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### The (re)introduction of dual-class share structures in Hong Kong: a historical and comparative analysis

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# The (re)introduction of dual-class share structures in Hong Kong: a historical and comparative analysis

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## ABSTRACT

In April 2018, Hong Kong issued new listing rules to introduce the dual-class share structure, also known as weighted voting rights (WVR), under which a special class of shareholders' voting rights are conferred disproportionately with respect to their equity interest. The WVR was used in Hong Kong in the 1980s but was banned in 1989. The debate on the WVR was rekindled by the Alibaba event in 2013. The WVR structure has benefits and costs. Thus, Hong Kong lays down relevant supporting mechanisms, including entry requirements, disclosure requirements and safeguard requirements. The WVR regime in Hong Kong appears to be more stringent than jurisdictions that have either long allowed WVR listings, notably the United States and Canada, or recently chose to do so such as Singapore. This paper argues that the (re)introduction of the WVR regime is generally a positive development for Hong Kong, but there are still some lingering concerns.

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**KEYWORDS** Dual-class share structure; weighted voting rights; Hong Kong securities markets; corporate governance; shareholder protection

## 1. Introduction

On 24 April 2018, the Hong Kong Securities and Exchanges Limited ('HKEX') formally introduced new listing rules ('2018 New Listing Rules') under which listing applicants can adopt the dual-class share structure, also known as weighted voting rights ('WVR').<sup>1</sup> According to the conventional 'one-share, one-vote' ('OSOV') rule, each share attaches a proportionate amount of voting rights (i.e. one share conferring one voting right). In contrast, under the WVR structure, shareholders' voting rights are conferred disproportionately

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<sup>1</sup>Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited ('HKEX Listing Rule'). This refers to the listing rule for companies listed on the Main Board of the Stock Exchange of Hong Kong ('SEHK'), which is the sole stock exchange in Hong Kong and is wholly owned by the parent company, HKEX. The 2018 New Listing Rules came into effect on 30 April 2018.

with respect to their equity interest, which are differentiated by different classes of shares.

Essentially, the WVR structure creates a divergence between cash flow and voting rights. The rationale behind the WVR structure is to enable founders or controlling shareholders of a company to raise equity financing without surrendering control.<sup>2</sup> Traditionally, this was used mostly by family-run media companies, such as The Wall Street Journal and The New York Times, as a strategy to avoid hostile takeovers under the name of protecting journalistic integrity.<sup>3</sup> In 2004, Google became one of the first companies to bring it to the mainstream, particularly high-tech companies.

The introduction of the WVR regime represents a radical departure from the OSOV rule that has long served as the bedrock principle of corporate governance in Hong Kong. This is largely due to the rising propensity from large Silicon Valley counterparts in China, such as Alibaba, in demanding WVR structures, and the fierce competition among leading stock exchanges. While the introduction of the WVR regime may effectively attract substantial capital inflows into Hong Kong, the risks of jeopardising investor protection remains a primary concern. Indeed, the 2018 New Listing Rules did not come by easily, reaching its final adoption after five long years of consultation and deliberation, and even today the debate continues. Hence, this paper aims to critically examine the newly implemented WVR regime from historical and comparative perspectives, shedding light on whether it is appropriate and well-designed for the local conditions in Hong Kong.

This paper is organised as follows. It begins with an overview of the WVR structure in Part 2, which introduces the concept of the WVR as well as its historical development in Hong Kong. Part 3 then examines relevant theoretical issues on the WVR, including a cost–benefit analysis and a taxonomy of legal strategies for reducing agency costs. Based on those discussions, Part 4 compares the supporting mechanisms in Hong Kong with jurisdictions that have either long implemented a WVR regime (USA and Canada) or has recently introduced a WVR regime (Singapore). Part 5 then applies the observations made in the previous sections to evaluate the newly-introduced WVR regime in Hong Kong. The final part concludes.

## **2. WVR in Hong Kong: a historical perspective**

### **2.1. Overview of the legal framework**

It should be noted at the outset that Hong Kong-incorporated companies are in fact allowed to issue different classes of shares with differing rights

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<sup>2</sup>S Nuesch, 'Dual-Class Shares, External Financing Needs, and Firm Performance', (2016) 20 *Journal of Management & Governance* 525–51, at 526.

<sup>3</sup>K Eechambadi, 'The Dual Class Voting Structure, Associated Agency Issues, and a Path Forward', (2017) 13 *New York University Journal of Law and Business* 503–34, at 514.

attached. Under section 588(4) of the Companies Ordinance<sup>4</sup> and section 50(4) of the Companies (Model Articles) Notice<sup>5</sup>, the number of votes vested in a company's share is subject to its articles of association, which may be freely drafted to stipulate different classes of shares attaching different number of votes. This is the default position under the general framework of company law.

However, for listed companies, there is an additional layer of regulation imposed by the HKEX listing rules. As empowered under section 23 of the Securities and Futures Ordinance ('SFO')<sup>6</sup>, the HKEX listing rules prescribes the requirements that must be adhered to before securities of any company can be listed, as well as on-going obligations throughout the period of listing.<sup>7</sup> Under the HKEX Listing Rules, share structures are much more restricted when compared to the broader rules of company law under the Companies Ordinance.<sup>8</sup>

## **2.2. Historical developments**

### **2.2.1. The restrictions on WVR in the 1980s**

Prior to 1987, the HKEX Listing Rules did not contain a default restriction of the WVR structure. However, as a result of negative market reaction, regulators responded by imposing a ban on them. In late March and early April of 1987, following the announcements of issuing superior shares (called 'B shares') via bonus issues by three local giants, namely Jardine Matheson Holdings Limited, Cheung Kong (Holdings) Ltd and Hutchison Whampoa Ltd, the Hang Seng Index ('HSI') dropped by 3.7 per cent<sup>9</sup> due to market fears of a bandwagon-effect for the WVR share proposals.<sup>10</sup> During that time, class B shares were not common on the exchange and only five listed companies<sup>11</sup> had this structure. As a swift response to stabilise the market, the regulators being the HKEX and the Government's Office of Commissioner for Securities<sup>12</sup> issued a joint statement leading to the restriction of B share issues, weeks after the B share proposal announcements.<sup>13</sup> The resulting effect of this joint

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<sup>4</sup>Cap. 622.

<sup>5</sup>Cap. 622H.

<sup>6</sup>Cap. 571.

<sup>7</sup>HKEX Listing Rule 2.01, at part 2-1.

<sup>8</sup>Cap. 622.

<sup>9</sup>Hong Kong Exchanges and Clearings Ltd, 'Concept Paper: Weighted Voting Rights' (2014), at 26.

<sup>10</sup>J Nylander, 'Should Hong Kong Permit Weighted Voting Rights?', *The Hong Kong Institute of Chartered Secretaries* (2015), published 5 January 2015, at <http://csj.hkics.org.hk/site/2015/01/05/should-hong-kong-permit-weighted-voting-rights-2/>

<sup>11</sup>They include Swire Pacific Ltd; Lane Crawford International Ltd; Wheelock Properties Ltd; Realty Development Corp Ltd and Grand Hotel Holdings Ltd. See Hong Kong Exchanges and Clearings Ltd (n 9) at 25–26.

<sup>12</sup>This was Hong Kong's previous securities regulator prior to the formation of the current Securities and Futures Commission in 1989.

<sup>13</sup>Hong Kong Exchanges and Clearings Ltd (n 9) at 26.

statement along with recommendations of the 1987 Standing Committee on Company Law Reform<sup>14</sup>, eventually led to the default WVR restriction under Rule 8.11 of the Main Board listing rules in 1989.<sup>15</sup>

By virtue of Rule 8.11, all companies listed on the SEHK must have shares where the prescribed ‘*voting power*’ must bear a ‘*reasonable relationship*’ to the equity interest of fully paid shares. Strictly speaking, this means no shareholder would be entitled to greater voting rights than any other shareholders given the equity stake invested is equal. Thus, Rule 8.11 prohibits any form of WVR structures<sup>16</sup> and additionally upholds the ‘fair and equal treatment of shareholders’<sup>17</sup> principle by aligning the voting power and equity interest of shares.<sup>18</sup> Rule 8.11, however, does incorporate two exceptions where WVR shares are allowed. First, as a product of the recommendations of the 1987 Standing Committee on Company Law Reform, WVR structures are allowable under ‘*exceptional circumstances*’.<sup>19</sup> However, as of now, there have yet to be any examples falling under such exception. Second, companies already trading with B shares prior to the introduction of Rule 8.11 are allowed to maintain such structure. However, of the five previously mentioned companies, only Swire Pacific Ltd. remain listed on the SEHK at present.<sup>20</sup> As mentioned below, the new WVR regime in Hong Kong is implemented as an additional third exception to Rule 8.11.

### ***2.2.2. Re-emergence of the WVR debate after the 2013 Alibaba IPO application***

Since the adoption of Rule 8.11 in 1989, the matter of WVR (or class B shares) has not resurfaced in Hong Kong until recent rejection of the Alibaba initial public offering (‘IPO’) by Hong Kong regulators in 2013. Without doubt, this is the triggering catalyst leading to the re-emergence of WVR discussions.

In the midst of September 2013, Alibaba ended its plan to list in Hong Kong after its proposed ‘partnership structure’ was rejected under Rule 8.11. What unexpected following this decline was an unprecedented amount of fund

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<sup>14</sup>The then Financial Secretary, Sir Piers Jacobs commissioned the Standing Committee to give opinions on the issue of B shares. See *ibid* 27 and Appendix I for the actual report by the Standing Committee.

<sup>15</sup>*ibid* at 28.

<sup>16</sup>To put it another way, it also implements the OSOV structure.

<sup>17</sup>HKEX Listing Rule 2.03(4), at part 2-1.

<sup>18</sup>Hong Kong Exchanges and Clearings Ltd (n 9) at 18.

<sup>19</sup>The Standing Committee concluded that there was a legitimate need for the availability of ‘B shares’ under ‘exceptional circumstances’ such as national security or public interest, but subject to a case-by-case approval. See *ibid* at 28.

<sup>20</sup>Upon searching on the HKEX web page, only Swire Pacific (stock code: 0019 for Class A and 0087 for Class B) can be found from the five previously dual-class listed stocks. See Hong Kong Exchanges and Clearings Ltd, *Market Data – Equities*, at [https://www.com.hk/Market-Data/Securities-Prices/Equities?sc\\_lang=en](https://www.com.hk/Market-Data/Securities-Prices/Equities?sc_lang=en).

(USD 25 billion) raised by the Alibaba IPO on the New York Stock Exchange ('NYSE'), only a year later.<sup>21</sup>

With the benefit of hindsight, many believed that the decline caused a tragic loss for the Hong Kong market and it was an excessive protectionist decision by the regulators.<sup>22</sup> Although Hong Kong still managed to rank as the second largest IPO market in terms of the amount of IPO funds raised in 2014, it should be noted that the aggregate amount of USD 29 billion raised from 122 IPOs was not substantially higher than the amount from the Alibaba IPO alone (USD 25 billion). Nevertheless, those who greatly value strong corporate governance praised HKEX's robust stance to uphold the traditional OSOV system.<sup>23</sup>

### 2.2.3. *Developments of the WVR debate*

Since the lost-out of Alibaba, the HKEX has put the WVR debate into serious consideration by publishing several consultation papers involving analyses and discussions of a possible WVR regime in Hong Kong – perhaps as an effort to address the disapproving voices of the Alibaba case. After almost one year from rejection, the HKEX published a concept paper<sup>24</sup> to seek market view of WVR structures proposals. After receiving ample market feedback, the HKEX proposed a possible WVR framework containing a list of safeguards and ring-fencing measures in the WVR Consultation Conclusions Paper.<sup>25</sup> However, only six days following the publication, the Securities and Futures Commission ('SFC') issued a formal statement announcing that the Board of the SFC had unanimously rejected the HKEX draft proposal.

Two years later, the HKEX revived the WVR matter through its New Board Concept Paper<sup>26</sup> in 2017. By proposing a new and separate board to be created in addition to the two existing boards (being the Main and GEM Boards), the HKEX tried to ringfence the WVR structures and dispel concerns over its impact on the whole market. This new round of the WVR campaign received overwhelming support (91% of respondents) from the market by attracting more diversified issuers especially those in the area of 'New Economy'.<sup>27</sup> Interestingly, the SFC also reversed its stance towards the WVR regime and supported the HKEX. Further, considering that a sea change

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<sup>21</sup>L Chen, R Mac R and B Solomon, 'Alibaba Claims Title For Largest Global IPO Ever With Extra Share Sales' (2014), *Forbes*, published 22 September 2014, at <https://www.forbes.com/sites/ryanmac/2014/09/22/alibaba-claims-title-for-largest-global-ipo-ever-with-extra-share-sales/#567287ba8dcc>.

<sup>22</sup>RS Chan and JKS Ho, 'Should Listed Companies Be Allowed to Adopt Dual-Class Share Structure in Hong Kong?' (2014) 43 *Common Law World Review* 155–82, at 174.

<sup>23</sup>PJ Davies and A Massoudi, 'Alibaba Abandons \$60bn Hong Kong Listing', *Financial Times* (26 September 2013), at <https://www.ft.com/content/525f4bc2-25ae-11e3-ae8-00144feab7de>.

<sup>24</sup>Hong Kong Exchanges and Clearings Ltd (n 9).

<sup>25</sup>Hong Kong Exchanges and Clearings Ltd, 'Consultation Conclusions: To Concept Paper on Weighted Voting Rights' (2015), at 44–45.

<sup>26</sup>Hong Kong Exchanges and Clearings Ltd, 'Concept Paper: New Board' (2017).

<sup>27</sup>These are companies from industries such as 'Biotechnology, Health Care Technology, Internet & Direct Marketing Retail, Internet Software & Services, IT Services, Software, Technology Hardware, Storage &

had taken place in the public's attitudes towards the WVR structure,<sup>28</sup> the HKEX decided to abandon the plan of limiting the WVR structure in the new board and try to allow it in the whole market. Hence, the HKEX issued another consultation paper on the reform of the Main Board Listing Rules in late February 2018.<sup>29</sup> Finally, on 24 April 2018, with positive feedback from the market and the SFC, the HKEX published the final version of the new listing rules, which took effect on 30 April 2018.

The WVR regime was implemented by adding a new chapter (Chapter 8A) to the 2018 Listing Rules. Chapter 8A stipulates an extensive list of conditions and safeguards for a company to be qualified to adopt the WVR structure.<sup>30</sup> The HKEX emphasised that the OSOV shall remain as the ideal structure, and the WVR regime shall serve as an exception to the OSOV structure.<sup>31</sup> This is achieved by inserting an additional criterion under the existing list of 'exceptions' of Rule 8.11, whereby a company must satisfy the requirements stipulated under Chapter 8A.<sup>32</sup>

### 3. Debating the WVR: an analytical framework

#### 3.1. A cost-benefit analysis of the WVR

There has been a long-standing debate on the desirability of the WVR structures from the viewpoint of a cost-benefit analysis. In brief, supporters of the WVR structures argue that the regime could enable the companies to pursue long-term innovations and strategies maximising the market returns and the diversity of issuers.<sup>33</sup> On the other hand, opponents argue that the WVR structure increases the risks of expropriation and entrenchment by the WVR shareholders and further may lead to indirect concerns to the greater market.<sup>34</sup>

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Peripherals'. See Hong Kong Exchanges and Clearings Ltd, 'Consultation Conclusions: New Board Concept Paper' (2017), at 5.

<sup>28</sup>According to our interviews with SFC, HKEX and market participants, several factors may help explain why the market and, particularly the SFC, took a 180 degree turn in the WVR debate. First, there has been a growing recognition of the great need and competitive pressure that Hong Kong faces in attracting listings of new economy companies. With the departing of the Alibaba and the draining away of the long-time source of listing business, namely the state-owned enterprises from Mainland, Hong Kong came to realize that it is time to embrace the era of the so-called 'new economy'. Second, as will be discussed in detail, the WVR regime in Hong Kong has carefully designed a congeries of mechanisms to address the problems that the WVR structure may cause. Finally, the change of government in July 2017 in Hong Kong provided political incentives and opportunities to support the WVR structure.

<sup>29</sup>Hong Kong Exchanges and Clearings Ltd, 'Consultation Paper: A Listing Regime for Companies from Emerging and Innovative Sectors' (2018).

<sup>30</sup>Hong Kong Exchanges and Clearings Ltd, 'Consultation Conclusions: A Listing Regime for Companies from Emerging and Innovative Sectors' (2018), at 36.

<sup>31</sup>*ibid.*

<sup>32</sup>HKEX Listing Rules Listing Rule 8.11(3), at part 8-11.

<sup>33</sup>See e.g. TJ Chemmanur and Y Jiao, 'Dual Class IPOs: A Theoretical Analysis' (2012) 36 *Journal of Banking and Finance* 305–19, at 306; Z Goshen and A Hamdani, 'Corporate Control and Idiosyncratic Vision' (2016) 125 *Yale Law Journal* 560–795, at 576.

<sup>34</sup>See e.g. JW Howell, 'The Survival of the US Dual class Share Structure' (2017) 44 *Journal of Corporate Finance* 440–50; R Masulis, C Wang and F Xie, 'Agency Problems at Dual-Class Companies' (2009) 64 *The Journal of Finance* 1697–727, at 1698.



### 3.1.1. Costs of WVR

In general, the WVR structure encourages the controlling shareholder to engage in opportunistic behaviour at the cost of non-controlling shareholders, either directly by way of voting rights at the shareholder meeting or indirectly through the management they choose. By separating voting rights from cash flow rights, the WVR structure has the potential to create very large agency costs, including the risks of expropriation and entrenchment.<sup>35</sup> Other things being equal, the agency costs of the WVR structure have been said to be an order of magnitude larger than those under the traditional OSOV structure.<sup>36</sup>

The WVR structure exacerbates the risks of expropriation because the disproportionate economic interest proliferates the divergence of interests between the controlling shareholders and the non-controlling shareholders. Since holders of WVR shares have a much smaller economic interest relative to their voting rights, they consequently bear smaller financial risks for decisions that favour their personal interests instead of maximising company profits and shareholder value.<sup>37</sup> Another facilitator for expropriation risks is the weakened monitoring corporate governance function under a WVR structure.<sup>38</sup> Due to the separation of control and ownership in a public company, the traditional corporate governance function is for shareholders to elect members of the board of directors, who then performs the monitoring function of the company, including contracting for suitable officers to run the day-to-day operations of the company. Since the shareholders select the board, there exist a 'check and balance' mechanism to align the interests of the shareholders (the principal) and the management (the agents). However, under the WVR structure, the board oversight function is undermined as the controlling company management elects the board instead of the majority shareholders, due to their superior voting power. This may lead to heightened propensity of self-dealing or 'tunnelling' transactions, and accordingly, may also place a greater burden on connected-party transaction monitoring.

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<sup>35</sup>Due to the separation of voting rights from cash flow rights under a WVR structure, the WVR shareholders are controlling shareholders in terms of voting rights, but may be minority shareholders in terms of cash flow rights. Hence, to avoid confusion, this paper refers to the WVR shareholder as controlling shareholder rather than majority shareholder.

<sup>36</sup>Lucian Bebchuk, Reinier Kraakman and George Triantis, 'Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Creation and Agency Costs of Separating Control From Cash-Flow Rights' in Randall K Morck (ed), *Concentrated Corporate Ownership* (University of Chicago Press 2000) 445–60.

<sup>37</sup>LA Bebchuk and K Kastiel, 'The Untenable Case for Perpetual Dual-Class Stock' (2017) 103 *Virginia Law Review* 585–630, at 602.

<sup>38</sup>T Wen, 'You Can't Sell Your Firm And Own It Too: Disallowing Dual-Class Stock Companies from Listing on the Securities Exchanges' (2014) 162 *University of Pennsylvania Law Review* 1495–516, at 1498; M Ganor, 'Why Do Dual-Class Firms Have Staggered Boards' (2016) 10 *Ohio State Business Law Journal* 147–92, at 156.

Further, the WVR structure creates entrenchment risks whereby the controlling shareholder and the management they choose 'entrench' themselves with perpetual control of the company. Under a OSOV structure, evidence of company underperformance signals the shareholders that the board of directors are suboptimal in managing the company. If underperformance persists, shareholders may remove members of the board and elect a superior management body to steer the company back to an equilibrium level.<sup>39</sup> However, under the WVR structure, shareholders lack the voting power to remove the board of directors, irrespective of how poorly they manage the company. Moreover, the WVR structure insulates the management from the threat of hostile takeovers which is widely seen as a powerful mechanism to pressurise the management to work diligently for the best interest of the company. A further form of the entrenchment risk is the so-called 'next generation' problem. Essentially, this concerns the problem where the controlling shareholder has full autonomy to elect his or her successors and thus, creating an everlasting dictatorship scenario.

### **3.1.2. Benefits of WVR**

One of the strongest rationales in support of the WVR structure is that it can better enable the company to pursue long-term objectives and visions when compared to OSOV structures. This is because the WVR structure can help overcome the following two main problems associated with the OSOV structure, including information asymmetry between ordinary shareholders and the management, and different investment time horizons among shareholders.

To start with, there may be a discrepancy among shareholders as to the means of achieving the goal of maximising investment returns, due to the issue of information asymmetry. While ordinary shareholders may be influenced by commonplace information and statistics, the controlling shareholders and the management they appoint may possess visions and strategies unknown to the public that may produce above-market returns, despite of initial losses. Such visionary knowledge may need to be concealed from the public as means of preserving competitive advantages or that they are simply too novel for the ordinary shareholders to understand.<sup>40</sup> This may be particularly true in the high-technology industry, due to its complexity and dynamic nature. Further, there exists a disparity in the investment time horizons among shareholders. Many shareholders may prefer short-term returns, while some shareholders may be more interested in the long-term growth of the company. A company with the OSOV structures may be more

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<sup>39</sup>Sanford J. Grossman and Oliver D. Hart, 'One Share-One Vote and the Market For Corporate Control' (1988) 20 *Journal of Financial Economics* 175.

<sup>40</sup>V Govindarajan and A Srivastava, 'Reexamining Dual-Class Stock' (2017), *Tuck School of Business Working Paper No. 3023323*, at 4–5.

likely to be compelled to adopt short-termism. In contrast, the WVR structure can help shield the company from these pressures and enable them to pursue long-term opportunities.

More broadly, the availability of the WVR structure increases the attractiveness of a capital market to issuers who value such a share structure and provide a wider range of investment options for investors. This is important as the investors are not a homogenous group in terms of their investment style and risk preference. Hence, the WVR structure can improve the competitiveness of the market by increasing the diversity of securities offering to investors and its attractiveness to issuers. The increased competitiveness of a capital market will then indirectly contribute to the general economy through various supporting business activities. These spill-over contributions can be substantial and takes multiple forms such as the commissions made by the IPO sponsors, the legal fees involved with the IPO process and the stock exchange fees both before and after the IPO – just to name a few. For example, regarding the Alibaba IPO on the NYSE, sponsorship fees totalling USD 300 million were paid to its bankers and brokerages<sup>41</sup>, while legal fees amounted to USD 15.8 million.<sup>42</sup>

### **3.2. A taxonomy of legal strategies for reducing agency costs**

Agency costs are inherent in the corporate context and law can play an important role in reducing them. It has been argued in a very influential book that the legal strategies for controlling corporate agency costs can be grouped into five areas, including agent constraints, affiliation terms, incentive alignment, appointment rights and decision rights, and under each of the five areas, there are two different types of legal strategies.<sup>43</sup> In addition, disclosure is crucial to the functioning of the above legal strategies by providing relevant information.<sup>44</sup> This provides a very useful framework for analysing the legal strategies for reducing agency costs of the WVR structures as identified above, and thus will be briefly summarised below.

To start with, law seeks to constrain agents by commanding them not to engage in certain behaviour which would harm the interests of their principles, either through rules or standards. The debate on the relative efficacy of rules versus standards has been a longstanding one,<sup>45</sup> but generally,

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<sup>41</sup>Trefis, 'Alibaba Hands Out Generous Fees to Investment Banks Involved In Its IPO', *Forbes* (1 October 2014), at <https://www.forbes.com/sites/greatspeculations/2014/10/01/alibaba-hands-out-generous-fees-to-investment-banks-involved-in-its-ipo/#77c4a395e936>.

<sup>42</sup>C Sullivan, 'Alibaba IPO Legal Fees Dwarf Facebook's', *Reuters* (6 September 2014), at <https://www.reuters.com/article/us-alibaba-ipo-legal/alibaba-ipo-legal-fees-dwarf-facebooks-idUSKBN0H100D20140906>.

<sup>43</sup>Reinier Kraakman, John Armour and Paul Davies, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3<sup>rd</sup> edn, OUP 2017), 31–38.

<sup>44</sup>*ibid* 38–39.

<sup>45</sup>See e.g. Louis Kaplow, 'Rules Versus Standards: An Economic Analysis' (1992) 42 *Duke Law Journal* 557.

each has its own strengths and weaknesses. For instance, rules are more certain and can be more easily enforced, but may suffer from rigidity and invite loopholes; standards are more flexible but may lead to uncertainty and inconsistency in compliance and enforcement. Hence, both rules and standards are needed to form a balanced approach to reducing agency costs.

Second, affiliation terms mean the terms on which principals affiliate with agents, including terms of entry and terms of exit. Under the terms of entry, the law can protect principals by enabling them to make a free and informed decision on whether to contract with agents. Alternatively, the terms of exit can give principals a decent chance to escape opportunistic agents.

Third, incentive alignment strategies are divided into trusteeship and reward, according to the nature of the incentives used to reduce the agent's opportunistic behaviour. There are two types of incentives in the economic literature, including economic incentives such as monetary payment and ethical or moral incentives such as conscience, pride and reputation.<sup>46</sup> Economic incentives are usually high-powered in that they are concrete and sharply focused; moral incentives are conceptually low-powered, even though they may be more important for many people in practice. The trusteeship strategy, which is named after its origin in the role of a 'trustee' proper, relies upon moral incentives on the part of the agent, while the reward strategy, as the name suggests, uses monetary incentives to induce the agents to serve the interests of their principals.

Fourth, appointment rights include selection rights and removals rights. In the corporate context, appointment rights are usually used in relation to directors and managers, but they are also important to address agency problems of controlling shareholders in relation to non-controlling shareholders.

Fifth, decision rights are divided into initiation and ratification rights, allowing the principals to initiate or ratify management decisions respectively. As the corporate form is based on the delegation of managerial powers to the board of directors, shareholders usually do not have the power to initiate managerial decisions, and are empowered to ratify the most fundamental corporate decisions only.

It should be noted that we basically adopt the above analytical framework but with one important modification. Under the taxonomy supplied above, the two different types of legal strategies in each of the five areas are considered as *ex ante* and *ex post* strategies. But as the book itself concedes, due to issues such as overlapping, it does not wish to 'overemphasize the clarity or analytic power of this categorization ...', and just offers it as a heuristic device.<sup>47</sup> We will then use the terms *ex ante* and *ex post* in a different way.

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<sup>46</sup>Oliver Williamson, *The Economic Institutions of Capitalism* (1985), 137–41.

<sup>47</sup>Kraakman, Armour and Davies (n 43) 38.

As will be discussed in more detail later, different jurisdictions have designed different mechanisms to support their WVR regimes, which we term ‘WVR-supporting mechanisms’. Broadly speaking, WVR-supporting mechanisms can be divided into *ex ante* and *ex post* mechanisms. On the one hand, *ex ante* supporting mechanisms seek to prevent or deter the opportunism of the agents, including the controlling shareholders and the management they appoint. Hong Kong has put in place three groups of new requirements for WVR companies, including entry requirements, disclosure requirements and safeguard requirements. On the other hand, *ex post* supporting mechanisms refer to the routes for aggrieved shareholders to seek remedies after the occurrence of opportunistic behaviour by the agents. For instance, as the agents’ misbehaviour may usually harm multiple principals but each in relatively small value, an important issue here is the availability of class action. In effect, *ex post* mechanisms are essentially law enforcement, which can be broadly divided into public and private enforcements. As with any legal regime, the efficacy of the WVR regime is a function of both substantive rules and enforcement mechanisms.

#### 4. WVR-supporting mechanisms: jurisdictional comparison

The foregoing discussion shows that the WVR structure has both benefits and costs, and that WVR-supporting mechanisms, *ex ante* and *ex post*, work to control agency costs. The real question is not simply whether the WVR structure should be allowed or not in any jurisdiction, but what supporting mechanisms should be introduced to generate a WVR structure with net benefits in the context of a particular jurisdiction. In other words, the WVR structure may have different versions with different effects due to different supporting mechanisms adopted in different jurisdictions.<sup>48</sup> Hence, we will discuss and compare the WVR-supporting mechanisms in Hong Kong with Singapore,

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<sup>48</sup>Since the supporting mechanisms vary from jurisdiction to jurisdiction, caution should be exercised in generalising empirical findings about the effect of the WVR structure on firm value in any particular jurisdiction. Most empirical studies are conducted in the US, and even there, empirical results are mixed. See e.g. S Nuesch, ‘Dual-Class Shares, External Financing Needs, and Firm Performance’ (2016) 20 *Journal of Management & Governance* 525–51 (finding that WVR firms outperformed OSOV firms in terms of total shareholder returns); S Baugess, M Slovin and M Sushka, ‘Large Shareholder Diversification, Corporate Risk Taking, and the Benefits of Changing to Differential Voting Rights’ (2012) 36 *Journal of Banking & Finance* 1244–53 (indicating that the adoption of WVR shares promotes firm performance); but see R Masulis, C Wang and F Xie, ‘Agency Problems at Dual-Class Companies’ (2009) 64 *The Journal of Finance* 1697–727, at 1698–700 (reporting evidence of the detrimental effects of the WVR); P Gompers, J Ishii and A Metrick, ‘Extreme Governance: An Analysis of Dual-Class Firms in the United States’ (2010) 23 *The Review of Financial Studies* 1051–88 (finding that the WVR led to lower firm valuations). Latest researches, however, show that the costs of the WVR structure tends to rise, while the benefits decline, as companies with such structures mature, see Hyunseob Kim and Roni Michaely, *Sticking Around Too Long? Dynamics of the Benefits of Dual-Class Structures*, working paper, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3145209](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3145209); Martijn Cremers, Beni Lauterbach and Anete Pajuste, *The Life-Cycle of Dual Class Firms*, working paper, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3062895](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3062895).

the US and Canada.<sup>49</sup> Singapore is Hong Kong's arch-rival for the status of leading financial centre in Asia, and both have recently chosen to adopt the WVR structure. The US and Canada have had the WVR structure for many years, but with different supporting mechanisms. This sets the stage for the later discussion of how the supporting mechanisms embody the aforementioned various legal strategies for reducing controller opportunism.

## 4.1. Hong Kong

### 4.1.1. Ex ante mechanisms

Included in the HKEX 2018 New Listing Rules<sup>50</sup> is a new WVR regime to allow innovative companies to list in Hong Kong with a WVR share structure. This new regime involves more stringent rules specifically required for WVR applicants in addition to the existing Listing Rules as Chapter 8A.

**4.1.1.1. Entry requirements.** The 2018 New Listing Rules permits only new issuers<sup>51</sup> to adopt WVR structures setting up entry requirements in terms of company characteristics and expected market capitalisation. To close the loopholes that may enable circumventions of the 'new' issuer requirement there is also an anti-avoidance provision in Rule 8A.05, the infringement of which may invoke SFC's enforcement powers.<sup>52</sup>

Regarding the quantitative requirement, the rules require an expected market capitalisation of HKD 10 billion as the minimum requirement for a company to be eligible for a WVR structure.<sup>53</sup> Where an applicant company has an expected market capitalisation of less than HKD 40 billion, there is an additional requirement of having at least HKD 1 billion of revenue from the most recent audited financial year.<sup>54</sup> This market capitalisation requirement is intended to limit WVR companies only to '*established and high profile companies*'.<sup>55</sup>

In terms of the qualitative characteristics, to be regarded as suitable for a WVR listing the HKEX requires that issuers can demonstrate that they are '*both eligible and suitable for listing with a WVR structure*'.<sup>56</sup> Five criteria are set out in a separate guidance letter<sup>57</sup> to ensure only innovative companies

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<sup>49</sup>Other major jurisdictions adopting the WVR structure include Denmark, Finland, the Netherlands, Sweden and Switzerland. HKEX, *Concept Paper on Weighted Voting Rights* (2014) para 111-1 to 111-17.

<sup>50</sup>Hong Kong Exchanges and Clearings Ltd (n 30).

<sup>51</sup>HKEX Listing Rule 8A.05, at part 8A-3.

<sup>52</sup>Hong Kong Exchanges and Clearings Ltd (n 30) at 31.

<sup>53</sup>HKEX Listing Rule 8A.06(2), at part 8A-3.

<sup>54</sup>*ibid.*

<sup>55</sup>Hong Kong Exchanges and Clearings Ltd (n 29) at 34.

<sup>56</sup>HKEX Listing Rule 8A.04, at part 8A-3.

<sup>57</sup>Hong Kong Exchanges and Clearings Ltd, *HKEX Guidance Letter: Suitability for listing with a WVR Structure* (April 2018).

of good quality and high growth are listed with WVR shares.<sup>58</sup> These criteria are as follows:

- (1) the applicant issuer must be an 'innovative' company<sup>59</sup>
- (2) the applicant issuer must demonstrate a track record of high business growth that can be objectively measured by operational metrics
- (3) each WVR shareholder must have been materially responsible for the company growth by way of his or her skills and knowledge
- (4) each WVR shareholder must be an individual with an active executive role within the business and must be a director of the issuer
- (5) the applicant issuer must have received meaning third party investment from at least one sophisticated investor who shall retain at least an aggregate of 50% of their total investment at the time of listing.

The HKEX will consider the totality of circumstances to determine the suitability for WVR so that demonstration of any or all of the five criteria may not in and of itself guarantee the suitability of the applicant.<sup>60</sup> Acknowledging that the above determination will inevitably involve certain degree of subjectivity, the HKEX intends to provide further clarity to the market as they develop further experience with innovative and emerging companies.<sup>61</sup>

**4.1.1.2. Disclosure requirements.** To increase the transparency and public awareness of WVR companies, the HKEX requires additional disclosures for WVR companies. A 'WVR warning' will be prominently disclosed on the front page of all listing documents, periodic financial reports, circulars, notifications and announcements<sup>62</sup> as well as documents of or evidencing the title of listed equity securities of a WVR issuer.<sup>63</sup> For all listing documents and periodic financial reports, the 'WVR warning' would further include a description of the WVR structure, the rationales for the company to adopt a WVR structure, and the associated risks for shareholder.<sup>64</sup> In the proposal stage of the WVR rules, the HKEX initially required that all corporate documents for disclosure would need to include the description, rationales and associated risks of

<sup>58</sup>Hong Kong Exchanges and Clearings Ltd (n 29) at 33.

<sup>59</sup>Companies would be expected to meet more than one of the following characteristics: (1) its success is demonstrated to be attributable to the application, to the company's core business, of new technologies; innovations; and/or a new business model, which also serves to differentiate the company from existing players; (2) R&D is a significant contributor of its expected value and constitutes a major activity and expense; (3) its success is demonstrated to be attributable to its unique features or intellectual property; and/or (4) it has an outsized market capitalisation / intangible asset value relative to its tangible asset value. See *ibid* at 2–3.

<sup>60</sup>*ibid* at 1.

<sup>61</sup>Hong Kong Exchanges and Clearings Ltd (n 30) at 36.

<sup>62</sup>HKEX Listing Rule 8A.37, at part 8A-12.

<sup>63</sup>HKEX Listing Rule 8A.38, at part 8A-12.

<sup>64</sup>HKEX Listing Rule 8A.37, at part 8A-12.

the WVR company.<sup>65</sup> However, the HKEX concurred with the market feedback that this would not be practical and lowered the requirement.<sup>66</sup> This warning informs the public that the company is controlled under a WVR structure and informs public investors of the potential risks of investing in a company with a WVR structure. Moreover, the holders of WVR shares must also be identified in the listing documents and also interim and annual reports. To enhance the visual differentiation between WVR companies from non-WVR companies, a unique stock marker 'W' will be placed at the end of the stock name.<sup>67</sup> Lastly, as suggested from market feedback, the HKEX have agreed to include the requirement that WVR issuers must disclose in its listing documents and annual and interim reports all circumstances whereby the WVRs attached to shares would cease.<sup>68</sup>

**4.1.1.3. Safeguard requirements.** To mitigate the above-mentioned WVR risks of expropriation and entrenchment, the New Listing Rules enhance safeguard requirements for WVR companies. These include mechanisms that (1) protect non-WVR shareholders' voting rights, (2) limit the divergence of rights between WVR shares and non-WVR shares, (3) restrict WVR shareholders to be directors and (4) enhance monitoring by board committees.

First, the New Listing Rules align the voting rights between WVR holders and non-WVR shareholders as a means of limiting the voting power of WVR shares in certain situations. It is required that non-WVR shareholders amounting to at least 10% of voting rights on a OSOV basis are able to convene general meetings and also add resolutions to the meeting agenda.<sup>69</sup> Furthermore, certain key matters must be voted on a OSOV basis, whereby any WVR shares will be treated as OSOV shares. The following are the key matters to be voted under a OSOV basis:

- (1) changes to the listed issuer's constitutional documents, however framed;
- (2) variation of rights attached to any class of shares;
- (3) the appointment or removal of an independent non-executive director;
- (4) the appointment or removal of auditors; and
- (5) the voluntary winding-up of the listed issuer.<sup>70</sup>

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<sup>65</sup>Hong Kong Exchanges and Clearings Ltd (n 29) at 38.

<sup>66</sup>Hong Kong Exchanges and Clearings Ltd (n 30) at 42–43.

<sup>67</sup>HKEX Listing Rule 8A.42, at part 8A-13.

<sup>68</sup>HKEX Listing Rule 8A.41, at part 8A-13, see also Hong Kong Exchanges and Clearings Ltd (n 30) at 42.

<sup>69</sup>HKEX Listing Rule 8A.09, at part 8A-4.

<sup>70</sup>HKEX Listing Rule 8A.24, at part 8A-9.



Essentially, this significantly limits the scope of voting power abuses by WVR shareholders and hence, increases the monitoring effectiveness upon the WVR shareholders. Of particular importance to corporate governance is that independent non-executive directors ('INEDs') are appointed on a OSOV basis so as to ensure the independence of these directors from the WVR shareholders.

Second, unlike the US regime, the powers of WVR shares are comparatively restricted to reduce the risks of increased agency cost associated with WVR companies. To mitigate the disproportionality of equity interests in WVR shares, the New Listing Rules prescribes a maximum voting power of ten times that of non-WVR shares.<sup>71</sup> Also, WVR shareholders must collectively own a minimum of 10% of the economic interest of the company's total issued share capital.<sup>72</sup> Originally, in the proposed WVR rules<sup>73</sup>, the requirement also included a maximum economic interest threshold of 50% of the company's issued share capital to '*restrict the use of WVRs to individuals that would otherwise not be able to exercise control over the listing applicant after listing*'.<sup>74</sup> However, market feedback was of the view that such requirement would be unattractive and may hinder Hong Kong's competitiveness as a listing venue. The HKEX acknowledged such concerns in light of legitimate commercial reasons for allowing WVR beneficiaries to hold more than 50% of the economic interest of the company, such as substantial post-listing funding needs, and decided to remove the requirement in order to '*enable the WVR beneficiary to retain control of the issuer post-listing*'.<sup>75</sup> Moreover, WVR shares can only be benefited with enhanced voting rights for resolution on general meetings and in all other aspects, the rights of WVR and non-WVR shares must be equivalent.<sup>76</sup> This limits the variance of inconsistent rights attached to companies as seen in the US. Additionally, to obstruct the applicant company in increasing the rights of WVR shares after listing, the New Listing Rules restricts any post-listing alterations of the terms of WVR shares with the effect of increasing their rights.<sup>77</sup>

Third, the New Listing Rules restrict WVR shareholders to only individuals of the board of director of the applicant company with specific sunset clauses.<sup>78</sup> To ensure that only directors can benefit from WVR shares, it is required that upon the transfer of WVR shares<sup>79</sup> these shares will be converted to normal non-WVR shares on a proportionate basis.<sup>80</sup> Similarly, where the holder of

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<sup>71</sup>HKEX Listing Rule 8A.10, at part 8A-4.

<sup>72</sup>HKEX Listing Rule 8A.12, at part 8A-5.

<sup>73</sup>Hong Kong Exchanges and Clearings Ltd (n 29) at 35.

<sup>74</sup>*ibid*Hong Kong Exchanges and Clearings Ltd (n 30) at 38–39.

<sup>75</sup>*ibid*.

<sup>76</sup>HKEX Listing Rule 8A.07, at part 8A-4.

<sup>77</sup>HKEX Listing Rule 8A.16, at part 8A-6.

<sup>78</sup>HKEX Listing Rule 8A.11, at part 8A-4.

<sup>79</sup>HKEX Listing Rule 8A.18, at part 8A-7.

<sup>80</sup>HKEX Listing Rule 8A.21, at part 8A-8.

WVR shares is deceased, ceases to be a director, deemed by the SEHK to be incapacitated, or to no longer meet the requirement of a director, the WVRs of those shares will be ceased.<sup>81</sup> The effect is to attach fiduciary duties to holders of WVR shares to prevent them from acting against the best interest of the company such as engaging in expropriation activities. Further, this can ensure that WVR shareholders are the managing individuals who provide the material contributions to the long-term innovative success of the company. Hence, allowing these companies to fully capitalise on the benefits of WVR shares to utilise the proprietary visionary abilities of their management body. Additionally, this also alleviates the entrenchment risks of the 'next generation' problem, as the successors of the original directors would not be benefited with WVR shares.

Finally, to strengthen the monitoring function in WVR companies, the HKEX requires applicants to establish a Corporate Governance Committee, which is chaired by and consists entirely of INEDs, with the objective of ensuring that the company is operated for the benefit of all shareholders.<sup>82</sup> In the proposal stage of the WVR rules, the original condition only required that the Corporate Governance Committee to be composed of a majority of INEDs.<sup>83</sup> Taking into account the market's concern that the corporate governance safeguards should be strengthened, the HKEX amended the rules to require that all members should be INEDs.<sup>84</sup> The Corporate Governance Committee must also disclose a Corporate Governance Report on a semi-annual basis, summarising of the work that it has done.<sup>85</sup> As INEDs are voted on a OSOV basis, this alleviates the WVR risks regarding INEDs and thus they can safeguard shareholder interests in board-level decisions. In addition, WVR companies will need to have Nomination Committees chaired and comprised of a majority of INEDs for the purpose of nominating INEDs to the board<sup>86</sup>, ensuring that INED nominations stay fully independent. Furthermore, WVR companies will need to engage a compliance advisor on a permanent basis to advise on any WVR-related problems such as potential conflict of interests between WVR management and non-WVR shareholders.<sup>87</sup>

To give force to the requirements, there is an additional requirement for WVR companies to incorporate all the requirements in the HKEX Listing Rule chapter 8A into the company's articles of association.<sup>88</sup> As the articles serve as the contractual documentation binding the company management and the shareholders, any breach of the terms in the articles serves as a

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<sup>81</sup>HKEX Listing Rule 8A.17, at part 8A-6–8A-7.

<sup>82</sup>HKEX Listing Rule 8A.31, at part 8A-11.

<sup>83</sup>Hong Kong Exchanges and Clearings Ltd (n 29) at 38.

<sup>84</sup>Hong Kong Exchanges and Clearings Ltd (n 30) at 45.

<sup>85</sup>HKEX Listing Rule 8A.32, at part 8A-11.

<sup>86</sup>HKEX Listing Rule 8A.27 and Rule 8A.28, at part 8A-10, and section A5, Appendix 14.

<sup>87</sup>HKEX Listing Rule 8A.33 and Rule 8A.34, at part 8A-11–8A-12.

<sup>88</sup>HKEX Listing Rule 8A.44, at part 8A-13.

breach of contract which shareholders can sue upon. This creates an additional cause of action for shareholders to receive remedies personally.

#### **4.1.2. Ex post mechanisms**

There is currently no contingency fee and class action framework in Hong Kong, which is viewed to act as a deterrent to management abuses.<sup>89</sup> The only similar form of aggregate litigation is through representative proceedings under Order 15, Rule 12 of the Rules of the High Court (Cap 4A). However, this has been criticised as inadequate and too restrictive, particularly where the case involves a large class of claimants.<sup>90</sup> Indeed, although the SFO allows individual shareholders to sue for damages after incurring a loss as a result of market misconduct, there have not been any such lawsuits reported to date.<sup>91</sup>

## **4.2. Singapore**

### **4.2.1. Ex ante mechanisms**

On 28 March 2018, the Singapore Exchange ('SGX') published their second consultation paper on the 'Proposed Listing Framework for Dual Class Share Structures'<sup>92</sup> which sets out the proposed rules for implementing their WVR regime. On 26 June 2018, the SGX published the finalised WVR listing rules ('Singaporean WVR rules') after incorporating market feedback with immediate effect.<sup>93</sup> As with Hong Kong, Singapore puts in place relevant measures to mitigate the risks associated with WVR structures, which have now been incorporated into the SGX Mainboard Listing Rules. Unlike Hong Kong, however, the WVR rules are not contained in a single new chapter, but rather are scattered around several chapters, including Chapters Two, Six, Seven, Eight and Twelve, with the bulk of the core WVR requirements inserted as subsection 10 of Rule 210 under Chapter Two, titled 'Dual Class Share Structure'.<sup>94</sup>

**4.2.1.1. Entry requirements.** The Singaporean WVR rules obligate additional entry requirements for WVR companies in terms of qualitative suitability only. Originally, like the Hong Kong law, there was a proposed minimum

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<sup>89</sup>Hong Kong Exchanges and Clearings Ltd (n 9) at 22.

<sup>90</sup>K Dicks, 'The Proposed Class Action Regime for Hong Kong' *Deacons* (19 June 2012), at <http://www.deacons.com.hk/news-and-insights/publications/the-proposed-class-action-regime-for-hong-kong.html>.

<sup>91</sup>SFO, ss281, 305.

<sup>92</sup>Singapore Exchange, 'Proposed Listing Framework for Dual Class Share Structures' (2018).

<sup>93</sup>Singapore Exchange, 'SGX Launches Rules for Listing of Dual Class Shares Companies' *News and Updates* (26 June 2018), at [https://www.sgx.com/wps/wcm/connect/sgx\\_en/home/highlights/news\\_releases/sgx\\_launches\\_rules\\_for\\_listing\\_of\\_dual\\_class\\_shares\\_companies](https://www.sgx.com/wps/wcm/connect/sgx_en/home/highlights/news_releases/sgx_launches_rules_for_listing_of_dual_class_shares_companies).

<sup>94</sup>Rule 210(10), SGX Mainboard Rules.

market capitalisation rule, however such additional requirement has been abandoned because a majority of market respondents objected to heightened admission requirements for WVR structures. As such, the SGX's main board quantitative requirements apply equally to WVR companies.

With respect to qualitative suitability, the Singaporean WVR rules require that only new issuers are to be permitted to adopt WVR structures and that it will publish further guidance on suitability factors after it has received and reviewed a sufficient number of potential applications for WVR structures.<sup>95</sup> However, at this initial stage, the SGX listed six qualitative factors that may be taken into account in the suitability assessment for WVR applicant issuers.<sup>96</sup> These are as follows:

- (1) the business model of the applicant, for example, that the applicant has a conceptualised long-term plan that contemplates ramping up growth at a fast pace
- (2) the applicant issuer's track record, including operating track record of the company, business or group<sup>97</sup>
- (3) the role and contribution of WVR shareholders to the success of the applicant issuer. In case of a permitted holder group (as explained below), its relevance to the business or group
- (4) the participation of sophisticated investors
- (5) if the permitted holder group is a trust or corporate vehicle, the suitability of the arrangement, including an assessment of whether sunset features or other safeguards are in place to govern the holding structure
- (6) other features of the applicant issuer that require a WVR structure

Further, as an additional review of WVR listing applications, pursuant to Rule 110(4)(a) of the SGX Mainboard Rules, the Listing Advisory Committee will be referred to provide advice on the applicant's WVR safeguards for initial cases which involve unprecedented issues.<sup>98</sup>

**4.2.1.2. Disclosure requirements.** The Singaporean WVR rules include additional disclosure requirements specifically for WVR companies to increase the clarity to investors. The rules require WVR issuers to include a statement

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<sup>95</sup>Singapore Exchange (n 92) at 2.

<sup>96</sup>These qualitative factors are not found in the SGX Mainboard Listing Rules, but are listed in the consultation conclusions paper as the factors that the SGX may take account of. Singapore Exchange, 'Responses to Comments on Consultation Paper: Proposed Listing Framework for Dual Class Share Structures' (2018) at 10–11.

<sup>97</sup>In its proposed rules, the SGX initially only included operating track record. However, after reviewing market feedback, the SGX considered it relevant to also take into account other factors such as corporate governance track record and also to expand the track record scope to not only the issue but also companies also managed by the issuer's founder(s) as well. Singapore Exchange (n 96) at 4–5.

<sup>98</sup>ibid at 4 and Singapore Exchange (n 92) at 2.

on the cover page of its annual report to cover the following details pertaining to each holder of WVR shares:

- (1) the name of the shareholder
- (2) the number of WVR shares
- (3) the total voting rights of the WVR shares
- (4) the number of non-WVR shares
- (5) the total voting rights of non-WVR shares
- (6) the total voting rights of both WVR and non-WVR shares<sup>99</sup>

Furthermore, the applicant issuer must prominently disclose in its prospectus, offering memorandum, introductory document and shareholder's circular, the details of the WVR structure and its associated risks, its rationale for adopting it, key matters that are subject to enhanced voting rights and their implications to non-WVR shareholders, key provisions in its constitutional documents relating to WVR shares and also the six details relating to each holder of WVR shares (as also applicable to annual reports above).<sup>100</sup> To clearly distinguish WVR companies from non-WVR ones, the rules require a prominent statement emphasising that the company is a WVR company on the cover page of its prospectus, offering memorandum, introductory document and shareholder's circular<sup>101</sup>, and on a continuing basis, in its announcements<sup>102</sup>, any other circulars<sup>103</sup> and annual reports.<sup>104</sup> As part of its earlier proposals to the WVR regime, the SGX aims to enhance the awareness of WVR companies by requiring WVR stocks to be clearly identified on trading screens and will also conduct educational measures for investors.<sup>105</sup>

**4.2.1.3. Safeguard requirements.** To protect shareholders against the expropriation and entrenchment risks related to WVR structures, the SGX imposed the following eight safeguard requirements.

First, maximum voting differential. To limit the voting inequality between WVR and non-WVR shares, the SGX imposes a maximum of ten votes per WVR share and that the voting ratio between WVR and non-WVR shares cannot be altered after listing.<sup>106</sup>

Second, a moratorium on the transfer of shareholdings by WVR holders. To ensure that holders of WVR shares do not suddenly abandon their commitment to the WVR company and to align their interest to the non-WVR

<sup>99</sup>Rule 1207(i), SGX Mainboard Rules.

<sup>100</sup>Rule 610(10), SGX Mainboard Rules.

<sup>101</sup>Rule 610(10)(a), SGX Mainboard Rules.

<sup>102</sup>Rule 753, SGX Mainboard Rules.

<sup>103</sup>Rule 1206(7), SGX Mainboard Rules.

<sup>104</sup>Rule 1207(9)(i), SGX Mainboard Rules.

<sup>105</sup>Singapore Exchange (n 92) at 7.

<sup>106</sup>Rule 210(10)(d), SGX Mainboard Rules.

shareholders<sup>107</sup>, the SGX requires that holders of WVR shares must give contractual undertakings to adhere to a moratorium on the transfer or disposal of their entire shareholdings in the WVR issuer at the time of listing for at least 12 months after listing.<sup>108</sup>

Third, protected rights of non-WVR shareholders. To protect the rights of non-WVR shareholders in voicing their opinions in general meetings and to avoid disenfranchisement, the rules require that non-WVR shareholders holding a minimum of 10% of the voting rights on a OSOV basis are able to convene a general meeting.<sup>109</sup> In its proposal stage, the SGX sought market feedback on its other option of requiring the 10% threshold to be counted under by the total voting rights of all shares instead of by an OSOV basis.<sup>110</sup> However, after an overwhelming majority of feedback being against such an option, the SGX went forth with the OSOV basis in the end.<sup>111</sup>

Fourth, restriction on post-listing WVR share issuance. To avoid further entrenchment, the SGX rules prohibit any further issuance of WVR shares unless by a rights issue, bonus issue, scrip dividend scheme or the consolidation or subdivision of shares, with each case being in conjunction with the issuance of non-WVR shares.<sup>112</sup> Further, any corporate actions such as those mentioned above, must not increase the ratio of voting rights of WVR shares against non-WVR shares prior to such corporate action.<sup>113</sup> Further, any issuance of WVR shares must be approved under a special resolution held in a general meeting.<sup>114</sup>

Fifth, automatic conversion of WVR shares upon transfers. WVR shareholders are limited to a 'responsible director' or a group of persons or entity within the 'permitted holder group' of the issuer applicant.<sup>115</sup> In addition, the holders of the WVR shares must be specified at the IPO stage and in the case of a 'permitted holder group', the scope of the 'permitted holder group' must also be specified at IPO stage.<sup>116</sup> Originally in the proposal stage, the SGX required only directors of the issuer to hold WVR shares so as to limit holders of WVR shares to individuals who are subject to fiduciary duties to add extra protection upon minority shareholders.<sup>117</sup> Yet the SGX recognised that where a group of founders wish to collectively become holders of WVR shares, it may be impractical to require all of them to be directors as each of them may have different roles towards the growth of the

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<sup>107</sup>Rule 225, SGX Mainboard Rules.

<sup>108</sup>Rule 229A, SGX Mainboard Rules.

<sup>109</sup>Rule 210(10)(g), SGX Mainboard Rules.

<sup>110</sup>Singapore Exchange (n 92) at 4.

<sup>111</sup>Singapore Exchange (n 96) at 6.

<sup>112</sup>Rule 803A(1), SGX Mainboard Rules.

<sup>113</sup>Rule 803A(3), SGX Mainboard Rules.

<sup>114</sup>Rule 803A(2), SGX Mainboard Rules.

<sup>115</sup>Rule 210(10)(e), SGX Mainboard Rules.

<sup>116</sup>Rule 210(10)(c), SGX Mainboard Rules.

<sup>117</sup>Singapore Exchange (n 92) at 5.

issuer.<sup>118</sup> Consequently, the SGX devised the ‘permitted holder group’ to give flexibility to a group of persons or entity to collectively hold WVR shares of the issuer.<sup>119</sup>

There are also automatic conversion provisions that, upon certain triggering events, will automatically convert WVR shares into non-WVR shares on a OSOV basis, unless specifically approved by shareholders through the enhanced voting process (as explained below).<sup>120</sup> The triggering events are as follows:

- (1) where the WVR share is sold or transferred to any person, and in the case of a permitted holder group, any person not within the group
- (2) where a responsible director ceases to be a director (whether through death, incapacity, retirement, resignation or otherwise), and in the case of a permitted holder group, other than where a new responsible director is appointed

If enhanced voting processes are undertaken, the relevant holder of the WVR shares, the person whom is to be sold or transferred the WVR shares, and such responsible director or their associates must abstain from voting in such resolutions.

Sixth, enhanced independence of board committees. To confirm the independence of board committees, thereby ensuring accountability and oversight, the SGX rules require that the audit, nominating and remuneration committees must be composed of a majority of INEDs and also chaired by an INED.<sup>121</sup>

Seventh, enhanced voting process for key matters. Similar to the Hong Kong regime, certain key matters must be voted upon through an ‘enhanced voting process’, which is conducted under a OSOV basis.<sup>122</sup>

Finally, constitutional backing of the new rules. The SGX rules also require that the issuer must incorporate some of the provisions regarding WVR structures, namely Rules 210(10)(c) to 210(10)(i) of the SGX Mainboard Rules, into its articles of association and other constitutional documents.<sup>123</sup>

#### 4.1.3. Ex post mechanisms

As with Hong Kong, Singapore does not have a class action and contingency fee system. Although there are a number of procedures that may aggregate multiple claims, they are not effective in practice.<sup>124</sup> For instance, the court can decide to consolidate proceedings or try multiple claims on the same

<sup>118</sup>Singapore Exchange (n 96) at 10.

<sup>119</sup>ibid.

<sup>120</sup>Rule 210(10)(f), SGX Mainboard Rules.

<sup>121</sup>Rule 210(10)(i), SGX Mainboard Rules.

<sup>122</sup>Rule 730B, SGX Mainboard Rules.

<sup>123</sup>Rule 210(10)(j), SGX Mainboard Rules.

<sup>124</sup>Alexander FH Loke, ‘Mounting Hurdles in Securities Litigation: Addressing the Funding and Collective Action Issue’ (2010) 22 Singapore Academy of Law Journal 660.

occasion if there is some common question of law or fact,<sup>125</sup> but the condition is that the plaintiffs must have consciously chosen to participate in the litigation. Further, similar to Hong Kong, Singapore allows the representative proceeding in which a litigant may sue on behalf of another without necessarily having obtained the consent of the latter, but there is a 'same interest' requirement which is overly restrictive and has impeded the efficacy of the procedure.<sup>126</sup>

### **4.3. The United States**

#### **4.3.1. Ex ante mechanisms**

There are multiple stock exchanges in the United States ('US'), but for the purpose of this analysis, only the two largest exchanges, the NYSE and the NASDAQ are taken into consideration. Despite being the most prominent WVR structure jurisdiction, the US has minimal additional requirements for WVR companies under the rules of both the NYSE and NASDAQ.

**4.3.1.1. Entry requirements.** In general, neither the NYSE nor the NASDAQ has additional entry requirements specifically for WVR companies. However, they both adopt a rule that substantially restricts the freedom of companies to reduce the voting power of outstanding shares by the issuance of super voting stocks.<sup>127</sup> The restriction on issuing super voting stock is primarily applicable to the issuance of a new class of stock. Hence, this effectively means that only new issuers can adopt the WVR structure.

**4.3.1.2. Disclosure requirements.** Both the listing rules of the NYSE or NASDAQ do not have additional disclosure requirements specifically for WVR companies.

**4.3.1.3. Safeguard requirements.** As noted earlier, both the NYSE and NASDAQ prohibit the post-listing reduction of voting rights of existing shareholders of publicly traded common stock.<sup>128</sup> This means that a listed WVR company cannot further issue more WVR shares that would reduce voting rights of existing shareholders. However, companies with existing WVR structures would generally be permitted to issue additional shares of the existing super-voting stock, provided that voting rights of existing shareholders will not be reduced.

Further, under the NYSE Listed Company Manual, additional safeguards must be provided to holders of non-voting shares. These are (1) any non-voting shares must meet all original listing standards, (2) the rights attached to non-voting

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<sup>125</sup>Rules of Court (Cap 322), Order 15, Rule 4; Order 4, Rule 1.

<sup>126</sup>Rules of Court (Cap 322), Order 15, Rule 12.

<sup>127</sup>NYSE Listed Company Manual, Rule 313(A) and NASDAQ Stock Market Rule 5640.

<sup>128</sup>NYSE Listed Company Manual, Rule 313(A) and NASDAQ Stock Market Rule 5640.



shares should be substantially the same as other shares except for voting rights, and (3) holders of any listed non-voting common shares must receive all communications, including proxy material, sent generally to the holders of the normal voting shares.<sup>129</sup> The NASDAQ listing rules however do not have similar additional safeguards for holders of non-voting shares.

#### 4.1.4. *Ex post mechanisms*

The key feature of the US legal framework for aggrieved shareholders is the availability of class actions coupled with contingency fee system. The legal environment in the US is well known to be highly litigious. In 2017, there were a total of 432 shareholder actions, making it one of the most litigious class-action years since a federal law preventing frivolous actions took effect back in 1995.<sup>130</sup> In relative terms, the ease of action in the US is rather high, meaning that there is a higher tendency for aggrieved shareholders to obtain remedial damages from WVR share abuses. However, it has been observed that there is also an increase in poor quality lawsuits that are often dismissed or settled for minimal sums.<sup>131</sup>

### 4.4. *Canada*

#### 4.4.1. *Ex ante mechanisms*

Canada's largest stock exchange, the Toronto Stock Exchange ('TSX') permits the listing of companies with WVR shares. Compared to the US, there are more requirements for WVR companies, albeit still minimal.

**4.4.1.1. *Entry requirements.*** The TSX listing rules do not have additional entry requirements specifically for WVR companies. However, a listed company is not allowed to issue any securities that have voting rights greater than those of its existing voting securities, unless the issuance is made to all holders of the existing voting securities on a pro rata basis.<sup>132</sup> This means that a non-WVR listed company cannot adopt the WVR structure to favour selected shareholders and thus the WVR structure is in effect confined to new issuers.

**4.4.1.2. *Disclosure requirements.*** Under the TSX rules, there are stock symbol designations for company shares with different voting rights that must be displayed in all security certificates.<sup>133</sup> For example, the words of 'restricted

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<sup>129</sup>NYSE Listed Company Manual, Rule 313(B)

<sup>130</sup>J Stampel, 'A Lawsuit a Day: U.S. Securities Class Actions Soar', *Reuters* (31 January 2018), at <https://www.reuters.com/article/us-stocks-classaction/a-lawsuit-a-day-u-s-securities-class-actions-soar-idUSKBN1F12FM?il=0>.

<sup>131</sup>*ibid.*

<sup>132</sup>TSX Company Manual, Part VI (H), Section 624(m)

<sup>133</sup>TSX Company Manual, Part VI (H), Section 624(c) - (f)

voting' will be displayed for restricted voting class of shares.<sup>134</sup> This serves as a minimal differentiation mechanism for interested investors.

**4.4.1.3. Safeguard requirements.** Listed WVR companies may make a further issuance of multiple-voting securities that would maintain (but not increase) the percentage voting position of a holder of multiple-voting securities, subject to relevant conditions as the TSX considers desirable in any particular case.<sup>135</sup> One of the conditions is minority approval of security holders, which means approval given by a majority of the votes cast by shareholders excluding the promoters, directors, officers, insiders of an issuer or proposed recipient of such shares.<sup>136</sup> This requirement is intended to prevent transactions which would reduce the voting power of existing security holders through the use of securities carrying multiple voting rights.

Further, the TSX imposes coattail provisions that ensures holders of inferior-voting shares to participate in a take-over bid on equal terms as those with superior-voting shares.<sup>137</sup> Such coattail provisions need to meet different criteria, depending on the circumstances under which the shares are traded,<sup>138</sup> and be cleared prior to listing with the TSX.<sup>139</sup>

#### 4.1.5. Ex post mechanisms

The Canadian legal framework also allows for class actions and contingency fee system – much like the US. However, unlike the US, the number of securities class action is significantly fewer. According to a recent report, only six new securities class actions were filed in 2017 and four of those were actions against a public company.<sup>140</sup> Further, from 2015 to 2017, only 14 TSX-listed companies were sued in a securities class action.<sup>141</sup>

## 5. Evaluating the Hong Kong WVR regime

As discussed above, the four jurisdictions examined in this study, namely Hong Kong, Singapore, the US and Canada, have in place different WVR-supporting mechanisms. For clarity of comparison, they are summarised in Table 1.

This part will proceed to compare the WVR supporting mechanisms *ex ante* and *ex post* in the four jurisdictions, and draw difference between the analytical frameworks discussed earlier, identify the legal strategies being utilised to

<sup>134</sup>TSX Company Manual, Part VI (H), Section 624(c)(iii)

<sup>135</sup>TSX Company Manual, Part VI (H), Section 624(m)

<sup>136</sup>TSX Company Manual, Part VI (H), Section 624(n)

<sup>137</sup>TSX Company Manual, Part VI (H), Section 624(l)

<sup>138</sup>*ibid* Section 624(l) (1) and (2).

<sup>139</sup>*ibid*.

<sup>140</sup>B Heys and R Patton, 'Trends in Canadian Securities Class Actions: 2017 Update: Trickle of New Cases Suggests a Slow Rate of Filings Is the New Norm', *NERA*, (20 February 2018) at 3, at [http://www.nera.com/content/dam/nera/publications/2018/PUB\\_2017\\_Recent\\_Trends\\_Canada\\_0218.pdf](http://www.nera.com/content/dam/nera/publications/2018/PUB_2017_Recent_Trends_Canada_0218.pdf).

<sup>141</sup>*ibid*.

reduce the WVR agency costs. Based on this, we will evaluate the WVR regime in Hong Kong, particularly in its local context.

## **5.1. A generally positive development for Hong Kong**

### **5.1.1. Ex ante supporting mechanisms in HK are well-designed**

As discussed earlier, the new WVR regime in Hong Kong adopts a large number of new listing requirements that are specifically designed to control controlling shareholders' opportunism. These *ex ante* WVR supporting mechanisms are broadly grouped into three categories, namely entry requirements, disclosure requirements and safeguard requirements.<sup>142</sup> Below is an anatomy of these requirements according to the taxonomy of legal strategies for reducing agency costs as noted earlier.<sup>143</sup>

To start with, the entry requirements primarily embody the affiliation strategy by permitting only new issuers to use the WVR structure and setting out a list of selection criteria. This allows the investors to freely decide *ex ante* whether they want to join a WVR company, and ensures that the investors will be able to contract with a WVR company on a set of mandatory terms. In designing the listing criteria, the HKEX uses both clear-cut rules such as financial tests and flexible standards such as character tests. It also adds legal constraints by requiring the WVR shareholder to be a director of the issuer so as to apply directors' fiduciary duties. Although there exist some conventional methods to constrain controlling shareholders under Hong Kong company law, such as the unfair prejudice remedy (also known as oppression remedy) and the equitable constraint on abuse of majority voting, they are not as powerful as the directors' fiduciary duties.<sup>144</sup>

Further, the safeguard requirements make use of several different legal strategies to deal with the agency problems caused by the WVR structure. The legal strategy of decision rights is used in two forms here. On the one hand, non-WVR shareholders can exercise voting rights on certain major transactions; on the other, as all the new listing requirements are automatically incorporated into the company's constitution, non-WVR shareholders have a new basis for bringing suit against WVR-shareholders. The incentive strategy, particularly trusteeship, is applied in the form of the heavier reliance put on independent directors and the new requirement of the corporate governance committee. The strategy of legal constraints manifests itself in certain rules such as the maximum voting power that can be attached to one WVR share and the minimum economic interest that WVR shareholders must hold. Among the five types of legal strategies commonly used for reducing

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<sup>142</sup>See above Part 4.1.1.

<sup>143</sup>See above Part 3.2.

<sup>144</sup>Hong Kong Companies Ordinance, s724.

**Table 1.** Jurisdictional comparison of WVR supporting mechanisms.

Jurisdictions	<i>Ex ante</i> mechanisms		<i>Ex post</i> mechanisms	
	Entry requirement	Disclosure requirement	Safeguard requirement	Class action and contingency fee
Hong Kong	Yes	Yes	Yes	No
Singapore	Yes	Yes	Yes	No
US	No	No	Minimal	Yes
Canada	No	Minimal	Minimal	Yes

agency costs, the pair of selection and removal rights are largely absent, because the very purpose of the WVR structure is to allow WVR-shareholders to pursue long-term business goals without much fear of removal. Yet, Hong Kong has tried to introduce relevant sunset provisions under which WVR privileges will cease to exist.

Finally, the disclosure requirements provide the information necessary to protect non-WVR shareholders as a powerful regulatory strategy in itself or through other mechanisms including the entry requirements and safeguard requirements as discussed above. For instance, the investors can better exercise their affiliation rights, to the extent that the WVR company needs to clearly identify itself and disclose information on its WVR structure and other major issues. This is important for protecting the investors as they can make an informed decision on entering the company and at a market price which usually reflects the existence of the WVR structure.

From a comparative perspective, the *ex ante* WVR-supporting mechanisms in Hong Kong are the most comprehensive and stringent among the four jurisdictions examined in this paper. While the WVR regime in Singapore is broadly modelled on that in Hong Kong, some of the requirements are revised to become more relaxed.<sup>145</sup> For example, unlike Hong Kong, Singapore does not strictly confine the WVR structure to ‘innovative’ company; nor does it adopt the market capitalisation requirement. Further, the WVR shareholding in Hong Kong is restricted only to individuals who serve as directors of the company. This requirement effectively casts the WVR shareholders in a dual role, namely WVR shareholders *cum* directors, ensuring that the WVR power can only be accorded to ingenious entrepreneurs deeply involved in the management of the company and its exercise is subject to the constraints of the fiduciary duties. However, Singapore drops the above restriction to allow the route of ‘permitted holder group’ under which multiple individuals can choose to hold WVR shares through a special purpose vehicle. This would add a further layer of agency problems and lose the benefit of using the powerful tool of the fiduciary duties to control WVR-shareholders.

<sup>145</sup>See above Part 4.2.1.

In comparison, the Hong Kong-style *ex ante* WVR-supporting mechanisms are not found in the US and Canada.<sup>146</sup> Compared to the US, Canada has more requirements, particularly in relation to the disclosure and safeguard aspects, which are designed to reduce problems and thus litigations.<sup>147</sup> This may help explain why, as will be discussed below, both jurisdictions allow for contingency fee and class actions, but the number of litigations in the US is significantly higher than that in Canada. Hence, we should have a holistic view of the *ex ante* and *ex post* supporting mechanisms in a given jurisdiction. Plausibly, the significantly more stringent *ex ante* WVR requirements in Hong Kong may reduce the chance of the WVR shareholders abusing their power and thus the need for judicial remedies *ex post*.

### 5.1.2. HK lacks US-style *ex post* mechanisms but has functional substitutes

The predominant limitation to the *ex post* protection framework in Hong Kong is the unavailability of class actions and contingency fee system. As argued by opponents of WVR, the lack of class action in Hong Kong deprives investors the ease of taking legal remedies in the event of misconduct by WVR companies and thus disapproves the implementation of WVR regime in Hong Kong.<sup>148</sup> However, despite the lack of class action, Hong Kong has functionally similar mechanisms under the SFO. A prime example is s213 under which the SFC can bring the so-called ‘surrogate action’ to seek compensation on behalf of and for aggrieved investors.

In the recent 2013 landmark case of *Securities and Futures Commission v Tiger Asia* (‘Tiger Asia’)<sup>149</sup>, it is confirmed that the SFC can use s213 to seek a court determination of market misconduct and final orders for shareholder remedies. This allows the SFC to bring an action regarding a potential event of market misconduct on behalf of the aggrieved shareholders. In effect, section 213 acts as the ‘public analogue’ of the private route of action under section 305<sup>150</sup>, thus expanding the ‘ammunition’ of the SFC in combating market misconduct and protecting investors. As stated by SFC’s former Executive Director of Enforcement, Mr Mark Steward, section 213 can play a helpful role in situations where individual actions are difficult to commence due to the

<sup>146</sup>See above Parts 4.3 and 4.4.

<sup>147</sup>See e.g. S Tinaikar, ‘Executive Compensation Disclosure and Private Control Benefits: A Comparison of U.S. and Canadian Dual Class Firms’ (2017) 29 *Journal of International Accounting, Auditing and Taxation* 32–51.

<sup>148</sup>RS Chan and JKS Ho, ‘Should Listed Companies Be Allowed to Adopt Dual-Class Share Structure in Hong Kong?’ (2014) 43 *Common Law World Review* 155, 178; Kong Shan Ho, ‘Revisiting the Viability to Allow Dual-Class Share Structure Companies to List in the Financial Market of Hong Kong’ (2018) 47 *Common Law World Review* 167.

<sup>149</sup>[2013] HKEC 703.

<sup>150</sup>*ibid.*

anonymity of market wrongdoers or where the individual quantum of damages is too insignificant to justify an action.<sup>151</sup>

Since the *Tiger Asia* case in 2013, the SFC has had an impressive track record of successful actions under section 213 with substantial payouts to aggrieved shareholders.<sup>152</sup> For example, in the recent case of *Securities and Futures Commission v Qunxing Paper Holdings Co Ltd (No 2)*<sup>153</sup>, the court granted compensation orders totalling HKD 1.42 billion under section 213 against Qunxing Paper Holdings Company Limited along with a few of its senior members as well as its subsidiary Best Known Group Limited, to compensate investors of Qunxing shares due to findings of false and misleading disclosures in Qunxing's IPO prospectus. Further, in the case of *Securities and Futures Commission v Sun Min*<sup>154</sup>, the Court of First Instance made a restoration order under section 213 against Ms Sun Min to pay HKD 15.6 million to 51 investors who suffered from her misconduct of insider dealing.

Hence, from a functional perspective, public enforcement by the SFC has served as a meaningful substitute for private enforcement in the form of class action, thereby affording strong investor protection in Hong Kong.<sup>155</sup> In fact, the s213 mechanism in Hong Kong has some competitive advantages vis-à-vis the class action in the US. To start with, the aggrieved shareholders in Hong Kong do not need to take the trouble and cost to litigate, as the SFC acts as the plaintiff in such cases. Yet, the remedies are payable to the aggrieved shareholders and not to the SFC.<sup>156</sup> In addition, s213 offers a wide range of court orders to protect investors, including the freezing order, the disqualification order and the restoration order.<sup>157</sup> To be sure, the efficacy of the s213 depends essentially on the integrity and capacity of the SFC, but as noted above, the SFC has had a demonstrable record of using s213 actively to protect investors. Empirical research suggests that the investors in Hong Kong have benefitted from SFC surrogate actions (such as section 213 actions), received larger compensations than US investors who sought redress through class actions.<sup>158</sup>

Furthermore, the importance of class action in protecting investors in the context of the WVR structure may seem to be somewhat exaggerated. In

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<sup>151</sup>M Steward, 'Legal Week's Corporate Counsel Forum' *Securities and Futures Commission* (11 June 2013), at [https://www.sfc.hk/web/EN/files/ER/PDF/Speeches/Mark\\_20130611.pdf](https://www.sfc.hk/web/EN/files/ER/PDF/Speeches/Mark_20130611.pdf).

<sup>152</sup>See Y Hu, 'The Role of Public Enforcement in Investor Compensation: A Hong Kong Perspective' (2017) 46 *Common Law World Review* 216–38, at 228–29; DC Donald and PWH Cheuk, 'Hong Kong's Public Enforcement Model of Investor Protection' (2017) 4 *Asian Journal of Law and Society* 349–85, at 375.

<sup>153</sup>[2018] HKCFI 271.

<sup>154</sup>[2017] HKEC 1479.

<sup>155</sup>Robin Hui Huang, Hailong Li and Gavin Yao Lin, 'The Anatomy of Securities Class Action in China: A Functional and Comparative Approach With the United States' (2018) 4 *Securities Regulation Law Journal* 365, 387.

<sup>156</sup>See section 213(2)(b), *Securities and Futures Ordinance* (Cap. 571)

<sup>157</sup>See sections 213(2)(a) to (g), *Securities and Futures Ordinance* (Cap. 571)

<sup>158</sup>Hu (n 152) 216–38, at 229.

the US, empirical data show that most of the securities class actions are related to problematic disclosure issues instead of abuse of power under the WVR structure.<sup>159</sup> In Canada, as discussed earlier, despite the availability of class action, the actual number of securities class actions is very small. This suggests that even if class action were to be allowed in Hong Kong, it might not function as vigorously as expected.

Finally, apart from s213 which is focused on market misconduct, there are several other SFO provisions under which the SFC can bring surrogate action to protect investors. For instance, the SFC can use s212 to obtain a winding-up order. Under s214, the SFC can bring action to seek remedies for unfair prejudice to the shareholders caused by directors and controlling shareholders in the operation of the company. S214 has been used by the SFC in practice to effectively substitute for unfair prejudice action and derivative action usually brought by shareholders.<sup>160</sup> Together, these various types of surrogate action may provide a functional equivalent to the US class action in protecting investors.

### **5.1.3. Putting the cost-benefit analysis in the HK context**

When evaluating the WVR structure in Hong Kong, it is important to put the cost-benefit analysis into context. Indeed, the real question is whether and how Hong Kong has managed to find ways to reduce the agency costs while reaping the benefits. As discussed earlier, the *ex ante* WVR-supporting mechanisms established in Hong Kong are generally well-designed and the most stringent among its counterparts in the jurisdictions examined in this paper. It utilises a combination of cost-reducing legal strategies, including agent constraints, affiliation terms, incentive alignment, appointment rights and decision rights. Hong Kong also has effective enforcement strategies as *ex post* supporting mechanisms.

While the costs and benefits of the WVR structure are difficult to measure in quantitative terms, they are affected by local conditions and one needs to a contextual analysis when weighing them up. For instance, the entrenchment risks as created by the WVR structure in Hong Kong seem to be less of a worry than that in the US, because for various reasons such as the family-controlled pattern of most listed companies and the stringent law for hostile takeovers, the market for corporate control in Hong Kong has long been far from effective with a dearth of hostile takeovers.<sup>161</sup>

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<sup>159</sup>Cornerstone Research, *Securities Class Action Filings 2017 Year in Review* (2017), 9.

<sup>160</sup>See e.g. *Re Styland Holdings Ltd* (2012). From a comparative perspective, the unfair prejudice action in Hong Kong performs a similar function to the controlling shareholders' fiduciary duties in the US.

<sup>161</sup>As one of the main reasons for using the WVR structure in the US is to ward off the threat of hostile takeovers, an interesting question may arise why Hong Kong-listed companies still want the WVR structure given the weak market for hostile takeovers in Hong Kong. Several considerations may help explain it. First, for innovative high-tech companies which the WVR structure is mainly designed for, they usually have multiple rounds of fundraising and the founders' shareholdings are diluted along the

Further, in relation to the increased competitiveness of the market in Hong Kong, not only may a WVR regime help to enhance HKEX's attractiveness to issuers, it may also serve to diversify the demographic of listed companies both in terms of industry and place of origin. One major concern for the Hong Kong capital market is that there is a heavy concentration of companies from the property and financial sectors. These two dominating industries represent a substantial 44% of the market capitalisation of the SEHK, while on the other hand, the fast-growth new economy companies amount to only 3%, as of 2017.<sup>162</sup> Compared to US markets which allows for WVR such as the NASDAQ and NYSE, the concentration of new economy companies in terms of market capitalisation percentage in these bourses are significantly larger, coming at 60% and 47% respectively.<sup>163</sup> These figures show that companies from the high-tech and innovative sectors can be substantial and Hong Kong is far behind its competitors in attracting them. Further, Hong Kong needs to do more to promote innovation to maintain competitive advantage. According to the Global Innovation Index 2018, Hong Kong ranked 14th, which is much lower than the US (6th) and Singapore (5th).<sup>164</sup>

Since new economy companies particularly favour WVR structures, a WVR regime will accordingly increase Hong Kong's suitability as a listing venue. Hong Kong's efforts to introduce the WVR structure have already started to bear fruit. Just three days after the HKEX 2018 New Listing Rules came into effect, the Mainland-based smartphone manufacturer, Xiaomi Corp., submitted its application for listing. Xiaomi was officially listed on 9 July 2018 to become the first listed company under the new WVR regime, which was followed by Meituan Dianping on 20 September 2018. Going forward, Hong Kong stands to benefit from further potential listings of Mainland Unicorn companies.

In a sense, the significance of the introduction of the WVR structure in Hong Kong can be best illustrated in the flurry of responses of its competitors including Singapore and Mainland China. As noted earlier, Singapore followed suit soon after Hong Kong decided to allow WVR listings. The same is true of Mainland China. At the beginning of 2018, the China Securities Regulatory

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way. Hence, it is very hard, or close to impossible, for the founders to retain more than 50% of shares so as to have absolute control of the control. Second, even if it is possible for the founders to keep more than 50% of shares, it would be economically more attractive for them if absolute control of the company could be obtained without the need to have the proportionate equity capital locked up in the company. Finally, in practice, although one may not need to have more than 50% shareholding to control a listed company, the control is not absolute, and it may be susceptible to hostile takeovers by outsiders, or challenges from existing shareholders. Hence, HKEX considers the WVR structure as 'incentive mechanisms' for founders of start-ups in that it protects start-ups from hostile takeovers. HKEX, *Hong Kong's Listing Regime Enters New Era, Featuring Emerging and Innovative Firms* (November 2018).

<sup>162</sup>ibid at 11.

<sup>163</sup>ibid.

<sup>164</sup>World Intellectual Property Organization, *Global Innovation Index 2018* (July 2018).



Commission ('CSRC') announced that one of its work priorities is to reform the listing regime, providing more support to 'new economy' companies. In late March 2018, the CSRC rolled out a pilot scheme to encourage Mainland innovative 'Unicorn' companies to list at home through the issuance of Chinese depository receipts ('CDR') that allows Chinese investors to directly purchase securities of overseas listed companies. On June 6, 2018, the CSRC published new rules to the pilot scheme that are said to provide the institutional foundation for innovative companies to issue CDRs in the Mainland, albeit under a set of strict selection criteria. Finally, on 5 November 2018, the Chinese President, Mr Xi Jinping, personally announced the plan for establishing the so-called 'Science and technology innovation board' where the WVR structure will be permitted to attract 'new economy' listings in Shanghai, and on 1 March 2019, the STIB was formally opened for business, adopting very similar rules on WVR to those in Hong Kong.

## **5.2. Lingerin g concerns**

### **5.2.1. Weaknesses of the new WVR regime**

As discussed earlier, the 2018 New Listing Rules impose various entry requirements on WVR applicants, but there are legitimate concerns regarding their practical effectiveness. It has been said that company size confers no assurance that a company will treat shareholders fairly and conversely, misconduct by large market-capitalised companies will create even greater impact on the market.<sup>165</sup>

Further, doubt has been cast on the effectiveness of anti-circumvention rule that ensures the use of the WVR structure by only new applicants.<sup>166</sup> Importantly, the HKEX 2018 New Listing Rules do not include an anti-circumvention mechanism with regard to acquisitions of OSOV companies by a WVR company. Under this scenario, the OSOV company operates under the control of the parent WVR company and could lead to transfers of significant asset from the OSOV company to the parent WVR company.

Finally, the New Listing Rule places a strong emphasis on INEDs and compliance advisers to provide WVR safeguards. The HKEX respectively set out in Listing Rules 8A.30 and 8A.34 its expectation of how INEDs and Compliance Advisers may contribute to investors' protection. The question to be asked here is whether these protection rules constitute an over-reliance on INEDs and Compliance Advisers, given the longstanding debate on the efficacy of INEDs in Hong Kong.<sup>167</sup>

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<sup>165</sup>Securities and Futures Commission, 'SFC statement on the SEHK's draft proposal on weighted voting rights', *SFC News & Announcements* (25 June 2015), at <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=15PR69>.

<sup>166</sup>*ibid.*

<sup>167</sup>The HKEX has recently published its conclusions to a consultation paper with the objective of improving corporate governance concerns including the level of independency of INEDs. See Hong Kong

### 5.2.2. *Uncertainties over access of investors to WVR shares*

Since the new WVR regime requires a relatively high market capitalisation, it is likely to expect some of these WVR applicants to be included as components in the market indices. On 7 May 2018, the Hang Seng Indexes Company Limited announced that the coverage of the Hang Seng Composite Index ('HSCI') would expand to include among others, companies with a WVR share structure, in accordance to market feedback and endorsement by the HSI Advisory Committee.<sup>168</sup> Xiaomi, being the first WVR company listed in Hong Kong, is now the constituent stock of the HSCI. In recent years, there is an increasing popularity for passive funds to invest indices by default without performing due diligence into the structure of the company. Hence, the investors who dislike WVR companies can find themselves indirectly investing in them through index tracking funds.

On the other hand, the securities exchanges in Mainland China have recently announced that Hong Kong-listed companies with a WVR structure such as Xiaomi, will not be included in the southbound tranche of the Mainland-Hong Kong Stock Connect program, and thus will not be available to the investors in Mainland.<sup>169</sup> This would put a significant speed bump onto the development of WVR companies in Hong Kong, given that the WVR regime is aimed mainly at attracting listings of Mainland-based innovative companies. If WVR companies like Xiaomi were included under the Stock Connect program, they could have the best of both worlds: the WVR structure, maturity and stability of Hong Kong's capital market with a primary listing in Hong Kong, while at the same time reach Chinese investors back home. As the Hong Kong-listed companies included under the Stock Connect program can be traded as if they were listed in Mainland, this can generate several important benefits. In addition to the usual advantage of being in home grounds, shares in the Chinese stock market may receive higher liquidity and valuation compared to Hong Kong, with the benchmark CSI Shanghai-Shenzhen Index trading with a 'price to earnings ratio' of 23 times compared to 11 times on the HSI.<sup>170</sup>

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Exchanges and Clearings Ltd, 'Consultation Conclusions: Review of the Corporate Governance Code and Related Listing Rules' (2018).

<sup>168</sup> Hang Seng Indexes Company Limited, 'Consultation Conclusions on the Eligibility of Foreign Companies, Stapled Securities and Weighted Voting Right Companies for Inclusion in the Hang Seng Composite Index', *Press Releases* (7 May 2018), at <https://www.hsi.com.hk/static/uploads/contents/en/news/pressRelease/20180507T000000.pdf>.

<sup>169</sup> L Moon, 'Xiaomi Shares Fall After Mainland Bourses Block Them from Chinese Investors in Stock Connect Pool', *South China Morning Post* (16 July 2018), at <https://www.scmp.com/business/companies/article/2155391/xiaomi-shares-fall-after-chinese-bourses-block-mainland-investors>.

<sup>170</sup> R Mak, 'Xiaomi IPO Escalates China's Battle of the Bourses' *Reuters* (15 June 2018), at <https://www.reuters.com/article/us-xiaomi-china-breakingviews/breakingviews-xiaomi-ipo-escalates-chinas-battle-of-the-bourses-idUSKBN1JB0K8>.

### 5.2.3. Challenges for the regulators

As discussed earlier, the 2018 New Listing Rules introduces an array of supporting mechanism for the WVR regime, including entry requirements, disclosure requirements and safeguard requirements. There can be significant challenges for the regulators to ensure that those requirements are applied in a consistent, fair and vigorous way.

For instance, some of the qualitative requirements of the suitability assessment, such as the determination of the material contribution of WVR shareholders towards an applicant's growth or whether the applicant satisfies as 'innovative', are not entirely straightforward and thus will leave huge room for the HKEX to exercise discretion in the decision-making process. Indeed, some have criticised that Xiaomi, the first WVR company under the 2018 New Listing Rules, is simply China's Apple and not sufficiently innovative. Even the SFC itself has duly recognised that the qualitative requirements of the suitability assessment could only be examined subjectively and thus may lead to uncertainty and unfair decisions.<sup>171</sup> Further, the 2018 New Listing Rules adopt event-based sunset clauses under which the WVR shareholder may lose the WVR power if certain events occur. One of such events is that the WVR shareholder is deemed by the HKEX to be incapacitated for the purpose of performing his or her duties as a director.<sup>172</sup> While this provides a flexible means for the HKEX to terminate the WVR structure when its benefits have become outweighed by its costs over time, there is uncertainty on what constitutes incapacitation, and thus its efficacy will depend on how the HKEX exercises its discretion.<sup>173</sup>

The above issue can become particularly acute due to the inherent conflict of interest arising from the dual role of the HKEX. On the one hand, the HKEX has become a listed company on its own exchange since June of 2000.<sup>174</sup> Like any listed company, the HKEX is accountable to its shareholders in terms of

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<sup>171</sup>Securities and Futures Commission, 'SFC Statement on the SEHK's Draft Proposal on Weighted Voting Rights' *SFC News & Announcements* (25 June 2015), at <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=15PR69>.

<sup>172</sup>HKEX Listing Rule 8A.17(3).

<sup>173</sup>Some scholars have suggested that dual-class structures should sunset after a fixed period of time (such as ten or fifteen years) unless their extension is approved by shareholders unaffiliated with the controller. See LA Bebchuk and K Kastiel, 'The Untenable Case for Perpetual Dual-Class Stock' (2017) 103 *Virginia Law Review* 585–630. The HKEX considered this idea of time-defined 'sunset' clause but eventually rejected it for several reasons. First, it may 'trigger a change in control at a listed issuer that would occur at an arbitrary date in the future when the change may not be in the best interests of the company or its shareholders' and would cause excessive uncertainty to the WVR shareholder and the company when the sunset date approaches. Second, it is 'likely to make the Hong Kong regime uncompetitive versus overseas markets', particularly the US and the UK, where no requirement for a sunset clause exists. Finally, the listing rules just set out minimum standards and the WVR company can adopt additional sunset clauses. Hong Kong Exchanges and Clearings Ltd (n 30) 41–42.

<sup>174</sup>The demutualisation of the HKEX materialised after a reform to merge the organised securities exchanges in Hong Kong initiated by the then Financial Secretary in his budget speech in 1999. See BM Ho, 'Demutualization of Organized Securities Exchanges in Hong Kong: The Great Leap Forward' (2002) 33 *Law and Policy in International Business* 283–367, at 286–87.

profit-maximisation, and thus needs to attract more listings to generate revenue. On the other hand, it is vested with a statutory duty under the SFO as the front-line regulator of the securities and futures markets.<sup>175</sup> It discharges this duty via two broad tasks being: '(a) the establishment and promulgation of [the Listing Rules] prescribing listing requirements for listing applicants and listed issuers; and (b) the fair and impartial administration of the Listing Rules'.<sup>176</sup> Hence, in order to maintain market confidence, the HKEX needs to be very careful in enforcing the WVR regime.

The WVR regime is different from the traditional OSOV regime in many ways, and it is still a very novel thing in Hong Kong. To help investors make informed investment decisions, the HKEX and the SFC need to undertake a more active role in properly promoting the WVR regime through offering and funding investor education programmes. At a fundamental level, Hong Kong adopts a disclosure-based securities regulatory philosophy, under which companies can legally issue their shares for investors to choose, as long as adequate information disclosure is made. The success of the WVR regime will in large part depend on the extent to which investors properly understand the information on the nature and operation of the WVR companies and take them into account in making their investment decisions.

## 6. Conclusion

This article aims to evaluate the WVR regime in Hong Kong that was recently implemented in late April of 2018. Historically, WVR companies existed in Hong Kong in the 1980s, but due to various reasons, was effectively banned in 1989. After almost 30 years, the global economic and financial landscape have changed significantly, and the debate on the WVR resurfaced in Hong Kong, with the most notable catalyst being the HKEX losing the record-breaking Alibaba IPO to the NYSE in 2014.

From a theoretical perspective, the WVR structure has costs in terms of expropriation risks and entrenchment risks, as well as benefits of enabling the company to focus on long-term performance and enhancing the competitiveness of the market. It is important, however, to have a contextual analysis of the costs and benefits of the WVR structure in a particular jurisdiction, and the real question essentially boils down to the balancing act of whether and how we can find ways to reap the benefits whilst mitigating the costs in the local context. Indeed, the re-introduction of the WVR structure in Hong Kong is accompanied by relevant supporting mechanisms, including entry requirements, disclosure requirements and safeguard requirements.

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<sup>175</sup>Section 21(1), Securities and Futures Ordinance (Cap. 571)

<sup>176</sup>Hong Kong Exchanges and Clearings Ltd, 'Overview' (2018), *HKEX How We Regulate*, at [https://www.hkex.com.hk/Listing/How-We-Regulate/Overview?sc\\_lang=en](https://www.hkex.com.hk/Listing/How-We-Regulate/Overview?sc_lang=en).

This paper analyses the WVR-supporting mechanisms in Hong Kong to identify the legal strategies used to control agency costs and compares them with those in Singapore, the US and Canada. It is found that the Hong Kong regime is most stringent *ex ante* among the jurisdictions compared and has effective *ex post* enforcement routes. There are some lingering concerns, however, including some technical weaknesses, uncertainties over access of investors to WVR shares and challenges for the regulators. In sum, the re-introduction of the WVR regime is generally a positive development for Hong Kong, but it remains to be seen whether the WVR regime will achieve the purpose for which it was introduced.

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