ACGA

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(Attention: Listing Policy & Product Admission)

By post and email: listingrules@sgx.com

ACGA Submission on SGX Consultation:
"Possible Listing Framework for Dual-Class Share Structures"

The Asian Corporate Governance Association (ACGA) is an independent, not-for-profit association chartered under the laws of Hong Kong. The Association is dedicated to assisting companies and markets across Asia in their efforts to improve corporate governance practices. In our educational outreach, we are guided by a practical, long-term approach. ACGA's operations are supported by a membership base of institutional investors, such as public pension funds and fund managers, as well as listed Asian companies, international accounting firms, business associations and universities. ACGA now has more than 110 organisations as members, two-thirds of which are institutional investors with more than US$26 trillion in assets under management globally. They are also significant investors in the Singapore market.

General Concerns

We take Singapore's concerns about the importance of maintaining a healthy financial ecosystem seriously and believe that the "Report of the Committee on the Future Economy"[1] represents a sincere effort to frame issues of importance to the city's long-term development. Under Recommendation 3.3 (page 31), the Report briefly touches upon dual-class shares, stating:

> "For listed companies, the Government should permit dual class share (DCS) structures while instituting appropriate safeguards to promote market transparency and mitigate governance risks. DCS listings are increasingly being considered, for example, in industries such as information technology and life sciences."

ACGA's comments on the consultation paper and proposals relating to dual-class shares (DCS) are based on our conclusion that DCS is not a suitable policy response to the issues highlighted in the Committee on the Future Economy paper—and will almost certainly prove counterproductive for Singapore and bring harm to other parts of the region.

[1] The Committee on the Future Economy was convened in January 2016 by the Prime Minister to "review Singapore's economic strategies". Its report, published on February 9, 2017, proposed seven strategies and numerous recommendations. For a copy of the report, see: https://www.gov.sg/microsites/future-economy/the-cfe-report/overview

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Quite simply, we believe that DCS has the potential to threaten the quality of Singapore's equity market, resulting in unintended consequences that cannot be managed with "appropriate safeguards". Indeed, should SGX proceed with DCS, we believe that any benefits will likely prove short-lived and largely enjoyed by a small group of issuers and intermediaries, while the costs will be long-term and damaging to the overall market, with negative externalities both locally and regionally. Far from being a cost-free, technical adjustment to boost the funding of innovation in Singapore, we conclude that DCS has the potential to increase regulatory uncertainty in Singapore and trigger a cycle of competing policy initiatives in other Asian stock markets.

ACGA's membership is active in a diverse range of global markets and maintains significant exposure to Singapore's equity market. We are cognisant of the fact that stock markets have multiple stakeholders and that balancing diverse interests is a critical feature of any well-managed market. Nevertheless, we believe that the analysis presented in the consultation paper is compromised by a decision to conflate the interests of market intermediaries (banks, brokers, professional services firms) with the market as a whole. It does this by equating the short-term interests of intermediaries and a small group of potential issuers with positive long-term market outcomes. This runs the risk of exaggerating the potential benefits of DCS, while ignoring the fact that some of Singapore's perceived challenges relate to issues now common in many financial centres: market volatility, disruptive innovation, cost-cutting by global investment banks and asset managers, and aggressive competition for listings. Indeed, SGX is not the only market operator in the region experiencing a difficult operating environment at present.[2] At the same time, it is important to factor in recent shifts in the priorities of large institutional investors—both asset owners and managers—who are taking new steps to address their fiduciary obligations with greater attention to the long-term governance fundamentals of the markets in which they invest.

We would note also that the timing of this proposal is at odds with the orderly conduct of policy development which has benefitted Singapore as a market operator. Singapore only recently released its own stewardship code, titled "Singapore Stewardship Principles for Responsible Investors",[3] with the goal of better aligning incentives between long-term investors and corporate issuers. This important policy initiative is demonstrably at cross-purposes with differentiated voting rights of any sort. Moreover, Singapore does not yet have an institutional investor stakeholder base of sufficient breadth or depth to counteract the negative effects of DCS through the practice of stewardship alone.

We believe that the credibility of SGX's regulatory system—and much of the good work done in corporate governance over the past decade—may be called into question as a result of this DCS initiative. If Hong Kong's recent experience with its Growth Enterprise Market (GEM) is any guide, efforts to embrace less mature issuers with "safeguards" can result in heightened pressure for more active enforcement which regulators cannot always deliver.

We elaborate on these points below.

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[2] For a summary of the challenging business environment that exchanges globally faced in 2016, see the "2016 Market Highlights" report published on February 10, 2017 by the World Federation of Exchanges. The Asia-Pacific region was particularly hard hit by declines in trading volume and value, led by a sharp market correction in China in January 2016. See: https://www.world-exchanges.org/home/index.php/news/world-exchange-news/world-federation-of-exchanges-publishes-2016-market-highlights

[3] Published by the Stewardship Asia Centre on November 3, 2016. For a copy of the principles, see: http://www.stewardshipasia.com.sg/principles/singapore_stewardship_principles.pdf

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Specific Concerns

A long-term market discount?

The proposal framed by the consultation rests on a false proposition that DCS can be viewed as a targeted response to the capital needs of potentially "innovative" companies. We believe that this misrepresents the issues and the impacts of DCS on the Singapore market. The Singapore stock market enjoys a well-deserved reputation for high governance standards. The hard work of the government in supporting steady and transparent governance improvements over more than 10 years has arguably benefitted all Singapore listed companies and created a positive valuation framework for companies with a clear nexus to the Singapore economy. All other things being equal, DCS poses the risk that the value of the overall market could fall as investors price in the impact of lower governance standards, affecting the value of secondary issues, future issuers, and any related fees.

Evidence for an entrenched market discount is building, in large part because long-term institutional investors are increasingly taking their ownership responsibilities seriously and integrating governance risk into their investment process. When ACGA members were polled on the impact of introducing "weighted voting rights" and other "non-standard shareholding structures" into the Hong Kong market in 2014, members expressed the view that this would result in a long-term discount on the market's valuation. Of the 25% of members who provided a specific discount estimate, the range was between 10-25%, with an average of 13%. A further 26% believed the market would suffer a discount, but did not venture an estimate, while 7% believed the discount would only affect issuers with such capital structures. Around a third of respondents had no opinion, and only 7% said there would be no discount at all. While one could dispute the probable level of any discount, the key conclusion to draw is that a significant proportion of global institutional investors believe a discount is likely. This would have grave consequences for all investors, retail as well as institutional.[4]

Surveys conducted more recently by other groups, such as the International Corporate Governance Network (ICGN), suggest that concern over any discount from dual-class shares is growing. In 2016, 84% of respondents to an ICGN survey opposed differential voting rights and 67% indicated that they would negatively affect share valuations. Just as important, 22% responded that they would not invest in differentiated voting rights shares.[5]

Risking a race to the bottom

The proposition that DCS will give an advantage to Singapore as a market that can attract and retain mobile, "innovative" issuers ignores the strong likelihood that should Singapore proceed with DCS, it will trigger similar initiatives from other regional markets, many of which are fully capable of competing on lower governance standards. As a result, we do not envision exclusive benefits for specific issuers on the Singapore market from the implementation of DCS.

[4] "ACGA Survey on Alibaba and Non-standard Shareholding Structures" (April 2014). For a copy, see: http://64.78.5.244/pdf/acga-survey-alibaba-and-nonstandard-shareholding-structures-apr-2014

[5] ICGN Viewpoint on "Differential share ownership structures" (February 2017). For a copy, see: https://www.icgn.org/sites/default/files/ICGN%20Viewpoint%20differential%20share%20ownership.pdf

Quite the contrary, we believe that the implementation of DCS in Singapore would likely trigger a damaging race to the bottom regionally. This could limit benefits to the Singapore market and erode the valuation framework that currently benefits all Singapore listed companies, as well as potential future issuers. Most urgently, Hong Kong Exchanges and Clearing (HKEx) is considering policy options including a new third board, which would include companies with a DCS share structure. If SGX introduces DCS, it is highly likely that Hong Kong will respond in kind as quickly as possible and lure away many of the same companies that Singapore hopes to attract. If this were to happen, the interests of investors and intermediaries in both markets would likely suffer and the hope that unique competitive advantages would accrue to Singapore as a first mover would be misplaced.

We also take issue with the argument made by some intermediaries—and touched upon in the SGX consultation paper—that since markets already allow a range of securities with no voting rights (preference shares, warrants and other derivatives) then the introduction of shares with differential voting rights would make 'no real difference' to the status quo. We strongly disagree with this view. The other securities mentioned either offer a *quid pro quo* for the lack of voting rights, such as higher dividends for preference shares, or serve a different purpose (eg, investment risk management). The inequity of DCS is that shares of the same class are accorded different voting rights on an entirely arbitrary basis and offer no economic *quid pro quo*. "Safeguards" are policy tools or soft listing rules that offer no economic value and may not be properly enforced by exchanges, especially as the latter face conflicts between their regulatory and business functions.

Weak checks and balances

The decision to propose DCS for the Singapore market is premised on the notion that "appropriate safeguards" can be designed to mitigate risks in relation to entrenchment and expropriation. We appreciate the desire to examine a range of technical fixes for the flaws of DCS. Nevertheless, the consultation paper in section 2.10 identifies the two most relevant safeguards in reference markets using DCS such as the United States—stronger fiduciary obligations for controlling shareholders and an effective class-action mechanism for enforcing claims. Singapore lacks both of these basic safeguards as well as the risk tolerance common to other reference markets. As a result, we believe that none of the proposed safeguards offer credible checks and balances that would meaningfully address the governance flaws in DCS or the realities of the Singapore market context.

It should also be noted that although the sectors highlighted in the consultation paper as potential DCS issuers are often viewed as innovative, equities in these sectors are often associated with high product development risks and information asymmetries that compromise traditional disclosure practices. These are not characteristics that are normally associated with a need for reduced governance safeguards.

Taking a broader regional view, our scepticism regarding safeguards also derives from discussions we held with ACGA members in 2014 when responding to a "Concept Paper on Weighted Voting Rights" from HKEx.[6] It quickly became apparent that it would not be possible to find a set of safeguards acceptable to both controlling and minority shareholders, since anything the latter might possibly accept (e.g., very short sunset provisions of no more than three years; DCS rights limited to the founder and not inheritable; rights of veto over, or selection rights for, independent directors) would likely be wholly unacceptable to controlling shareholders.

[6] ACGA letter on weighted voting rights to HKEx, November 28, 2014. While the letter does not address safeguards in detail, we discussed the issue at some length with our members during that year. See: http://64.78.5.244/upload/files/advocacy/20170404230558_297.pdf

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We should also emphasise here that the overwhelming majority of ACGA investor members were, and continue to be, adamantly opposed to DCS in any form. Our discussions on safeguards were in response to questions from certain members and an attempt on our part to consider the issue of safeguards with an open mind.

Entry requirements made of straw

In addition to safeguards, the SGX consultation also sets out "a 'straw man' proposal on potential additional admission criteria to help respondents concretise the types of companies that may be admitted using the DCS structure". These include such things as:

- Limiting DCS structures to newly listed companies only. Existing issuers would not be able to convert.
- DCS would only be allowed for listing applicants that have a "compelling reason" to adopt such a capital structure. Most IPOs would be expected to follow the existing "one-share-one-vote" model.
- SGX would conduct a "holistic assessment" of the suitability of each IPO applicant seeking a DCS structure, including industry, size, operating track record and so on.
- Issuers with DCS structures would need a minimum market cap of S$500m to reflect "palpable investor demand".
- Issuers must have raised funds in the past from sophisticated investors, referred to in the paper as "institutional investors, accredited investors or relevant persons".

While SGX makes it clear that such criteria are only offered for the "sole purpose of soliciting feedback", we find this line of thinking to have a fragile foundation. Following the principle of regulatory equality, it would be extremely difficult to limit DCS to newly listing companies. Existing issuers would almost certainly clamour for the same rights, claiming unfair treatment and an uneven playing field. Or they would find ways to list new entities with DCS structures, possibly delisting and then relisting.

The next challenge would come when SGX and its Listings Advisory Committee are forced to make subjective judgements on what constitutes suitability, saying Yes to some applicants and No to others. Again, those rejected will complain bitterly and appeal the decision—leading to a complicated and drawn out listing process. We do not see merit in any exchange subjecting itself to such a complex process.

Furthermore, limiting DCS to companies above a certain market cap appears to contradict the very purpose of the scheme—to allow the listing of new growth companies, some of which may be relatively small yet still worth investing in. Setting any minimum size will create arbitrary distortions and/or incentives for sponsoring banks to manipulate valuations and offering size.

Regarding sophisticated investors, there is ample evidence from around the region that the presence of such funds in companies pre-IPO is no assurance of quality (as the paper would like to suggest). Some of the more high-profile corporate collapses due to fraud or governance failings in Asia have had so-called sophisticated investors involved prior to listing or suspension (and often they suffer as much as other minority shareholders). It is too simplistic to imply they are a homogeneous group, when their skill at identifying and mitigating governance risk in their investments varies so widely.

Protecting Singapore's brand

In our review of the DCS proposal, we have explored a range of trends which appear to be reducing the strategic options available to Asia's mid-sized stock exchanges. We do not take these issues lightly, especially market developments that may influence the health of broader market eco-systems. As noted above, although DCS is often portrayed as a policy initiative that can be risk-adjusted and ring-fenced, we believe that it is more in the nature of a Pandora's Box. Indeed, certain events in recent months and other developments call into question the technician's view of DCS as a simple shift to greater "diversity" for issuers, resulting in a new pool of high beta stocks for investors.

Before closing the door on the debate about encouraging new financing structures in Singapore for innovation, we would encourage the Singapore authorities to consider the following:

1. Snap Inc.'s recent NYSE IPO can be interpreted as a reset of the norms for large founder-driven technology or "innovation" IPOs. Snap's decision to list only non-voting shares could render a DCS-with-safeguards policy significantly less attractive to founder-management teams that are prepared to list globally. Indeed, in a period where stock exchanges and intermediaries are chasing IPOs, relying on short-term adjustments to market structure are less likely to generate sustained market gains.

2. Any move toward DCS would increase the likelihood that large global institutional investors will scrutinize more carefully the governance structures of Singapore-listed companies and their inclusion in important global and regional indices. The Council of Institutional Investors (CII) in Washington D.C., as well as individual asset owners, are increasingly selecting for indices with constituents that can demonstrate positive governance characteristics. This supports their fiduciary goals and research that indicates good corporate governance is well aligned with improved long-term performance. CII is also actively engaging major index providers such as FTSE, Russell, MSCI, Dow Jones and S&P to exclude Snap from major indices.

3. Academics globally have made positive contributions to the literature concerning finance and innovation in recent years. As noted in the consultation paper, the results are never entirely definitive, however, and are often time-bound. Nevertheless, one important theme that comes out of work on technology and tech bubbles of the 2000s is that there is a diverse array of financial policies that can be used to encourage innovation.

   In addition, an important distinction should be made concerning the funding of innovative <u>projects</u> versus the funding of <u>companies</u> with founder-management. We raise this issue because the academic literature is distinctly mixed on the effectiveness of DCS relative to Singapore's stated policy goals. By contrast, the literature related to funding innovation suggests multiple strategies that might be suitable which could be ring-fenced and implemented with less risk to Singapore's main market.

   It is also worth pointing out that many earlier generation tech companies in the US—such as Apple, Amazon and Microsoft—achieved their success and produced landmark innovations without recourse to DCS structures. The claims of some new-generation Silicon Valley firms that DCS is integral to their outperformance is less than convincing.

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In this letter we have chosen to restrict our response to only Question 1 of the consultation paper. In light of ACGA's view on the structural challenges posed to market integrity by DCS, we do not believe that any of the technical adjustments presented for consideration as "safeguards" merit consideration. Without more meaningful legal checks and balances such as class-action legal remedies, we are sceptical that the entrenchment and expropriation risks discussed in the paper can be mitigated effectively.

Adoption of DCS would dramatically alter the governance fundamentals of the Singapore market and lead to a long-term erosion in its reputation for quality. It would almost certainly generate contagion around the region, thus affecting standards of corporate governance, investor protection and valuations in other markets. Sadly, it will most likely be counterproductive for Singapore, as many new issuers seeking DCS structures opt to go to other markets with deeper liquidity and/or more established institutions for counterbalancing the risks of DCS.

We strongly urge the Singapore authorities to reconsider this proposal.

Yours truly,

Jamie Allen
Secretary General

(Melissa Brown, a specialist consultant for ACGA, contributed to this letter.)

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