36ONE Asset Management

THE DEVIL'S IN THE DETAIL

In August 2022, Business Live published an opinion piece entitled "Making deals with the devil" in which the author accuses the JSE of compromising its commitment to shareholder rights.[1] This follows proposed changes to the listing requirements in which the JSE changes the rules on dual class shares (DCS). Specifically, the JSE's proposal reads:

"Considering developments in other leading international markets, the JSE is proposing the introduction of dual-class shares. This proposal will be accompanied with appropriate safeguards to afford the necessary investor protection and will allow the JSE to remain competitive and to attract new listings."

The amendments to the listing requirements are being introduced at a time when a growing number of issuers are delisting from the JSE. The past few years reflect 20 delisting's in 2020, 25 in 2021 and a further 25 in 2022. Moreover, very few new listings means that the JSE experienced a net decline in listed companies over this period. In part, the decline in listings can be attributed to increased competition from alternative platforms that have less stringent rules. As a commercial for-profit exchange, the JSE competes with stock exchanges in the United Kingdom (LSE), Hong Kong (HKEX), Singapore (SGX) and elsewhere. All these exchanges are keen to attract listings from companies in high-tech industries and innovative sectors. Problematically, these companies tend to have founders that have a strong preference for DCS structures as a mechanism to retain control of the business they started and that, quite often, are strongly associated with their personal brand.

At 36ONE, we appreciate that exchanges compete and that the playing field is not always level for an emerging market exchange, and although DCS structures increase flexibility and enable founders to execute their idiosyncratic visions, we believe that DCS structures can give too much power to management and insiders. A company is able to ignore general investor opinion that can keep management in check, which in turn increases agency costs. A company may have an excellent track record without any questionable transactions that can tarnish its reputation, but there is no guarantee that this track record will be maintained in the future. This is especially true when there is no mechanism to prevent a first and isolated transgression of good management principles from snowballing into repeated (and larger) missteps. Research also shows that advantages of DCS tend to fade over time as agency costs rise and the structures become inefficient. Worryingly, when matters have gone badly wrong, public shareholders of listed DCS companies have limited to no influence to effect change. As Shari Redstone wrote in the Financial Times: *"Shareholder democracy is a burden to companies that are well run. But for shareholders, this is akin to the burden of carrying an umbrella. When it begins to rain…the cost can suddenly seem like one worth paying."*[2]

By contrast, some argue that it is up to investors to decide in which companies to invest and that investors must ultimately decide if DCS should detract from a company's value. However, in a world that has embraced passive investing, it is worth noting that these investment vehicles do not deviate from the index constituents. Furthermore, the argument that one can rely on market forces alone for investor protection is nonsensical. The lack of investor protection is the reason that we have regulators, who must ensure effective monitoring of markets and enforce high corporate governance standards when market mechanisms fail.

The JSE proposes increasing the breadth and depth of capital markets whilst still including appropriate safeguards to minimise the risk for shareholders. The proposed safeguards of the JSE include many expert recommendations, such as time-based sunset clauses, capped vote differentials between different share classes and regulated voting processes for specific decisions. If the proposal should succeed in attracting new listings to the JSE, the benefits of this piece of regulatory innovation could well outweigh the risks to corporate governance. However, the caveat remains that effective safeguards need to be in place and rigorously implemented for a successful long-term outcome. As the familiar saying goes: "The devil is in the detail."

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[1] Rob Rose: Making deals with the devil, 18 August 2022. Available at: https://www.businesslive.co.za/fm/opinion/editors-note/2022-08-18-rob-rose-making-deals-with-the-devil/

[2] Shari Redstone: A dysfunctional family reunion at CBS/Viacom, 15 May 2018. Available at: https://www.ft.com/content/a309565a-5829-11e8-b8b2-d6ceb45fa9d0