WHAT THE MARKET EXPECTS OF CONTROLLING SHAREHOLDERS

For all the excitement and razzamatazz, the flotation of Alibaba in New York in September was a controversial event. Although Hong Kong might have appeared a more natural venue for a big Chinese company, Alibaba chose New York because the American market was prepared to go along with arrangements that give a key group of top managers a controlling interest well out of proportion to their financial stake.

Alibaba is thus one of a growing line of flotations in the US – Google, Facebook and Apple are similar – which do not respect the principle, often known as one share one vote, in which control rights are shared in proportion to the financial stake in the company held by investors.

Hong Kong's reservations about Alibaba reflect a view that there is a basic fairness in the one-share-one-vote. Because the financial risk is shared by all investors, it ought to be the case that the control rights, which enable investors to protect themselves against that risk, are also equally and proportionally shared. The high demand for the Alibaba shares and the growing prevalence of these kinds of arrangements in the US and other markets suggest, however, that the market view is more nuanced. It is thus worth taking a look at the pros and cons.

Supporters of extra control rights for founders or other key shareholders usually make the following arguments.

They say that founding shareholders may be reluctant to list their shares if they lose control over the company they have built up. This could damage the firm's prospects because it may not have access to the capital it needs to expand. At the same time investors would lose out on the opportunity to profit from the efforts of the founder. Since the founder is the one whose talent and energy built the company – and by implication did all the work - it is perfectly reasonable to allow him or her to keep control.

Besides, a well-entrenched controlling shareholder can take a coherent long term view of strategy rather being pushed around by the vagaries of a short term stock market. Too often the corporate strategy of big listed companies is driven by the short term expectations of investors who want returns now rather than in the distant future, even if this comes at the expense of long term opportunities. Enhanced control rights are seen as an antidote to the short termism that plagues many Western markets.

There is also a legal argument. If both the founding shareholders and those that are buying the shares are content with the restrictions on minority control rights, then they

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should be entitled to agree to this. To prevent them doing so amounts to an infringement of their freedom of contract, which is a basic right.

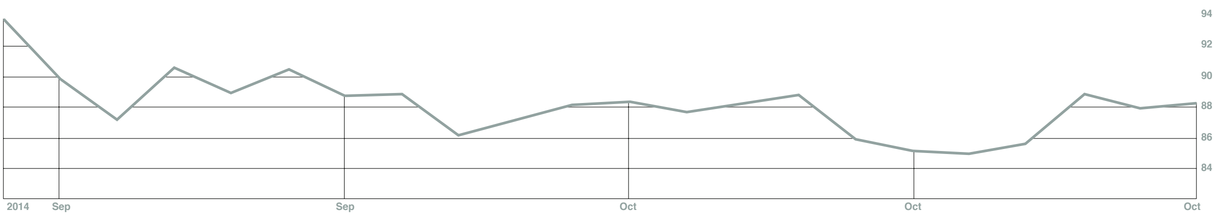
With the excitement around big flotations like Alibaba, even though the aftermarket can sometimes bring disappointments, it is easy to assume that these arguments should hold sway, but there are some strong arguments on the other side as well, which explain the refusal of Hong Kong to authorise the listing.

Enhanced control rights are usually all right as long as the minority shareholders are doing well. When this is no longer the case, either because the company has hit a difficult patch or because the controlling shareholder is extracting benefits at the expense of the minorities, things start to look a little different. Over the last couple of years some overseas mining companies listed in the UK market, notably Bumi plc and Eurasian Natural Resources(ENRC), gave very big problems because of the behaviour of dominant shareholders which caused the minorities serious financial losses. As a result the UK Listing Authority has revised its rules to allow, among other things, some safeguards over the election of directors when there is a controlling shareholder.

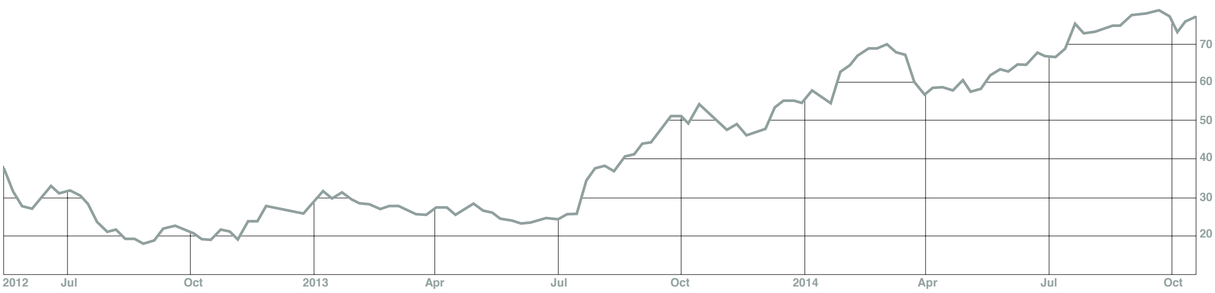
Since their fingers have been burned, large international investors are generally wary of arrangements which unduly protect and enhance the control rights of block holders. Their concern is that the controlling shareholder may use his or her power to divert entitlements to him or herself at the expense of the minorities. The risks are especially large when the controlling shareholder also owns companies that are not listed and is moving assets between them.

Enhanced control rights reinforce these concerns. They can also mean that management becomes entrenched and cannot be dismissed even if it is running a completely flawed strategy. Nor can the company be taken over, if things have reached the stage where it is better under a different owner. This is not to say that takeovers are always a good idea, but a properly functioning market in corporate control does provide a good discipline on management.

ALIBABA STOCK PERFORMANCE CHART



FACEBOOK STOCK PERFORMANCE CHART



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This is why many international investors, including large asset managers and sovereign wealth funds such as the Norwegian Bank Investment Management, which is one of the largest international investors in equities in the world, prefer companies to adopt the one share one vote principle. The question facing companies planning to list is how far to acknowledge this, especially since the international investors who are most worried are also the ones most likely to be called on to put up new capital if needed.

Even in normal times, the price of insisting on extra control rights is likely to be a higher cost of capital, since the minority shareholders will want compensation for the extra risk they are running. This can, however, be mitigated by measures to protect the minority shareholders. One idea that was suggested in the European Union in the early part of the last decade was that extra control rights should cease to operate when shareholders were voting on a takeover. In the event this proposal was rejected by the European Parliament and never implemented.

In contrast Sweden has a long established system for addressing the problem. Many Swedish companies have a controlling shareholder who enjoys extra voting rights, and the country is proud that this has given their companies the ability to take a long term strategic view of their business, but they also acknowledge the need to reach out to minorities and ensure that there is a consensus around the election of directors to the board.

For this reason Swedish companies have developed a particular approach to Nominations Committees, which normally consist of a representative of each of the four largest shareholders. Within the Nominations Committee, each member has a single vote, so that the controlling shareholder cannot force through the election of a new director who does not enjoy the support of at least two other top shareholders. When the formal election of the board happens at the general meeting, voting is on the basis of the previously allocated voting rights. The controlling shareholder will enjoy his or her extra voting rights but, because of the Nominations Committee process, cannot use them to force through directors to whom the minorities would object.

The Swedish system suits a relatively small country which values consensus but may be too cumbersome for other markets. Nonetheless, it is an example of a compromise which works and provides food for thought for companies considering flotation with extra voting rights for founding shareholders.

Two principles should operate when this is the case. First there has to be full transparency so that minority shareholders know exactly what sort of deal they are buying into. Second controlling shareholders do need to recognise the need to treat minority shareholders fairly. If they do not, their cost of capital will rise and they may fund it hard to raise additional funds from the market should they need them.

Whatever the excitement around a big new flotation, the original shareholders cannot escape the fact that the basic situation has changed. By tapping into other people's money, they have created a new set of obligations. If they do not honour these, at some point the market will exact a price.

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