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# Hong Kong regulators caught between rock and hard place in Alibaba IPO saga

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***Peter Guy***

*Regulators now face challenge on how to handle new structures while upholding governance*

Controversy surrounding Alibaba's potential HK$100 billion listing plan is only likely to intensify in Hong Kong in the wake of the firm's announcement yesterday that it is starting the process for a share sale in New York.

Finding a scapegoat to blame for the loss of the most eagerly awaited technology listing since Facebook's US$16 billion initial public offering last year will doubtlessly become something of a spectator sport.

But what could Hong Kong Exchanges and Clearing or the Securities and Futures Commission have done differently and does the loss of the deal now argue definitively for a change to the city's governance principles?

The key sticking point in the months-long saga was the SFC's rejection of Alibaba's demand that its partners be able to nominate a majority of the company's board.

David Neuville

This is not a persuasive argument and leads to a slippery slope of future exemptions

A key governance principle of Hong Kong's listing rules is a restriction on dual-class share structures or other schemes that allow controlling shareholders or managers to possess disproportionate voting power.

Alibaba wanted an exemption for its structure, which it said was inherent to the uniqueness of the business it had developed. As the rule book has a provision for exemptions, it could have been granted. But that reasoning might simply not have been specific enough to allow it.

"The stock exchange's listing committee cannot make a principled differentiation for exemption based on industry sector. This is not a persuasive argument and leads to a slippery slope of future exemptions," David Neuville, a partner at Cadwalader, Wickersham & Taft, told the South China Morning Post.

Joseph Lee, a principal at law firm Joseph PC Lee & Associates, says the bigger issue for Hong Kong is that enforcement of investors' legal claims against listed companies

headquartered in the mainland is problematic and imposing penalties like listing suspensions on such firms can worsen the position of investors.

"It leaves them holding shares that cannot be traded in an open market," Lee said. "Merely allowing a special class of governance or creating a new section of listing rules to suit them without a clear enforcement regime or litigation system would not be ideal."

Numerous contradictions exist between Alibaba's demands and the stock exchange's duties.

Alibaba says e-commerce on the mainland is so challenging that a uniquely talented management team must be empowered and protected from outside interference.

But, as Lee points out, if the listing company, its business and industry are so complex, is it truly a suitable vehicle for public investors?

And if the point of the structure is to keep control of vision and corporate philosophy in the face of speculative hedge fund raids, is that really a problem in Hong Kong versus New York?

"There are few hostile takeover attempts and no class-action suits. So there are fewer reasons for a controlling group to entrench itself," Lee said.

As Hong Kong's listing authorities grapple to find a way forward, perhaps the most constructive solution lies in allowing new structures, but limiting the duration and term of their special powers.

"One possibility would be to allow them special treatment, but don't allow them to pass or trade it onward. Those special rights could be specific to the controlling group at listing," said Neuville.

For example, by agreement of the controlling shareholders, the rights and ownership of Google's super voting shares cannot be passed on in perpetuity, thereby limiting their duration to the current owners.

Meanwhile, requiring greater financial disclosure from unique listings is unlikely to resolve the governance question.

"It actually sends a bad message - that regulators are so unsure of how to handle this structure that they can only ask for more disclosure and decline responsibility for addressing the structure head-on. And it implies that there is something wrong with these types of companies," Neuville said.

And if Hong Kong does eventually accept dual-class share structures, the complexion of the market may not change at all.

Many listed companies in the city are 75 per cent owned or controlled by a family or group, which means there is no difference in practice between that structure, a partnership scheme and dual-share classes.

"Either can effectively do whatever they want with the business and inflict their whims on minority shareholders, subject to their fiduciary duties and short of committing fraud," Neuville said.

Arguably the best test of corporate governance is how the market prices the firm's stock.

"It is better to disclose the governance structure and let the market and investors make their own decisions."

Meanwhile, the decisions ahead for the SFC and the stock exchange are some of the toughest in the history of the city's share market.

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