary. Market misconduct would also be criminal offences under Pt.XIV of the SFO, and civil enforcement could also be carried out against it. Therefore, flanked by many routes of enforcement against market misconduct, Hong Kong is emerging to be in line with international standards for investor protection.

6.004 More recently, the Securities and Futures Commission (SFC) identified inadequate internal control procedures as one type of market misconduct. In 2010, the SFC fined two Merrill Lynch subsidiaries, $450,000 for "systems and controls failings". A managing director mis-marked a trading book of illiquid securities from December 2007 to October 2008, illicitly gained access to the bank's computer systems, and changed the pricing parameters on a book of exotic options. The false marks inflated the value of the trading book by approximately about HK$25 million, concealing its actual loss. However, the SFC found that Merrill Lynch (Asia Pacific) and Merrill Lynch Futures (Hong Kong) did not have adequate internal control procedures in place to prevent fraud or dishonest activity related to the trading book. This indicated that the senior management had failed to adequately manage the risk, and the systems and controls fell short of their expectation. Meanwhile, the SFC recognised that Merrill Lynch's misconduct was not intentional and the bank had taken remedial steps to address the compliance weaknesses.[3] This case appears to suggest that the adequacy

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[1] Bernard S. Black, "The Legal and Industrial Preconditions for Strong Stock Markets", (Stanford Law School Working Paper No 179, 2001).

[2] Robert Prentice, "Whither Securities Regulation? Some Behavioural Observations Regarding Proposals for its Future", (2002) 51 *Duke Law Journal* 1397.

[3] Robert Cookson, "HK Watchdog Slaps Fine on Merrill Units", *Financial Times*, June 1, 2010, p.18.

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of internal control procedures, no matter whether they do help prevent fraud, does trigger the SFC's scrutiny when it comes to investigating management misconduct. The rationale is that inadequacy of internal control procedures proves the senior management's lack of skill, knowledge or experience in risk management, which may contribute to fraudulent activities. As the SFC pointed out in a statement after the penalty decision, "the proper implementation of an effective risk management framework could have enabled Merrill Lynch to detect the mis-marking earlier".[4]

6.005 During the period from 2013 to 2014, the SFC focused its enforcement on serious internal control failings. Sun On Tat Securities Company Ltd, China Securities Holdings Ltd, A One Investment Company Ltd, Credit Suisse Securities (Hong Kong) Ltd, UBS Securities Hong Kong Ltd, Sun Hung Kai Investment Services Ltd, China Everbright Securities (HK) Ltd and Cheong Lee Securities Ltd were all reprimanded and fined for various serious deficiencies, supervisory failures, and regulatory breaches. Both Credit Suisse Securities (Hong Kong) Ltd and UBS Securities Hong Kong Ltd agreed to engage an SFC-approved independent reviewer to review their systems and controls for ensuring compliance with relevant rules and regulatory requirements.[5]

6.006 In the global economic downturn, the SFC, concerned about choppy market conditions that may push some firms to the edge of failure, stepped up inspections over trading floors and asset management houses. The SFC's figures for inspections of licensed financial firms for the six months to the end of September 2011 indicated that it carried out 157 "risk-based onsite inspections", having increased 37.7 percent from one year earlier. SFC increased surveillance over brokerages and fund managers to check their trading positions and ensure that their client money is safeguarded. This ensured financial firms to comply with rules and prohibited them from engaging in excessively risky behaviour. These actions aimed to maintain the viability and financial soundness of licensed financial intermediaries, leading to managing financial risks faced by the industry. The SFC also flagged in its 2011–2012 budget that it planned to boost the size of its supervision team so that it could inspect high-risk or impact firms more frequently.[6]

2. Insider Dealing

2.1 Definition

6.007 Insider dealing is defined in s.270 of the SFO in the form of a list of various situations in which insider dealing occurs. Basically, an insider dealer is:

(a) a connected person to a listed corporation; "connected" being defined in ss.247 and 248, as a director, employee, substantial shareholder, a person who occupies a position that gives him access to relevant information in relation to the corporation, a person connected with another corporation but has access to the relevant information by virtue of a transaction, a person previously

[4] Robert Cookson, "HK Watchdog Slaps Fine on Merrill Units", *Financial Times*, June 1, 2010, p.18.
[5] SFC Annual Report (2013–2014), p.56.
[6] Reuters, "Financial Regulator Steps Up Inspections", *South China Morning Post*, January 14, 2012, B2.

connected with the corporation within six months of the insider dealing, or any public officer or officer or employee of a self-regulating entity such as the exchange who receives any relevant information to the corporation;

(b) a person who is contemplating or has contemplated making a takeover offer for the corporation; and

(c) a person who has received relevant information directly or indirectly from a connected person in (a) or a person in (b).

6.008 The act of inside dealing would be:

(i) a person in (a) above deals with the listed securities of the corporation, related corporations or any of their derivatives;

(ii) a person in (a) above procures another person to deal as above, having actual or reasonable knowledge that the other person would deal;

(iii) a person in (a) discloses relevant information directly or indirectly to another person, with actual or reasonable knowledge that that other person would either deal as above, or procure another to deal;

(iv) a person in (b) deals as above;

(v) a person in (b) procures another person to deal as above, having actual or reasonable knowledge that the other person would deal;

(vi) a person in (b) discloses relevant information directly or indirectly to another person, with actual or reasonable knowledge that that other person would either deal as above, or procure another to deal;

(vii) a person in (c) deals as above;

(viii) a person in (c) above procures another person to deal as above, having actual or reasonable knowledge that the other person would deal;

(ix) a person in (a), (b) or (c) procures another person to deal as above, having actual or reasonable knowledge that the other person would deal, in a stock market outside Hong Kong or a stock market that is not recognised; or

(x) a person in (a), (b) or (c) discloses relevant information directly or indirectly to another person, with actual or reasonable knowledge that that other person would either deal as above, or procure another to deal, in a stock market outside Hong Kong or a stock market that is not recognised.

6.009 The definition of insider dealing is the same under both the civil and criminal regimes. The range of insiders is fairly wide and tippees are covered. However, this range is arguably circumscribed as the original connection with a person connected to the corporation or to a person who may have been contemplating a takeover offer for the corporation, must be made. Thus, any person who may have come into some price-sensitive information, in a situation where there is no connection to the corporation, to any connected person, or potential takeover offeror, would not be regarded as an insider. Thus, primary tippees would be covered but secondary tippees may not be covered.

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6.010 The regulation of insider dealing is generally accepted to be necessary to maintain investor confidence.[7] However, there have been contrary writings to suggest that insider dealing has no effect on market confidence or development,[8] or that insider dealing actually benefits the market as it is nonetheless a release of price-embodied information into the market, hastening the efficient capital market to reflect the information.[9] Even if there is no statistically proven link between the regulation of insider dealing and actual capital market growth in any jurisdiction, the lack of such regulation is likely to raise concerns as the international community is largely in favour of such regulation.[10]

6.011 The following will examine the SFO provisions in detail to understand how each element of insider dealing is established.

2.2 "Relevant information"

6.012 The "relevant information" that is crucial to any of the acts described in (i) to (x) above is defined in s.245 of the SFO as specific information which is not generally available to accustomed or likely investors, and would materially affect the price of the listed securities, in respect of the following:

- the corporation;
- a shareholder or officer of the corporation; or
- the listed securities of the corporation or their derivatives.

6.013 Each of the elements "specific", "not generally available", and "material" have been discussed in Insider Dealing Tribunal reports of Hong Kong.

2.3 "Specific"

6.014 First, the element of "specific" in the definition of "relevant information" begs the question of what "specific" is, and whether it is opposite to "general"? How "specific" must "specific" be? The Insider Dealing Tribunal, in respect of the *Hong Kong Parkview Group Ltd* case,[11] thought that "specific" related to a single, individual item of information of some significance, such as a potential takeover offer, or potential acquisition or disposal. It did not refer to the general superior working knowledge of the officers and employees of the corporation. The Tribunal in the *Chevalier (OA) Ltd*

[7] Brenda Hannigan, *Insider Dealing* (London: Kluwer 1988).

[8] Eilis Ferran, *Building an EU Securities Market* (Cambridge: Cambridge University Press 2004) (which suggested that the EU Insider Dealing Directive had no effect on EU market developments).

[9] Henry G. Manne, *Insider Trading and the Stock Market* (New York: Free Press 1966).

[10] For example, IOSCO (International Organisation of Securities Commissions) conducts annual Internet Surf Days to survey member regulators' jurisdictions in respect of regulatory efforts made to maintain market confidence. Such core regulatory efforts include fraudulent solicitation of investors, fraudulent or misleading release of information, and insider trading. See IOSCO Technical Committee, *Press Release on Second Annual International Surf Day* (June 2001), on IOSCO's website, http://www.iosco.org/news/pdf/IOSCONEWS19.pdf.

[11] Dealing took place between August 13–16, 1993, report of March 5, 1997.

case[12] also agreed that "specific" had to refer to major or dramatic matters. The bulk of information that investment advisers may be privy to but not the general public, would also not fall within "specific".[13] However, "specific" did not require that all the details relating to the information had to be known, so long as the information was more detailed than mere market rumours.[14] One also notes that the specific information had to relate to the corporation itself, any shareholder or officer, or any listed securities or derivatives of the corporation or its related corporations. These limitations further circumscribe the information that could be regarded as inside information. If the information is related to for example, the revolt of institutional investors against the board of a sister corporation, that may not be regarded as one of the subject matter the information had to relate to.

2.4 "Not generally known"

6.015 Next, "not generally known" in the definition of "relevant information" related to accustomed or likely investors. Thus, it may suggest that the relevant information need not be disseminated to the public in order to be "generally known". However, as long as the accustomed or likely investors, usually professional investors, were aware, the relevant information could meet the requirement of being "generally known". This seemed to be the position in the Insider Dealing Tribunal's report with respect to the *HKCB Holding and HK China Ltd* case.[15] However, it has been opined in the Insider Dealing Tribunal's report on *Public International Investments Ltd*[16] that the "not generally known" requirement should not be limited to particular groups of investors, as market trading is a widespread phenomenon amongst all echelons of society, and hence, likely investors could include the public at large. However, in many cases, it would not usually be an issue determining that a piece of information is "not generally known" by *ex post* wisdom. Many insiders would have acted and gained a profit or avoided a loss before market price significantly changed to reflect a crucial piece of information. The fact that market price afterwards changed to reflect the information, would have meant that before that, any trade that the insiders had undertaken would more likely than not have occurred before the information became disseminated enough. Where the civil standard of proof is required to establish insider dealing,[17] proof of "not generally known" is unlikely to be sufficient.

[12] Dealing between April 26 to July 5, 1993, report of July 10, 1997.

[13] Insider Dealing Tribunal in relation to Public International Investments Ltd, dealing between November-December 1992, report of August 5, 1995.

[14] Report of the Insider Dealing Tribunal in respect of HKCB Bank Holding and HK China Ltd, dealing between May 1–23, 1997, report of October 11, 2004.

[15] Above. In that case, the information concerned was not even well-known within the related corporations, and thus, the threshold for "not generally known" was met.

[16] Report of the Insider Dealing Tribunal in respect of HKCB Bank Holding and HK China Ltd, dealing between May 1–23, 1997, report of October 11, 2004.

[17] Section 252(7) of the SFO expressly provides for the civil standard of proof for market misconduct proceedings before the Market Misconduct Tribunal. There has always been a question whether insider dealing in Tribunal proceedings had to be proven on a civil or criminal standard, and there has also been case law supporting a standard higher than civil, as insider dealing is regarded as "quasi-criminal"; see also *Dato Tan Leong Min v Insider Dealing Tribunal*, [1998] HKCFI 208 and [1999] HKCA 39.

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6.016 In Australia and Singapore however, there have been statutory attempts to define what information may be in the public domain or is generally available. Therefor, information that does not fall within those definitions could be regarded as inside information. However, the experience in Australia shows that many interpretive issues could arise upon definition of what may be in the public domain or is generally available. In the SFO, the lack of further attempts at guiding the interpretation of "generally known" or "not generally known" may make the interpretive issues simpler.

2.5 "Materiality"

6.017 Finally, the relevant information had to materially affect the price of the listed securities. Materiality is the standard used to define price- sensitive information whether in the US, the EU's Market Abuse Directive[18] or in the relevant legislation in Australia[19] or in Singapore.[20] The test adopted in the US is whether there is a substantial likelihood that a reasonable shareholder would consider the information important in deciding how to exercise his rights attached to the shares.[21] This seemed to be affirmed in the Insider Dealing Tribunal's report on *Lafe Holdings Ltd*.[22]

6.018 However, establishing whether a piece of information would substantially affect any investor's decision is a complex matter that would involve assessments from behavioural finance theories as well, and different investors may respond to different information in different ways. Due to its fluidity and possibly significant and large variances between different sets of circumstances, the term "material" is not defined in the SFO. In order to provide some guidance to the directors and market practitioners, the SFC published the Guidelines on Disclosure of Inside Information in 2012.[23]

6.019 The SFC Guidelines provide the meaning of the term "relevant information" in some non-exhaustive insights and in summaries of the key aspects of selected cases handled by the Insider Dealing Tribunal and the Market Misconduct Tribunal. Three key elements listed in the Guidelines are: (a) the information about the particular corporation must be specific; (b) the information must not be generally known to that segment of the market which deals or which would likely deal in the corporation's securities; and (c) the information would, if so known be likely to have a material effect on the price of the corporation's securities.[24]

6.020 The requirement of "specific information" is easy to establish as the specificity can be identified, defined and unequivocally expressed.[25] The element "information not generally known" can be interpreted in various manners. The SFC Guidelines states that "by its very nature, inside information is information known only to a few and not generally known to the market"[26] and that "press speculation, reports and rumors in the market cannot automatically be taken to be information generally known to the market, even though in some cases the media reports might have a wide circulation".[27] In addition, "where the information known to the market is incomplete … such information cannot be regarded as generally known and accordingly full disclosure by the corporation is necessary".[28] The element of "material price effect" is satisfied if "information is more likely than less likely that the price will be affected materially".[29] The SFC Guideline suggests that "the standard by which materiality is to be judged is whether the information on the particular share is such as would influence persons who are accustomed or would be likely to deal in the share, in deciding whether or not to buy or not to sell that share"[30] with this hypothetical objective test "to be applied at the time the information becomes available".[31]

18 2003/6/EC, OJ L096.
19 Corporations Act 2001, s.1002G.
20 Singapore Securities and Futures Act, ss.218 and 219.
21 *TSC Industries Inc v Northway Inc* 426 US 438 at 449 (1976).
22 Dealing between March 1, 1989 to May 5, 1989, report of February 22, 1990.
23 SFC's Guidelines on Disclosure of Inside Information, paras.23–39.
24 *Ibid*., para.16.
25 *Ibid*., para.17.

6.021 Furthermore, at any one point in time, it may be difficult to pinpoint which piece of information concerning a corporation would, more likely than not, substantially affect the price of securities, if there were other pieces of information concerning the range identified in s.245 of the SFO. The SFC's Guidelines reminds that "care must be taken to ascertain whether and how the investors' response, once the information is stripped of its confidentiality and becomes public knowledge, is attributable to the information released and/or affected by other events and considerations".[32] This reminder effectively suggests that "fixed thresholds of price movements or quantitative criteria alone are not suitable means of determining the materiality of a price movement".[33]

6.022 More recent cases from the Insider Dealing Tribunal have approached the test for "materiality" in the following ways. The Report on the case concerning *HKCB Bank Holding* and *HK China Ltd* has opined that the Tribunal should look at whether there was any other piece of information that could have affected the price of the securities, on or about the dates the price of the securities changed after the inside information in question had been reflected in the market. The absence of any other piece of information that coincided with the price change of the securities could give rise to the conclusion that the inside information in question was material. This seems to use an after-the-fact method to ascertain the materiality of the information. In other words, the Tribunal found materiality based on actual materiality proved in the price change. It is submitted that this methodology is rather unsatisfactory as materiality should be judged according to the time the inside trades took place, and such an assessment would undoubtedly be based on the *likelihood* of the effect of the information. Is not the gamble on the likely effect of the information, the subject of the insiders' indictment after all? It would be rather unusual if persons who calculated on the likely price-sensitiveness of a piece of information, and had the requisite *mens rea,* should go unpunished just because the market ultimately

26 SFC's Guidelines on Disclosure of Inside Information, para.18.
27 *Ibid*., para.20.
28 *Ibid*., para.21.
29 *Ibid*., para.23.
30 *Ibid*., para.26.
31 *Ibid*., para.27.
32 *Ibid*., para.29.
33 *Ibid*., para.28.

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did not think the information was significant enough. The case of *Henry Tai Hon Leong v Insider Dealing Tribunal*[34] discussed whether the lack of price movement after part of the information became known would mean that the information was not price-sensitive. The court refused to accept that actual price movement would determine the legal test of materiality and thus, this may be the more authoritative view on whether actual price movement should affect the legal interpretation of materiality.

6.023 In another case, the Insider Dealing Tribunal in *Chinney Investments Ltd*,[35] it was not very clear as to whether the Tribunal approached "materiality" as a question of fact or law. It gathered expert and professional evidence on whether a piece of information regarding top-up placements and the likely placee would be price-sensitive and relied on expert opinion to conclude on the materiality of the information. If the Tribunal regarded "materiality" as a question of fact, this is unusual as the well-established American approach on defining materiality treats the exercise of determining materiality as a question of law. Although the Tribunal is quasi-judicial in nature, it is still perhaps right to maintain a distinction between the finding of fact and the interpretation of law. But it may be argued that the nature of information that may affect the price of securities is a sophisticated subject, and expert evidence could be conclusive on the matter, bringing the issue of materiality more like one of fact dependent on the expert evidence in each case. The question of how to interpret materiality, and whether it is a question of fact or law may become more important in the future, as criminal and civil enforcement could be taken in court against insiders, and judges would have to face these issues. Before 2003, insider dealing was dealt with as an administrative transgression under the exclusive jurisdiction of the Insider Dealing Tribunal.

2.6 Mental element

6.024 The *mens rea* element of the insider in (a) and (b), as listed in 6.007 above, would be knowledge of the nature of the relevant information, and where disclosure is made to another to facilitate the acts in (iii), (vi) or (x) above in 6.008, there is a further layer of *mens rea* that the person who discloses should have knowledge or reasonable cause to believe in the other person's acts. The *mens rea* relevant for the person in (c) would be both the knowledge of the nature of the information, as well as the knowledge or reasonable cause to believe that the information came from a person in (a) or (b). See 6.007–6.010 above for the definition of insider and insider dealing.

6.025 Where there is only provision of knowledge and not reasonable cause to believe, it seems that actual knowledge would be required to be established. The argument could be made that as the provision stipulates actual knowledge in relation to the nature of inside information. It will be difficult to prove for sure that a piece of information is inside information, based upon the analysis on the elements of "specific", "not generally known" and "material". This is because the nature of inside information itself

[34] [2005] HKEC 1740.
[35] Dealing between September 22, and October 4, 1999 and report was issued on June 29, 2004.

is arguable. This is also the case with the legislation in Singapore, and this author has commented in another article that it is puzzling why constructive knowledge should be left out. Consequently, the prosecution has to prove actual subjective knowledge which is very difficult because the defendant can always deny such knowledge.[36] In the Australian case of In *R v Evans and Doyle*,[37] when the defendants dealt with the securities of the corporation about which they had obtained inside information, they thought that the information was already made public by the press release they initiated 30 minutes before the dealing took place. The defendants pleaded that they did not know that the information was not made public yet. On the facts, the trial judge found that the plea was not true. But the judge did not comment on whether an innocent mistake as to the nature of the information, could negate actual knowledge of the nature of the information. But an innocent mistake would have to negate actual knowledge, as actual knowledge of the nature of the inside information would never have existed.

6.026 There could be potential pitfalls with requiring only actual knowledge of the nature of inside information.

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3. Exceptions to Insider Dealing

3.1 Directors, liquidators, receivers and trustees in bankruptcy

6.027 Sections 271 to 273 of the SFO provide for the exceptions from insider dealing. The common exceptions for underwriters, would-be directors, liquidators, receivers and trustees in bankruptcy are present.

3.2 Innocent insider

6.028 Section 271(2) of the SFO exempts a corporation from insider dealing if the actual persons who dealt, had no knowledge of the inside information, although some directors or employees might have had the information. Thus, if a director who has relevant information orders an innocent subordinate to deal, the director's liability would attach to himself personally and not be attributed to the corporation.

3.3 Absence of mental element

6.029 Section 271(3) of the SFO exempts an insider if the trade does not include the purpose of securing a profit or avoiding a loss for himself. This provision is heavily criticised by one commentator,[38] who argues that profit has still been made or loss avoided at others' expense when the inside information was used in

[36] Chiu Hse Yu, "Australian Influences in the Insider Trading Laws in Singapore" (2002) *Singapore Journal of Legal Studies* 574.
[37] [1999] VSC 488.
[38] Katherine Lynch, "Stock Market Crises and Insider Dealing in Hong Kong: The Need for Regulatory Reform", in Raymond Wacks, *New Legal Order in Hong Kong* (Hong Kong: Hong Kong University Press 1999) 274.

trade. Thus, market integrity has still been compromised whether the subjective intention of the trader was to profit himself or not. However, as insider dealing is also a crime, *mens rea* is an important fundamental principle, and this exception could be argued as negating the *mens rea* to commit market misconduct. This interpretation is supported by the case of *Henry Tai*[39] as the court stated that the lack of "intention" was crucial to the success of the defence, and one of the factors showing a lack of intention could be if the insider had no choice but to sell shares.

6.030 One may argue that the insider without *mens rea* should be punished because of the potential effect on market integrity. Such argument uses a strict liability form of reasoning which needs stronger policy justification. It may well be argued that market integrity maintenance itself is a strong policy justification, however, market confidence can generally withstand some imperfections, and even scandals may not result in a financial crisis. Thus, it would be submitted that s.271(3) of the SFO does provide a worthy exception.

3.4 Agents and off-exchange transactions

6.031 Further, persons who deal without the requisite knowledge or deal as agents are exempt, and persons who dealt off-exchange with each other, both having the requisite knowledge, are also exempt. This is probably premised on that, off-exchange dealings between entities who may be in a superior knowledge position to market participants does not affect the listed price of securities and there is no misuse of informational advantage.

3.5 Personal representatives, trustees and persons exercising rights under options

6.032 Sections 272 and 273 of the SFO exempts certain personal representatives and trustees who have dealt based on advice obtained good faith, and persons exercising rights under options.

6.033 Permission from a relevant compliance unit to deal in shares would not absolve a person's liability for insider dealing if the permission is obtained dishonestly and fraudulently. In the case of *HKSAR v Du Jun* (2012) CACC 334/2009, there was evidence that the defendant had not told the truth of his holding of the relevant inside information to the compliance department when applying for permission to deal in the relevant shares. Consequently, the defendant was not allowed to shield his dishonesty behind the approval he managed to obtain from the compliance department, which he would not have received had he given the full and complete disclosure of the facts.[40]

[39] Case involves the inside dealing matter regarding *Siu Fung Ceramics Holding Ltd.*
[40] See also DCCC 787/2008.

4. Other Laws and Rules Governing Insider Dealing

4.1 The rules governing the listing of securities on the Hong Kong Stock Exchange

6.034 The Listing Rules seek to protect investors against improper use of confidential information by insiders, by *inter alia*, imposing a general obligation on the listed company to disclose to the market price sensitive information.[41] The Listing Rules also impose restrictions on dealings by a director in the securities of his or her company.[42] The director of a listed company is also under a duty to ensure that the employees of the company who are likely to be in possession of unpublished price sensitive information are subject to the same dealing restriction.[43]

4.2 The Code of Conduct module of the supervisory policy manual issued by the Hong Kong Monetary Authority

6.035 The Code of Conduct sets out the minimum standards of codes of conduct that the Hong Kong Monetary Authority expects an authorised institution to adopt. These include prohibition of staff members from dealing in the shares or securities of any listed company when in possession of privileged or price sensitive information not generally known to the public.

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4.3 The Code of Conduct for persons licensed by or registered with the SFC

6.036 The Code of Conduct imposes an obligation on the persons licensed by or registered with the SFC to implement and maintain measures appropriate to ensure compliance with the relevant law, rules, regulations and codes administered or issued by the SFC, the Hong Kong Stock Exchange (if applicable) and the requirements of any other regulatory authority that apply to a licensed or registered person.[44]

6.037 These rules and laws indicate that a properly prepared and communicated compliance system may be the best defence against insider dealing. In order to ensure the effectiveness of the compliance system, the institutions must communicate well with and provide training for employees on how to identify and handle inside information; what laws are applicable to the handling of inside information; common insider dealing problems and how to avoid them; and what to do if an employee suspects insider dealing has happened or is about to occur.

6.038 Educating employees on how to handle inside information is critically important. In the case of *HKSAR v Lam Kar Fai, Allen*, convictions were obtained against an investment banker and a fund manager. The investment banker was convicted for providing information on the possible takeover transaction involving a listed

[41] Rule 13.09, Listing Rules.
[42] Appendix 10, Listing Rules.
[43] Appendix 10, para.13, Listing Rules.
[44] Paragraph 12.1, the Code of Conduct.

CHAPTER 10

ALIBABA DRAMA AND INVESTOR PROTECTION

PARA.

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10.001 Alibaba's failed bid to list on the Hong Kong Stock Exchange (HKEx) made newspaper headlines because it would have been the largest listing in the territory by far. Whilst the merits and demerits of dual-class structure boil down to the choice of what shareholders want, it is nonetheless a departure from the "one share, one vote" ideal that the HKEx treasures. In the broader scheme of things, the HKEx sees its insistence on this basic attribute of "fairness" as a competitive edge that it possesses over exchanges on Mainland China. This Chapter analyses the underlying rationale behind the HKEx's rejection of Alibaba's lucrative listing in Hong Kong and considers whether an exemption should be offered in future so as to ensure that the territory does not lose out on lucrative IPOs.

1. Introduction

10.002 2013 witnessed drama regarding Alibaba's shift from Hong Kong to New York for its highly-anticipated listing. Alibaba is China's largest e-commerce player, akin to Amazon, eBay, and PayPal, and equally popular to Google, Yahoo and Facebook. However, based in China, it possesses some uniquely Chinese characteristics.[1] Alibaba, like its other competitors in China, is not only transforming the economy and making an impact on everyday life for Chinese consumers[2] but also leading the way in Chinese entrepreneurialism.[3] Alibaba operates the online shopping sites such as Taobao and Tmall as well as a major online payment platform, AliPay, which is changing China's retail and finance sectors. Its listing raised US$21.77 billion through selling 320.1 million American depository shares with a market capitalisation of US$108 billion,[4] making it the largest technology IPO on the New York Stock Exchange since Facebook Inc's listing in 2012 which raised US$16 billion.

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10.003 Further, Alibaba has already caused a number of ripples on the commercial law pond. One of them, as discussed elsewhere, touches upon China's regulatory measures in tackling the "variable interest entity" (VIE) structure, the validity of which was the source of a dispute among Alibaba, Yahoo and Softbank in 2011.[5] This article analyses the controversy surrounding Alibaba's failed attempt to list on the Hong Kong Stock Exchange (HKEx) and proposes that for the future an exemption to the banned dual-class share structure should be considered.

10.004 This Chapter proceeds as follows. Section 2 discusses Alibaba's failed bid to list in Hong Kong with a dual-class share structure and looks into Hong Kong's struggle to accept Alibaba's listing plan. The key legal and economic features of the dual-class

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1 Juro Osawa, "Meet Alibaba: China's Mix of Amazon, eBay and PayPal", *The Wall Street Journal*, March 17, 2014, B1.
2 Charles Clover, "Mobile Wars", *Financial Times*, March 20, 2014, p.7.
3 Jamil Anderlini, "The Billionaire Determined to Transform His Country", *Financial Times*, December 13, 2013, p.7.
4 Nicole Bullock and Sarah Mishkin, "Alibaba Prices Record-Setting IPO at US$68", *Financial Times*, September 19, 2014 (online); Ray Chan, "Alibaba Prices IPO Shares At US$68 Each", *South China Morning Post*, September 19, 2014 (online).
5 Shen Wei, "Will The Door Open Wider in the Aftermath of Alibaba? – Placing (or Misplacing) Foreign Investment in a Chinese Public Law Frame", (2012) 42(2) *Hong Kong Law Journal* 561–593.

share structure are analysed in greater detail in Section 3. HKEx's equity concerns are further examined in Section 4. Rejecting Alibaba's dual-share structure not only complies with the one share one vote principle, but also supports societal equity and harmony. The key counter-argument against HKEx's decision not to accept Alibaba's listing plan is HKEx's attraction to potential mainland listing companies. Section 5 looks into Hong Kong's competitive edges in attracting Mainland listings. A short conclusion follows in the end. While this Chapter chronicles Alibaba's failed bid to list in Hong Kong, normative contributions are crystalised from the insights into the circumstances and contextual considerations of why the HKEx decided against potentially one of the largest public company listings in the territory. In the scheme of things, there are bigger issues and reverberations for Hong Kong to consider.

2. Alibaba's Drama in 2013

10.005 Alibaba wanted to structure its initial public offering (IPO) with a dual-class voting scheme so that the founders of the company could maintain considerable control over the company after it goes public. However, the HKEx does not allow dual-class voting on the grounds that the dual-class voting structure violates Hong Kong's existing "one share one vote" rule. The dual-share structure has been explicitly banned by the HKEx since April 8, 1987. The dual-class share structure is allowed in the US enabling insiders to control a company after its IPO. Facebook, Google Inc. and other US companies were all organised in this manner, by issuing two classes of stock with different voting rights, giving founders and corporate officers a greater control in shareholder votes. Founders of US technology groups such as Google, Facebook and Zynga, among others, all have kept control of key decisions and board composition after floating using dual-class share structures.

10.006 In its negotiations with the HKEx, Alibaba made a proposal allowing the company's leading executives, through a partnership (including Jack Ma and other executives, altogether 20 partners, owning a little more than 10 percent of Alibaba) to nominate a majority of the directors after its debut. The structure would be best characterized as a partnership style of control over the company's fate, liken to US technology companies with dual-class shares. In essence, the founders of Alibaba have more voting rights than other future shareholders combined.

10.007 The purpose of putting the partnership-type arrangement (rather than a straightforward dual-share class structure) in place is to keep the founders' vision and direction of the company as well as the corporate culture intact. Jack Ma and his top executives would own about 10 percent of the company, compared with their contemporaries like Yahoo with about 24 percent and Softbank at 37 percent. The founders of the company believed that this share structure was an "open, innovative, responsible and sustainable system for a company's fundamental needs".[6]

[6] Charlotte So, "US Bourses Accept Board Plan: Alibaba", *South China Morning Post*, October 22, 2013 (online).

10.008 Yahoo and Softbank appeared to have supported Alibaba's justification. During negotiations with the HKEx, Alibaba was flexible with reducing the number of partners and binding them to a three-year share sale ban.[7] However, the current listing rules in Hong Kong meant that the founders of the company would not be able to hand-pick most of Alibaba's board members, post listing.

10.009 Oddly, even after the US exchanges gave a green light to Alibaba, taking no issue with its unusual corporate governance structure, Alibaba deployed a dual-track approach to simultaneously negotiate with both exchanges as its founders viewed Hong Kong as a more favourable listing venue. In order to make progress, Alibaba even agreed to make a compromise by giving up the nomination rights for the majority of the directors so long as the chief executive officer could be one of the founding shareholders.[8]

10.010 To its credit, HKEx did discuss the possibility of initiating a market-wide consultation on alternative share and control structures.[9] However, the consultation came too late in August 2014, just months away from Alibaba listing in the US. Alibaba consistently maintained to the HKEx that it did not seek to change the listing rules about the dual-share structure, all that it wanted was an exemption. Nevertheless, this distinction made no difference to the HKEx because what Alibaba sought was a departure from the principle of "one share, one vote".

10.011 Even though Alibaba Group had convinced New York regulators to accept its controversial executive partnership structure and list shares,[10] there were still challenges. The agreed share structure enabling the founder, Jack Ma and his management team to retain control of the company would effectively place other shareholders at a greater disadvantageous position than other dual-class listing models the US has permitted.

10.012 The existing listing rules in the US provide equity shareholders with the power to nominate or dispose of the directors. Under Alibaba's preferred structure, shareholders would not enjoy these rights, leaving such shareholders with no effective monitoring role. If Alibaba were to restructure the company, it would take a long time to go through the internal processes and garner approval from the existing shareholders. The partnership structure Alibaba maintains is uncommon for a company of its size.

10.013 The other hurdle Alibaba needed to overcome was its creditability on Wall Street after a 2011 dispute with Yahoo on secretly transferring AliPay, one of the most valuable assets of the group, to a third party owned by Ma outside of the group. The dispute is commonly referred to as a VIE problem, that is, an investment vehicle or a "variable interest entity" allowing Mainland firms to access capital from foreign investors through offshore platforms rather than through their mainland entities, in oder to avoid China's tight and complicated foreign exchange controls. This incident triggered a round of sell-offs in US listed Mainland firms, including sina.com, China's No.2

[7] Ray Chan, "Alibaba Abandons Hong Kong for New York, Sources Say", *South China Morning Post*, September 26, 2013 (online).
[8] Mary Ma, "Alibaba Behind Smokescreen", *The Standard*, October 22, 2013.
[9] Paul J. Davies, "Hong Kong IPO on Hold", *Financial Times*, November 11, 2013, p. 21.
[10] Ray Chan, "Alibaba Abandons Hong Kong for New York, Sources Say", *South China Morning Post*, September 26, 2013 (online).

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web portal. This was because US investors became suspicious of Mainland companies imitating Alibaba business practices.

10.014 In light of these controversies, Alibaba later adopted the board-nomination system when it decided to list in the US.[11] Both the New York Stock Exchange and Nasdaq accepted the special partnership structure that allowed its top executives to nominate the majority of board members.[12] Alibaba received written confirmation from both exchanges that it could list its shares on those platforms, qualifying for a foreign-company exemption enabling former and current executives to exert such influence over the company's board.[13] Alibaba also engaged in talks about the possibility of listing the firm on the London Stock Exchange.[14]

10.015 Opinion is divided in Hong Kong on whether the HKEx's no-decision was a wise one. While corporate governance activists cheered the outcome, it also meant that the HKEx had lost out on one of the most anticipated listings given the size of Alibaba's capitalisation. The deal could have added 2-3 percent, or about HK$200 million to the HKEx's 2013 revenues.[15] When the HKEx took over the London Metal Exchange in 2012 for the price of US$21.6 billion, it dragged on profits, as the exchange had spent millions on improving its technology. Alibaba spurning Hong Kong may in fact not have hurt the HKEx. 2013 witnessed an 11 percent profit increase, which ranked right after the New York Stock Exchange (climbing from fourth in 2012 to second in 2013).[16] Rejecting Alibaba may have had other side effects, like discouraging other Chinese internet companies from attempting to list in Hong Kong. Thus far, only two internet companies from mainland China had listed in the city out of the more than 30 that went public in the past decade.[17] In response to the HKEx's rejection of its proposal, Joe Tsai, Alibaba's co-founder and vice chairman who led the IPO effort said that "the question Hong Kong must address is whether it is ready to look forward as the rest of the world passes it by".[18]

10.016 The HKEx's decision reflected its desire to ensure unqualified transparency in disclosure as well as equitable considerations for investing when listing.[19] As such, Hong Kong listing rules explicitly ban dual-class shares and thus offered no room for Alibaba's intention. HKEx's concern was legitimate, as the partnership structure may have given top executives more rights than ordinary shareholders by allowing them to nominate a majority of candidates for election to the firm's board of directors. Allowing a dual-class share structure means the preferential treatment of one group of shareholders over another.

[11] The decision to list in New York could be regarded as a signal opting for American banks to play the leading roles in helping soothing any investor nerves on the Wall Street.

[12] George Chen and Ray Chan, "Alibaba in Talks with London Bourse After Hong Kong Snub", *South China Morning Post*, October 22, 2013 (online).

[13] Telis Demos, Juro Osawa and Jacob Bunge, "Alibaba: NYSE, Nasdaq Approve Partnership Structure Proposal", *Wall Street Journal*, October 22, 2013, B7.

[14] George Chen and Ray Chan, "Alibaba in Talks with London Bourse After Hong Kong Snub", *South China Morning Post*, October 22, 2013 (online).

[15] Paul J Davies, "Alibaba Abandons $60bn Hong Kong Listing", *Financial Times*, September 25, 2013 (online).

[16] Enda Curran, "Hong Kong Bourse Seeks Rule Changes", *The Wall Street Journal*, March 17, 2014, C3.

[17] Tencent is one of two mainland internet stocks. Tencent's market value soared to US$98 billion from US$800 million when it listed in 2004. Tencent stock accounts for about 3% of the Hong Kong exchange's average daily turnover and is among the top five traded stocks. Reuters, "Loss of Alibaba IPO Spurs Calls for Reforms of Hong Kong Listing Rules", September 27, 2013 (online).

[18] Matt Jarzemsky and Juro Osawa, "Alibaba Jabs at Hong Kong Bourse", *The Wall Street Journal*, September 27, 2003, C3.

[19] Compared to Hong Kong regulators, the US SEC is not a prudential regulator and focuses more on whether a company's disclosure includes all information that investors would regard as material to their investment decision, including whether the company meets the corporate governance standards of the relevant stock exchange.

10.017 The SFC has consistently echoed its position: a structure giving one group of shareholders more power than another is not acceptable, the position that moves away from the conventional principle of one share one vote. The SFC and the HKEx's listing committee have made it clear that no exemption will be provided for any company because local listing rules do not allow preferential treatment for one set of shareholders. Accepting Alibaba's request would have meant a significant change to the current listing rules. In denying Alibaba special status, Hong Kong's regulators made clear they are not willing to compromise when it comes to safeguarding small investors' interests and treating all shareholders alike. Furthermore, the HKEx needs take precedence over shareholder interest in the exchange's charter.

10.018 The Hong Kong government also lent its support to the SFC's stance in the controversy, and rejected calls to strip the stock exchange of its power to approve listings.[20] The HKEx has dual functions, being a market player as well as a regulator. According to Hong Kong law, the government has the final say on any listing issue and the chief executive can issue directives to the SFC even though this power has never been exercised. Some legislators have suggested that the government consider adopting the new rules in order to attract technology firms to list in Hong Kong.[21]

10.019 Even though one IPO will not have a substantial impact on the HKEx's ability to attract big IPOs, high-profile banner deals will have a bearing on its long-term success. One notable issue is the HKEx's dual role as IPO regulator, as well as a publicly traded company that benefits from listing fees and trading volumes. Naturally, there is a conflict of interest. In 2003, a Hong Kong government expert panel recommended merging the exchange's listing authority into the SFC but only one aspect of the entire proposal was eventually implemented. Now, the exchange is eager to boost its profitability. On the other hand, the Exchange's average trading volumes in 2012 were 39 percent below a 2007 peak. Companies have raised a combined US$7.9 billion through IPOs in Hong Kong through the end of October in 2013, up from US$5.6 billion during the same period in 2012.[22] Slowing mainland economic growth and a lack of large stock listings has been a drag on Hong Kong during the past two years. Notably, the AIA listing in 2010 was expected to breathe some life back into the market. Institutional investors reaped hundreds of millions of dollars of fast profits after AIA rallied strongly in the first weeks, boosting demand for smaller deals as well.

[20] Enoch Yiu, "Hong Kong Official Backs Market Regulator in Alibaba Listing Row", *South China Morning Post*, October 10, 2013 (online).

[21] *Ibid.*

[22] Josh Noble and Paul J Davies, "Hong Kong Battles to Liven Up IPO Market", *Financial Times*, October 2, 2013 (online).

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The exchange merged with the London Metal Exchange in 2012 for US$2.1 billion but the return from that merger may not fully kick in until 2015.

10.020 The Exchange itself has recognised its own inflexibility and looked into potential changes. It has been aware of the possibility of losing out in the race to list companies that are proposing alternative shareholder structures. Since 2009, the HKEx has missed out on a wave of Chinese tech IPOs. Nine of the ten largest IPOs by Chinese Internet-related companies have been listed in the US rather than in Hong Kong. Some members on the exchange's list committee have maintained that any change to the listing rules may be viewed as surrender to the commercial needs and a weakening of the rule of law. A one-off waiver is likely to create a perception to the market that the rule can be easily changed to satisfy a large player's needs.

10.021 In its June 25, 2015 statement[23] on the SEHK's draft proposal on weighted voting rights, the Board of the SFC unanimously concluded that it does not support the draft propsal for primiary listings with the weighted voting rights structures. Fairness and objectiveness were the two major factors the SFC considered and rejected the draft proposal. First, size does not justify special treatments under law and does not guaranteee fair treatment to shareholders. Any corporate misconduct by an issuer with a large market capitalisation is more liley to affect more investors and have a greater impact on the markets. Second, a set of "enhanced suitability" criteria proposed by the SEHK in its proposal that regulators rely on to determine the potential issuers' eligibility for weighted voting structure is subjective and inherently vague. These criteria include whether the applicant has some unique features that cannot be easily replicated and are likely to provide a sustainable competitive advantage, as well as the contribution of the founder or founders. In the SFC's view, the application of these subjective standards is likely to lead to regulatory uncertainty due to inconsistent and unfair decision-making processes.

10.022 Another troubling issue is how and when the exchange has showed its flexibility. The exchange's approach seems imbalanced and unpredictable. In 2009, the HKEx allowed Russian aluminium giant Rusal to list in Hong Kong even though the company failed to meet the profitability standards. Regulators allowed the offering to go ahead but restricted the retail portion of the deal, which remains below its IPO price. In 2011, however, the Exchange lost a US$5.5 billion IPO when Hutchison Port Holdings Trust, controlled by Li Ka-shing, was listed in Singapore as Hong Kong did not allow business trusts. This is because business trusts have an even more complicated shareholding structure that disenfranchises minority unit holders. The HKEx's loss of a lucrative listing prompted heated debate on whether Hong Kong was losing its competitive edge on listings. A structure similar to business trusts, a single investment, was created later that year, which enabling PCCW, headed

[23] SFC, SFC Statement on the SEHK's Draft Proposal on Weighted Voting Rights (June 25, 2015), available at http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=15PR69 (last visited on July 5, 2015).

by Li's son, to be listed raising US$1.2 billion. However, there were no regulatory amendments to strengthen the protection of minority unit holders' interests.[24] Since the majority unit holder of HKT Trust Limited is PCCW, it is thus impossible to remove and replace the trustee-manager, without the consent of PCCW.[25] Thus, the controller of PCCW has similar powers to those of majority shareholders in a company. Unlike the preference shares, unit holders of the shares can vote at the general meetings of HKT Limited with one vote for each share.[26] Therefore, the level of control PCCW has over HKT Limited is lesseded, compared with if it were to be listed under a dual-class structure.

3. Demystifying the Enigma Associated with Dual-Class Structure

10.023 In essence, a dual-class share structure is a device to safeguard the entrepreneurs control over a company as their ideas were thought to be the key drive behind it. The share structure divides the shareholders into several groups and then prioritises them according to different classes with different rights attached to each class. It is sometimes interchangeably used with corporate pyramids.[27] Thus, in a listed company with a dual-class share structure, public shareholders often have one class of shares, which carries limited voting rights whereas management has the other class of shares carrying enhanced voting rights. Technically, a dual-class share structure can help management and its allies defeat hostile takeovers, as their voting control can be easily relied upon to turn down any bid for the firm. However, the immediate consequence of adopting this structure is to detach corporate governance from shareholder activism.

10.024 The American Stock Exchange (Amex) has allowed firms to issue multiple classes of common stock on the condition that such shares have the right to elect at least 25 percent of the board of directors.[28] Yet the New York Stock Exchange had a listing rule explicitly prohibiting dual-class common stock dating from 1926.[29] The NYSE at one time considered changing this rule when General Motors issued dual-class common stock in 1982 in violation of the NYSE's rule.[30] During the time between General Motor's issuance of shares and June 1987, more than forty companies issued

[24] Raymond Chan, Vincent Kwan and Angus Young, "Publicly Listed Business Trust in Hong Kong", (2014) *Compliance and Regulatory Journal*, Forthcoming.

[25] *Ibid.*

[26] *Ibid.*

[27] Lucian A. Bebchuk *et al.*, "Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights", in Randall K. Morck (ed.), *Concentrated Corporate Ownership* (Chicago: University of Chicago Press, 2000) 445.

[28] Am. Stock Ex. Guide §10,022.

[29] Marcel Kahan, "Some Problems with Stock Exchange-Based Securities Regulation", (1997) 83 *Virginia Law Review* 1509.

[30] 17 CFR. §240.19c-4 (2005).

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disparate voting shares.[31] Due to competitive pressure from the OTC market, Amex and NASDAQ for corporate listings[32] as well as the narrowing advantage of an NYSE listing, NYSE attempted to abolish its single class common rule,[33] eventually succeeding in 1986. The SEC's r.19c-4, formally codified in the Securities Exchange Act 1934 in 1988, later allowed for a dual-class recapitalisation[34] on any exchange to disenfranchise shareholders so long as the limited voting stock is issued through an IPO and existing shareholder voting rights are not diminished. Both the NYSE and the NASD enforced listing rules embodying the sprint of r.19c-4 until the case of *Business Roundtable v SEC* in which the DC Circuit struck down the r.19c-4.[35] The regulation of voting rights is now primarily governed by the rules of the exchanges and state law.[36]

10.025 The dual-class structure has been particularly popular among media companies and publishers in the United States. Newspaper groups such as Washington Post or New York Times once used this share structure. US newspaper barons, who floated their businesses in the second half of the 20th century, used this structure to protect the editorial integrity of their properties from outside shareholders' pressure. These companies survived the controversy that has been attached to Rupert Murdoch's media empire. Nonetheless, Twenty-First Century Fox faced a challenge to the family's effective control in October 2013. The structure was a response to corporate threats. In the 1960s, UK companies used the structure to protect themselves from hostile takeovers, before institutional structures marshaled their opposition to such structures. The increasing prominence of corporate raiders in the US during the 1980s prompted the New York Stock Exchange to lift its ban on the structure in 1988, as it feared that a failure to do so would cause companies such as General Motors to desert it. Technology groups and private equity groups have elected to use the model in more recent times. The dual-class share structure was once very popular to public firms in the 1980s.[37]

10.026 In the US, 20 percent of companies do have dual-class shares. 0.2 percent of companies grant shareholders loyalty votes. This arrangement consists of granting common shares (five or ten votes per share if held for four years). US companies also issue non-voting

[31] Manning G. Warren III, "One Share, One Vote: A Perception of Legitimacy", (1988) 89 *Journal of Corporation Law* 92.

[32] Douglas C. Ashton, "Revisiting Dual Class Stock", (1994) 68(4) *St. John's Law Review* 863, 896.

[33] Jeffrey N. Gordon, "Ties that Bond: Dual Class Common Stock and the Problems of Shareholder Choice", (1988) 76(1) *California Law Review* 1, 7.

[34] A recapitalisation scheme is often used as a device to change the voting rights of shares, dividend or liquidation preferences, or to grant the company an option to redeem shares. Franklin A. Gevurtz, *Corporation Law* (St. Paul, MN: West, 2nd edn, 2010) 779–780.

[35] *Business Roundtable v SEC*, 905 F2d 406 (DC Cir 1990).

[36] Stephen M. Bainbridge, "The Short Life and Resurrection of SEC Rule 19c-4", (1991) 69 *Washington University Law Quarterly* 565, 574.

[37] SEC Office of Chief Economist, Update – The Effects of Dual-Class Recapitalizations on Shareholder Wealth: Including Evidence from 1986 and 1987, (July 16, 1987).

shares.[38] Among listed firms, 10 percent in the US and 22 percent in Canada (Toronto Stock Exchange Index) have dual-class shares.[39] US listed companies with weighted voting rights structures represent 14 percent of total market capitalization of all large US listed companies. The survival of the dual-class share structure in the US could also be attributed to its federal system. In the 1980s, the SEC appealed to the courts to ban such structures. The Court subsequently ruled the issue would have to be determined by state law.

10.027 The structure has now become *de rigeur* for the hottest technology IPOs, including Facebook, LinkedIn, Zynga, and Groupon, as the structure can help these companies to maintain their vision and value and retain a long-term perspective. The dual-class voting structure adopted by Facebook and Google allows the senior management including the founders to retain control of the companies even as they have tapped the market for funds. In the case of the News Corporation, the Murdoch family only owns 12 percent shares, but controls 40 percent of the votes through a special class of shares which entitles the Murdoch family to superior voting rights.[40]

10.028 In a larger picture, the structure allows entrepreneurs to bring their ideas to the public market at an early stage and enable companies to plan for the long term. Nonetheless, even in the US, some investors have been upset with the dual-share structure complaining that the technology companies using it have surrounded themselves with too many protections.

10.029 Civil law jurisdictions such as Germany, Italy, and Japan[41] place limits on dual-class shares.[42] So do Spain, South Korea[43] and China.[44] In continental Europe, several

[38] Institutional Shareholder Services, Proportionality Between Ownership and Control in EU Listed Companies: External Study Commissioned by the European Commission, (May 18, 2007) 130.

[39] Mike Burkart and Samuel Lee, "The One Share – One Vote Debate: A Theoretical Perspective", available at http://ssrn.com/abstract_id=987486, at 1.

[40] "Dual-class Share Structures: the Cost of Control", *The Economist*, July 21, 2001.

[41] In Japan, the Tokyo Stock Exchange (TSE) listing rules do not allow a listed company to have multiple voting shares. A Japanese listed company's articles may state that the shares of a certain class have limted or no voting rights. The number of such shares, however, may not exceed one-half of the total number of issued shares of the company. The TSE listing rules state that shares without voting rights can be listed on its main market. In reality, such shares were not issued. The Companies Act allows priority shares to be issued that give special rights on the appointment of directors. However, TSE rules prohibit a company from issuing such a share class after it has listed.

[42] Reinier Kraakman *et al.*, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: Oxford University Press, 2nd edn, 2009) 59.

[43] Korea company law does not allow a stock company to issue multiple voting shares. Korea company law was amended in 2012 to allow a stock company to issue non-voting shares and shares with limited voting rights that may be exercised only for certain matters but not others. Non-voting and limited voting shares must not exceed 25% of the total issued and outstanding shares of the stock company. Certain exceptions from this limit are permitted for non-voting shares issued under the authority of a Presidential Decree.

[44] Article 127 of the PRC Company Law provides legal ground for companies incorporated in Mainland China to issue different types of shares. However, companies are prohibited from issuing multiple voting shares. CSRC's Guide to the Articles of Association of Listed Companies (amended in 2006) states that companies' articles must include a provision that each share with voting rights held shall be entitled to one vote. Limited voting shares and non-voting shares without preferential rights to dividends cannot be issued by listed companies incorporated in Mainland China. There have been no cases in which any Mainland Chinese listed company granted special board nomination or appointment rights to particular persons in its articles.

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countries have changed their laws to accommodate deviations to the one share one vote principle.[45] The dual-class share structure is allowed on the grounds that a family business needs a long-term vision for their business. The structure permits a company to pursue different policies for the various classes of shareholder. Family shareholders might prefer to invest for the long term while outside investors might be more concerned about immediate financial returns. The structure is more transparent than some other mechanisms through which an investor seeks control of a company without owning more than half of the equity. In addition, it has been argued that, economically, dual-class firms are not necessarily less efficient and do not imply that minority shareholders are more likely to be expropriated by majority shareholders.[46] In Italy, Telecom Italia was a prime example how of the use of pyramid structures facilitates an entity with relatively little capital to control a company through various layers of intermediaries.

10.030 However, Hong Kong, Singapore,[47] and other stock exchanges continue to ban dual-class shares. These bans may be viewed as a legal tool to protect shareholders as a class (if shares are measured by cash flow) or minority shareholders (where shares are measured by voting rights).[48] The dual-class shares were in vogue in the UK during the 1960s, but were discouraged to the point of extinction. The core argument against dual-class shares boils down to fairness, as conventional wisdom suggests that there should be no second-class investors at the mercy of those who own no more of the company than they do, yet have greater rights.

10.031 These stock exchanges rejecting the structure are stronger believers in the principle of one share one vote and shareholder democracy, even in cases when it leads to inefficiency. Dual-class shares opponents fear that the structure prevents

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45 Benito Arrunada and Candido Paz-Ares, "The Conversion of Ordinary Shares into Non-voting Shares", (1996) 15 *International Review of Law and Economics* 352–372.

46 Institutional Shareholder Services, Proportionality Between Ownership and Control in EU Listed Companies: External Study Commissioned by the European Commission, (May 18, 2007) 16.

47 Singapore revised its Companies Act in 2013. In its Companies (Amendment) Bill, s.64 was abolished. Now public companies listed on Singapore Exchange (SGX) are able to issue different classes of shares subject to certain safeguards and restrictions, which include (i) the issue of shares with differential voting rights (particularly super-voting shares) should be subject to a higher approval threshold, such as special resolution rather than an ordinary resolution; (ii) holders of non-voting shares should be accorded equal voting rights for a resolution to wind up the company or a resolution which varies the rights of the non-voting shares; and (iii) where there is more than one class of shares, the notice of a meeting at which a resolution is proposed to be passed should be accompanied by an explanatory statement setting out the voting rights (or the lack of them) attached to each class of shares. Ministry of Finance, Report of the Steering Committee for Review of the Companies Act, Consultation Paper, June 2011, available at http://app.mof.gov.sg/data/cmsresource/public%20consultation/2011/Review%20of%20Companies%20Act%20and%20Foreign%20Entities%20Act/Annex%20A%20SC%20Report%20Complete.pdf. Prior to the new amendments to the Companies Act, Singapore's listed newspaper companies (e.g. Singapore Press Holdings) were exempted by law. The Singapore Newspaper and Printing Press Act mandates the issue of separate classes of shares with different voting rights by Singapore's listed newspaper companies. Every newspaper company must have two classes of shares, "management shares" and ordinary shares. Management shares must carry 200 vots each on any resolution relating to the appointment or dismissal of a director or any member of the staff of the newspaper company. Management shares cannot be issued or transferred except to citizens of Singapore or corporations granted written approval by the Singapore government. Permissions to hold management shares can be revoked by the Singapore government.

48 Reinier Kraakman *et al.*, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: Oxford University Press, 2nd edn, 2009) 92.

investors from acting as stewards of the company, and removes the incentive for management performance provided by the risk of being taken over. In the UK there are various proposals for broadening the types of share on offer while also protecting investors from exploitation. One possibility is to impose restrictions on the two classes:

(i) setting limits on the proportions of voting and non-voting shares; or

(ii) providing a sunset clause so that they phase out after a set period of time. Singapore is now considering embracing this structure, in pursuit of its push to become a home for tech and biomedical start-ups.

10.032 There can be some justifications for this dual-class structure. Compared to shareholders, management may have better information about the firm and consequently is more capable of making sound business judgments. In contrast, shareholders, due to their possession of inferior information, may distort management decisions by selling control of the firm. With more voting rights (but less cash-flow rights), management, through its retained control, is able to avoid this miscalculation by the shareholders. Seen from this angle, the dual-class structure can also be characterised as a control-enhancing mechanism[49] or an entrenchment device.[50] Inferior shareholder information may not be a valid argument in favour of having a dual-class share structure. In the capital markets, the accurate assessment of firm performance depends on the ability of outsiders rather than insiders. This seems to suggest that information asymmetry between shareholders and management has little relevance in justifying the dual-class share structure. In the same vein, management, equipped with super majority voting power, may protect the firm from some acquirers' predatory takeovers, thereby increasing shareholder welfare. However, this argument using the dual-class structure as a defensive device is not persuasive, as other alternatives are available to protect shareholder interests without granting management voting control, despite the fact that hostile takeovers may create higher premiums than negotiated mergers. Management may request voting power in order to avoid shareholder opportunism. Encouraging firm-specific human capital investment is another argument in favour of the dual-class structure. The firm is able to attract more specialised managers by offering concentrated voting control, which in turn brings rewards to the firm and wealth to the shareholders. With such super voting power, management can ensure enforcement of compensation terms promised by the firm and shareholders. The opponents of this line of thought could easily counter that placing more emphases on human capital departs from the core problem in corporate governance, as the agency problem is between shareholders and management which does not result in a better alignment of management and shareholder interests.

10.033 The benefit-cost analysis may be the key argument disfavouring the dual-class structure. The dual-class share structure is likely to impose some additional costs

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49 Reinier Kraakman *et al.*, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: Oxford University Press, 2nd edn, 2009) 155.

50 *Ibid.*, 191.

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on public shareholders, while the management's voting power is disproportionate to their equity in the firm. Different from a single-class IPO, in which the majority shareholder has to maintain a relatively large equity stake for corporate control, a dual-class IPO, however, allows majority shareholders to maintain its control with a minority stake. In other words, the principle of one share one vote is put in place to avoid discrimination against public shareholders in the single-class structure. The risk in the dual-class structure is on the side of public shareholders that the majority shareholder may reduce the equity while retaining control. Economically, public shareholders have to bear risks of exploitation as well as greater instability in the firm's market environment.[51] The counter argument to this line of thinking can also be based on the analysing costs and benefits derived from the structure. So long as there is an adequate disclosure and a reasonably efficient market, the purchasing shareholders will be compensated for the costs associated with a dual-class structure owing to an appropriate discount on the share price. Put differently, the entrepreneurs who sell the stock will bear the costs of the dual-class structure in exchange for the economic or non-economic advantages of assured control attached to their shares.

10.034 Apart from risk bearing, public shareholders can also extract benefits out of the dual-class capital structure. One of the economic benefits for public investors is the promise of an increased cash payment from the firm.[52] The entrepreneurs may want to assure continued family dominance so as to enjoy other economic and non-economic perquisites. In the absence of this "inoffensive" structure and the attached security, the founders may not be willing to raise money[53] or go public. Public shareholders can free-ride on monitoring by dominant shareholders owing to the continued concentration of ownership. This can be the reason that public shareholders invest into the firm, as dominant shareholders may have their reputation or self-interest to ensure the better performance of the firm. Concentrated control is the incentive as well as compensation for continued risk bearing and business operation. This argument is unconvincing as it effectively ignores the agency problem tied to the division of corporate power between shareholders and management. It also ignores "coercive" coordination costs public investors may have to bear in order to exercise their powers due to the problems associated with collective action.[54]

[51] Empirical research indicates a correlation between concentrated ownership and instability in the firm's market environment. Harold Demsetz and Kenneth Lehn, "The Structure of Corporate Ownership: Causes and Consequences", (1985) 93 *Journal of Political Economy* 1155.

[52] William A. Klein, John C. Coffee. Jr., and Frank Partnoy, *Business Organization and Finance: Legal and Economic Principles* (New York: Foundation Press, 8th edn, 2010) 126.

[53] *Ibid.*, 125.

[54] *Ibid.*, 126.

10.035 The pros and cons of inside (founding) shareholders and outside shareholders (investors) in the dual-class share structure are outlined in Table 10.1 below.

Table 10.1: Comparison between Inside Shareholders and Outside Shareholders in Dual-Share Structure

Shareholders	Inside Shareholders	Outside Shareholders
Shares	Possessing super-voting shares	Holding inferior-voting shares
Purposes	Easier to obtain funding from institutional investors such as private equity and hedge funds by selling preferred shares	Focusing more on preferred rights for the distribution of dividends and remaining assets in bankruptcy but less on corporate operations
Effects on Voting Rights	Protecting inside shareholders' voting rights from being diluted and help maintain their control over the company	Outside shareholders' voting rights are differentiated from founding shareholders'
Side-effect of Concentrated Voting Rights	The possibility of abusing their control and making suboptimal corporate decisions beneficial to themselves but harmful to the company	Eroding outside investors' confidence, and deterring them from investing more into the company
Efficacy of Corporate Governance	Encouraging more devotion and contribution from founding shareholders to the company	Hurting the efficacy of corporate governance rules due to free-riding, collective action and passivity problems
Effects on Ownership Model	More concentrated equity structure	Higher share turnover rate leading to a more dispersed equity structure
Effects on Majority-Minority Shareholders Relationship	More centralised business operation with a more efficient decision-making process	Higher costs of opposition due to the rising communication and coordination expenses and free-riding blockage
Theoretical Grounds	Breaking up the notion of "shareholder homogeneity"[55] which is based on the assumption that all shareholders have a uniform interest in wealth maximisation[56]	Undermining the shareholder primacy theory,[57] which is a democratic legitimacy argument[58]
Nature of Corporate Law	Private ordering and choice	Mandatory corporate governance rule

[55] Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", (1976) 3(4) *Journal of Financial Economics* 305, 310.

[56] In conventional company law scholarship, the general view is that companies are in existence to serve the interests of shareholders, which means that the company is run with the goal of maximising shareholder wealth. This is largely true even considering the fact that shares in a listed company are held by a variety of shareholders such as pension funds, sovereign wealth funds and governments, which have different priorities when coming to decide on corporate matters. In addition, shareholders have different time horizons for their wealth maximisation. For instance, some shareholders have a long-term investment vision while others have the plan to accumulate shares for a possible takeover or other preferences. The differentiation of shareholders in implementing the wealth maximisation strategy justifies a break-up of the uniform or centralised voting arrangement. Grant M. Hayden and Matthew T. Bodie, "One Share, One Vote and the False Promise of Shareholder Homogeneity", (2008) 30(2) *Cardozo Law Review* 445, 502.

[57] D. Gordon Smith, "The Shareholder Primacy Norm", (1998) 23 *Journal of Corporation Law* 277.

[58] Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, MA: Harvard University Press, 1991) 73.

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