

7 March 2008

Submission to the ASX Regulatory & Public Policy Unit on the proposal to amend listing rules to allow non-voting ordinary shares

1. Introduction

- 1.1 Regnan welcomes the opportunity to provide comment to the ASX Regulatory and Public Policy Unit on the proposed amendment of listing rules to allow the quotation of non-voting ordinary shares.
- 1.2 Regnan is a specialist governance research and engagement entity operating in Australia. It is owned by eight leading institutional investors who are responsible for approximately A\$ 350 billion of invested funds. At the time of this submission, Regnan was retained by eleven institutional investors with a mandate to proactively identify potential governance risks and engage investee companies in relation to these risks.
- 1.3 Regnan clients invest around A\$ 70 billion in S&P/ASX200 companies (approximately one in six dollars invested by institutions in the Australian stock market).
- 1.4 This submission reflects the views of Regnan and does not necessarily represent its client organisations.
- 1.5 Regnan believes that for the proposal to introduce non-voting shares to be considered in full, it is important to provide context by identifying which stakeholder or stakeholders have made requests for such a proposal. Without this information, Regnan does not believe the market can make a truly informed assessment of the motivations which have led to this proposal.

2. Market Overview

- 2.1 The Australian share market is characterised by a large and growing group of institutional investors. According to data of the Australian Bureau of Statistics (ABS), institutional investors accounted for approximately 40 per cent of all funds invested in the Australian share market as at December 2006. Due to Australia's system of compulsory superannuation, this proportion is expected to grow in the future as contributions continue to build.
- 2.2 It is important to understand the nature of these institutions and the implications for their investment behaviour. Due to their large size and long investment horizon (the typical superannuation fund member will work and save retirement money for around 40 years), institutional investors manage risk by holding highly diversified portfolios often spread across multiple fund managers. Consequently, shares are owned across the entire S&P/ASX200 over the long-term ("permanent share ownership").

- 2.3 As a result of this permanent share ownership, superannuation funds are constrained in their ability to fully divest single stocks from their ultimate portfolio.
- 2.4 Regnan believes that this defining feature of the Australian share market should be a core consideration when debating fundamental changes of listing rules, such as the introduction of non-voting shares.

3. Regnan's Concerns

3.1 Lack of Alignment

3.1.1 Regnan firmly believes that an alignment of shareholder and company interests remains paramount to the operation of a robust and sustainable capital market.

3.1.2 ASX argues that the introduction of derivative products in Australia has already undermined the alignment of shareholder and company interests. Regnan believes that this assertion is not substantiated. While the introduction of derivatives may have led to a welcome increase in market liquidity and efficiency, we do not agree that a misalignment of shareholder and company interests is the dominant feature of Australia's listed capital markets. In fact, the large and growing level of long-term institutional investment (see 2.1) gives evidence that the alignment between shareholder and company interests remains strong. We note that the ASX has not provided any measure of the alleged impact of derivative products.

3.1.3 The argument that market efficiency will be enhanced if investors can choose whether or not they value voting rights is equally flawed. As superannuation funds inevitably invest across the entire index (refer to permanent share ownership, points 2.2 – 2.3), a large proportion of the share market will be unable to avoid stocks which are not accompanied by voting rights. AWB being held by index funds is an example of this.

3.2 Lack of Accountability

3.2.1 Regnan believes it is a prerequisite for a functioning securities market that shareholders as owners of a company are protected in their right to hold corporate executives and directors to account. The proxy voting process for director re-elections and remuneration plans currently is the primary mechanism enabling this right.

3.2.2 The assertion that shareholders who are unhappy with management performance remain free to sell their shares is false, which is again a consequence of the concept of permanent share ownership (see 2.2 – 2.3).

3.2.3 It is Regnan's view that several significant corporate failures in Australia were caused by poor governance over stakeholder interests (for example, see Commissions of Inquiry into James Hardy [Jackson] and AWB [Cole]). Watering down accountability does nothing to enable shareowners to convey their concerns and expectations to management and directors, "If shareholders as owners are unwilling or unable to

exercise their powers or make themselves heard, directors and management will lack guidance or constraint from those whose interests they are supposed to serve (sic)¹.

3.3 Entrenched Management / Abuse of Power

3.3.1 If those who own a company cannot hold that company to account, there is a risk that directors and managers abuse investor capital for self-enrichment. This can occur via payment of disproportionately high salaries, inappropriate personal use of company resources, or other related-party transactions which benefit executives/directors or other associated parties to the detriment of shareholders.

3.3.2 Responsible and effective management/directors have no reason to be concerned at such accountability, whereas poor management/directors can be nurtured by the shield of non-voting shares.

3.3.3 A lack of accountability might also induce companies to assign directors who are less independent and less committed to shareholder rights.

3.3.4 Externally-managed listed trusts already give an indication of the self-enrichment which can occur when shareholder rights and management interests are not aligned. Regnan research conducted in 2005 has revealed that externally-managed listed trusts (which by their very nature lack accountability to unit-holders/investors) without a majority of external directors exhibit materially higher related party transaction (RPT) levels than those with a majority of external directors. The proportion of RPTs to market capitalisation for those without a majority of external directors was 6.75%, compared to 0.82% for those with a majority of external directors based on 04/05 data.

3.3.5 The ASX's proposal does not provide sufficient evidence to assure that a take-up of non-voting shares would be low enough to limit the damaging effects of management entrenchment. Furthermore, Regnan does not believe there is any acceptable level of management entrenchment in Australian capital markets.

4. Non-Voting Shares – Assumed Benefits

4.1 Greater capital raising flexibility

4.1.1 While Regnan recognises that the ability to issue non-voting shares will provide another avenue by which companies will be able to raise capital, we question the net benefits of non-voting shares as an option to raise capital when credit-worthy companies would be equally capable of raising the same capital using voting shares.

4.1.2 We argue that credit-worthy companies will not gain access to capital which is not already accessible through the issuing of voting shares, but that shareholders have much to lose if listing rules changed (as discussed in section 3).

¹ [2] HIH Royal Commission @Vol 3 6.3

4.1.3 We assert that unless the ASX can produce evidence that the introduction of non-voting shares will materially assist credit-worthy companies in accessing new capital, shareholder concerns outweigh the desire for greater capital raising flexibility.

4.2 Competitiveness of ASX listed companies

4.2.1 Regnan does not agree with ASX's claim that the current inability for Australian listed companies to issue non-voting shares is a material competition issue.

4.2.2 Regnan has not observed any discernible trend of Australian listed companies shifting to foreign jurisdictions to pursue a capital structure which includes non-voting shares. It is noted that News Corporation had already been granted special use of non-voting shares in Australia prior to its shift to the US, and Regnan is not aware of any other S&P/ASX200 company which has relocated to a foreign jurisdiction for the reason of non-voting shares.

4.2.3 Regnan encourages the ASX to produce evidence to demonstrate that a shift to foreign jurisdiction is a growing trend among S&P/ASX200 companies, and that such a shift is a result of a desire to incorporate non-voting shares in the capital structure. In the absence of quantitative data to support the assertion of a competition risk, Regnan regards this risk as non-existent.

4.3 Facilitation of dually-listed company securities

4.3.1 No comment.

4.4 Listing of Australian family-owned entities

4.4.1 Regnan does not agree with ASX's claim that non-voting shares need to be introduced in order to facilitate listings of family-owned companies.

4.4.2 According to an assessment by proxy voting adviser RiskMetrics, 17 of the leading 100 listed companies in the Australian stock market are family-controlled. These companies already exhibit a share structure in which the founding shareholder retains control over at least 30% of the total holding.

4.4.3 Regnan believes that these former privately-held companies would not have listed if existing ASX listing rules had proven prohibitive to companies with a founding shareholder. So long as current privately-held companies intend to act in the best interests of all shareholders then they, too, will have no trouble securing additional capital via listing under current ASX listing rules.

4.4.4 Unless the ASX can produce evidence that such privately-held companies, acting in all shareholders' best interests, would be unable to secure capital via listing under current ASX listing rules, it is our view that shareholder concerns outweigh any desire for family-owned entities to issue non-voting shares.

4.5 Reduced reliance on debt

4.5.1 As already pointed out in 4.1, there is no evidence that the introduction of non-voting shares will result in new sources of capital for credit-worthy companies. It follows that there is no evidence the introduction of non-voting shares will assist credit-worthy companies in reducing their reliance on debt.

4.5.2 Regnan does not support the logic that introducing non-voting shares might help retain listings which may otherwise seek private equity funds. We do not regard private equity as a strict competitor to the listed capital market, since private equity investors often delist a company only to relist it again after heavily restructuring it in order to reap higher returns. The listed market is a highly relevant ‘exit strategy’ for private equity and thus there is a low level of opportunity to embark on “jurisdiction shopping” by private equity. In addition, the growing adoption of the UNPRI which is further institutionalising governance across all asset classes will only increase the consistency of governance standards expected by institutional investors.

4.5.3 Even if more privately-held companies were to pursue an initial public offering, Regnan argues that such additional listings would not benefit the market if basic shareholder rights are undermined at the same time.

4.6 Enhance capital market efficiency

4.6.1 The assertion that the separation of economic and voting interest will increase market efficiency is not supportable. While it may lead to some level of increased trading activity, this will not necessarily result in a more efficient and robust Australian listed market if shareholder rights are fundamentally eroded at the same time.

4.7 Enhance economic efficiency

4.7.1 Regnan does not support the assertion that a separation of economic and voting rights will increase economic efficiency. The separation of these two rights carries high risks, prevents investors from holding directors and senior executives to account for their actions, and ultimately disadvantages institutional shareholders who would be unable to avoid non-voting shares due to their being “permanent share owners”.

5. “Straw Man” Proposal

5.1 Regnan believes that the straw man proposal put forth by the ASX falls down due to the concerns outlined above.

5.2 In addition, some specific criticisms of the straw-man proposal are documented below;

5.2.1 There appears to be no requirement for IPO’s to list any voting shares.

5.2.2 There appears to be no requirement for listed companies to maintain an acceptable proportion of listed and liquid voting shares.

5.2.3 There appears to be no requirement for listed companies to seek shareholder approval when issuing subsequent tranches of non-voting shares.

6. Summary

6.1 Regnan is clearly against the introduction of non-voting shares for the reasons outlined in this submission.