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Profits and protection weigh on Hong Kong's IPO rule makers

Wednesday, April 9, 2014

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Charles Li, the chief executive of the company that runs the Hong Kong stock exchange, can't seem to drop the Alibaba topic. As the company gears up for its US$15 billion listing in New York, Li has re-opened the discussion on why the tech giant didn't make the offering in his city and how the Hong Kong exchange can avoid missing out on major IPOs again in the future.

The debate comes down to whether Hong Kong should change its listing rules to capture demand for IPOs from the growing number of technology firms from the mainland? Or should it stand firm and stick with a widely respected principle that protects investors?

Last year, Alibaba officially announced that it was seeking a public listing. Hong Kong and New York, popular with Chinese firms that float overseas, duked it out for the business. With estimates valuing the company at around US$140 billion, the prize at stake is lucrative.

But the listing comes with strings attached. Alibaba's 28 partners, who hold 10-13% of the company according to various estimates, want to retain the right to appoint managers and retain its partnership structure. They say this is vital to protect the long-term strategy and vision that they have for the company.

This is incompatible with Hong Kong's "one shareholder, one vote" principle that is designed to

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protect public investors through equality of ownership. Talks between the two parties to accommodate Alibaba's request fell apart last September. In late October, Nasdaq and the New York Stock Exchange both said they would allow it.

Hong Kong was right not to alter its rules for the sake of one company. In a region full of complex, opaque ownership structures and boardrooms where investor rights are a secondary consideration, the city has a valuable reputation for reliability.

Giving in to Alibaba would have set a dangerous precedent for other similarly important rules to be changed for firms looking to list there. Rushing the consultation process to ensure Alibaba's IPO took place in Hong Kong would have given off the harmful perception that the city was willing to drop due process and financial regulations to attract big business. Worse, regulators could get entangled in a "race to the bottom," Syren Johnstone, a Hong Kong University law professor, told *China Economic Review* in March after Alibaba's decision.

But Hong Kong is in a precarious position. Its economy is heavily reliant on financial services, an industry in which it is super-competitive; for four of the past five years, it has been the world's largest IPO market, according to Dealogic. A sign of its pulling power are the big upcoming billion-dollar listings of retailer Watson and pork producer WH Group.

Yet while it can win large conventional businesses, as well as huge commodity trades thanks to its proximity to mainland China, many people including Charles Li and investment bankers fear it is missing out on the most lucrative IPO trend – technology stocks.

Such firms excite investors and often attract massive valuations. Mainland China rivals Silicon Valley in churning out the biggest tech firms in the world by number of users. However, despite Chinese firms' preference for Hong Kong, tech companies have tended to list in New York. Since 2009, nine of the 10 biggest IPOs by Chinese internet companies have been in the US, according to Dealogic. Tencent is the only big Chinese tech firm listed in Hong Kong.

If Hong Kong cannot adjust, it stands to lose out in the new economy, some critics argue. It is already under pressure from the US, which has allowed dual-class and other share structures for almost two decades. Furthermore, the central government in Beijing wants to turn Shanghai into a global financial hub, which will inevitably come at the expense of Hong Kong. Much of the city's IPO business is from mainland Chinese companies, private and state-owned.

The city needs to move forward. As Charles Li noted, "inaction [on this issue] appears to have helped nobody in Hong Kong, but it does hurt Hong Kong's competitiveness in attracting new economy companies." He claims that investors in the US have not been negatively affected by the unconventional ownership structures of Google and Facebook. Hong Kong, he writes, could adopt special rules to give tech companies the structures that they request.

But Li's argument ignores what opponents of change cite as their biggest concern: Investor protection. US investors can hold misbehaving firms to account through class action lawsuits. Hong Kong's Common Law system does not allow for this. It is prohibitively expensive for ordinary retail investors in the city to seek redress by themselves as they must pay for lawsuits upfront. Changes to the legal system haven't been part of the dialogue.

Li is correct to call for a "more rational and open discussion about weighted voting rights and our [Hong Kong's] future competitiveness." But reforms to the system cannot be limited to the securities industry alone. A much larger framework meant to protect investors, including judicial reform, must be included in that effort if Hong Kong wants to be on par with New York. The city cannot cut itself off from a huge new market for IPOs, but neither can it abandon its principle in pursuit of profit. Now is the time to let the talks start.

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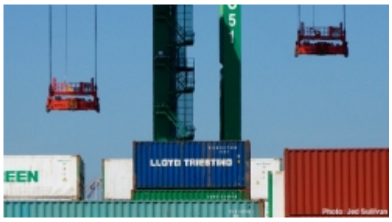

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