

**ICGN**

International Corporate Governance Network

ICGN Viewpoint

Stock exchanges and shareholder rights: a race to the top, not the bottom?¹

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Stock exchanges form a critical component of the global financial market ecosystem, serving as gatekeepers linking companies to investors and as a platform for trading the securities of listed companies. Investors, as providers of capital, are customers of stock exchanges, and constitute a key stakeholder base. In many areas, investors and stock exchanges are aligned in their views about promoting the health of financial markets, the protection of investors and the corporate governance of listed companies. But there are also potential areas of disconnect. These were explored in the plenary of ICGN's 2018 Milan conference and also in a private meeting in Milan between ICGN members and some representatives of the World Federation of Exchanges. The discussions focused on how stock exchanges influence corporate governance, and also raised questions about conflicts of interest and the governance of stock exchanges themselves.

Where is there alignment?

There are clear areas of shared interest between exchanges and investors. Both the investor and stock exchange communities promote sustainable value creation -- for individual companies and the integrity of the market as a whole². It was observed in the Milan conference that the public listing of companies is a social good, and contributes to the benefit of companies, as users of capital, and investors, as providers of capital. To this end exchanges play a particularly important role for investors in supporting good corporate governance through their listing and disclosure standards as well as their monitoring of for market abuse or manipulative trading.

At the same time the stock exchange and investment communities share a common concern with regard to the diminishing number of listed companies, particularly in Anglo American market economies such as the US and the UK. In a delegate poll at ICGN's Milan conference, 64% of the conference delegates agreed that costs associated with enhancing corporate governance requirements or short-termist performance pressures by traders are contributing factors behind the slowdown of IPOs and new listings in these markets. As alternative methods of finance develop to compete with traditional capital markets, investors and exchanges must ask themselves to what extent regulatory or listing burdens—or perceptions of investor short-termism may be contributing to lower incentives for public listings.

¹ An earlier version of this Viewpoint appeared in Board Agenda magazine, 11 October 2018: <https://boardagenda.com/2018/10/11/stock-exchanges-dual-class-shares/>

² Nandini Sakumar, World Federation of Exchanges, "Market Integrity: A Vision for the Future", ICGN Yearbook 2018: <http://icgn.flpbks.com/icgn-yearbook-2018/>

Potential for misalignment: the stock exchange as a profit centre

In spite of shared common ground between investors and stock exchanges, there is scope for misalignment. This potential is greatest in the case of for-profit exchanges, who themselves are listed companies. In earlier days, when the leading stock exchanges were mutual organisations, collectively owned by the brokerage community, exchanges were not operated as vehicles for capital gain. Now that this ownership model has shifted, particularly among the world's largest exchanges, it has become a very competitive sector, with exchanges around the world competing with one another to generate revenue both for listings and for a range of information and transaction services.

While exchanges have in place mechanisms to separate the “church” and “state” between listing and commercial functions, investors can expect that this greater “for profit” orientation of stock exchanges will inevitably encourage, if not pressure, exchanges to develop new initiatives for growth and the maintenance of a competitive market position. While that may be positive both for exchanges and their shareholders, the key risk that is that promoting commercial interests of exchanges in some cases may have the effect of lowering governance standards or investor protections. Specifically, investors wish to discourage the search for new growth and profits to prompt a collective “race to the bottom” on the basis of watering down listing requirements and investor rights – particularly in cases where the exchange wins, the issuer wins, the brokerage community wins, but the investor loses.

An example of this concern is articulated in the 2018 10-K (Securities and Exchange Commission annual filing) by the Intercontinental Exchange Inc. (ICE) statement on enterprise-wide risks.³ This statement not only points out the “intense” nature of competition among stock exchanges, but is also open about the exchange’s financial commitments, including “a substantial amount of outstanding indebtedness”. Having presented these competitive and financial pressures, it articulates a further risk:

“The for-profit exchanges’ goal of maximizing stockholder value might contradict the exchanges’ self-regulatory responsibilities. The listing of our common stock on the NYSE could potentially create a conflict between the exchange’s regulatory responsibilities to vigorously oversee the listing and trading of securities, on the one hand, and our commercial and economic interest, on the other hand.”⁴

While NYSE notes that it has structural protections to minimize these potential conflicts, it is also acknowledged that it cannot represent that such measures will be always successful. This is the crux of the concern. It is important to stress that these challenges are not unique to the NYSE; this is a fundamental risk for all exchanges that operate as for-profit companies.⁵

³ ICE is the parent company of the New York Stock Exchange (NYSE)

⁴ Intercontinental Exchange Inc. 2018 10-K filing with the United States Securities and Exchange Commission: https://otp.tools.investis.com/clients/us/intercontinental_exchange_group2/SEC/sec-show.aspx?Type=html&FilingId=12522714&CIK=0001571949&Index=10000

⁵ See Themis Trading Blog Feb 2017 <http://blog.themistrading.com/2017/02/stock-exchange-conflicts-of-interests/>

The risks of this exchange/investor potential disconnect can be illustrated with two current examples of market practice: the use dual class share structures and the role of high frequency trading (HFT). In both cases these practices are permissible within the scope of law and regulation—and are the source of listing, trading and data revenues for exchanges. But there are risks that these activities, while profitable for the exchanges, also can threaten minority shareholder rights of investors as key stakeholders. Many investors regard these as “grey areas”. The concern is that what may be legally or technically possible does not necessarily mean it is a good idea, without risk, or beneficial to all investors or stakeholders.

Dual class shares/shareholder rights

This ICGN plenary in Milan on the governance of stock exchanges was catalysed in many ways by the proliferation of dual class share structures in stock markets around the world. This topic has been a frequent focus of ICGN policy statements and public comment letters.⁶ ICGN and the investor community more broadly regard dual class shares negatively—insofar that they can entrench management, diminish external accountability and marginalise minority shareholder rights. The linkage of this issue to stock exchanges comes with regard to investor concern that some stock exchanges may be compromising listing standards relating to dual class share offerings as a competitive tactic to attract new listings. This represents a fundamental conflict of interest between investors and the stock exchanges with dual class share offerings.

ICGN’s most recent policy stance on dual class shares is detailed in comment letters sent in November 2018 to both ICE and NASDAQ.⁷ These letters cite the growing academic literature on dual class shares and support a recent petition by the Council of Institutional Investors (CII) in the US to introduce time based sunset provisions to new IPOs.⁸ To the strong majority of ICGN investor members who prefer a one-share one-vote structure, without any possibility for differential ownership, CII’s petition is in many ways a pragmatic compromise. It allows for dual class arrangements, for a period of a company’s life cycle, as long as there is an exit strategy through a sunset provision after seven years. From an exchange perspective, however, this challenge from investors to stiffen requirements for dual class share issues could potentially put the exchange at a competitive disadvantage to exchanges that have laxer requirements. This could have financial consequences for the exchange and the local underwriting community, so there are clear commercial pressures that may discourage exchanges from adopting, or even considering, a proposal such as the CII petition for time-based sunsets.

Even though dual share structures may be gaining ground in some markets,

⁶ See ICGN comment letters <https://www.icgn.org/policy/letters> and 2015 ICGN Viewpoint on differential ownership rights: <https://www.icgn.org/policy/viewpoints/differential-rights>

⁷ ICGN letter to ICE, November 2018: https://www.icgn.org/sites/default/files/24.%20ICGN%20Letter%20to%20NYSE%20Re%20Dual%20Class%20Share%20Structure%20s_0.pdf

⁸ See CII letter to ICE, October 2018: https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NYSE%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf

protection of minority shareholder rights remains a policy priority for ICGN and its members. ICGN will continue to engage with exchanges and to challenge the impact of dual class shares on company governance and performance.

High frequency trading

High frequency trading (HFT) is another controversial activity that serves as an important source of revenue for stock exchanges in some markets. ICGN has yet to take a policy position for or against HFT, and it is beyond the scope of this Viewpoint to do so. We recognise that HFT is legally permitted, and that it can bring the benefit of enhancing market liquidity and price formation. These benefits, however, must be weighed against the potential for market abuse. HFT enables high tech investors with powerful computers and algorithms to trade in microseconds and gain advantage over “slower” investors, both institutional and retail. Exchanges benefit by selling cable connectivity to HFT investors, facilitating in some ways an unlevel playing field and a form of equity ownership that is extremely short-term by definition. In treating company equities as simply securities to be traded – rather than as companies to invest in – HFT as a method of securities ownership is in many ways anathema to the principles of investor stewardship.

Moreover, as ICGN’s policy focus is increasingly looking at the relationship between corporate governance, responsible investment practices and systemic risks, we are alert to past “flash crashes” in stock markets prompted by HFT activity, such as the May 2010 crash in the US that disrupted markets with an intraday share price drop of over 9%. Securities regulators and exchanges are actively monitoring HFT, and some clearly fraudulent HFT-related practices relating to “spoofing”, quote stuffing or electronic front running are now illegal. However notwithstanding regulatory protections, there remains a concern that HFT, particularly at the very high-tech level, brings marginal social benefits and continues to have potential to manipulate financial markets and create unfair advantage to certain investors. Particularly given scope for in higher systemic risks for the market as a whole, this will call for ongoing monitoring by investors, as well as by exchanges and regulators.⁹

Investor expectations: exchange governance and oversight of conflicts of interest

The G20/OECD Principles of Corporate Governance makes only limited reference to stock markets, primarily their role of listing requirements and “fair and efficient price discovery.”¹⁰ The specific concerns over dual class shares and high frequency trading suggest there are broader consideration as well, and will continue to remain areas of debate, and possible contention, between exchanges and investors. They raise broad questions relating to the governance of stock exchanges themselves and how they maintain relations with the institutional investor community. Just as Section 172 of the UK Companies Act requires directors to “have regard” to the needs of key stakeholders, boards of stock exchanges should also show similar awareness of,

⁹ For a short review of HFT, including the some of the ethical questions, see: <https://sevenpillarsinstitute.org/case-studies/high-frequency-trading/>

¹⁰ G20/OECD Principles of Corporate Governance, 2015, section III: “Institutional investors, stock markets and other intermediaries”

and regard for, the concerns of institutional investors—as key customers of exchanges.

As a governance matter this is fundamentally a question of building stakeholder relations. This should include an awareness of where potential conflicts of interest exist between exchanges, investors and other stakeholders. Understanding and, when justified, mitigating these conflicts should be on the agenda of both the executive management teams and the boards of listed exchanges. Boards in particular are accountable to ensure that the exchanges resist the commercial temptation to take undue short cuts around investor or other stakeholder interests for the advantage of the exchange's own financial performance. Boards need to consider these conflicts and how the influence of the institutional investment community compares to that of the underwriting community—the companies, their brokers and their lawyers. Are investors given a fair voice and proportionate consideration relative to other exchange stakeholders? If not, how can the voice and concerns of investor be elevated?

The shared interests between institutional investors and exchanges suggest the importance of the investment and stock exchange communities maintaining and building mutual understanding to address potential concerns or areas of misalignment, but to address common interests, such as overcoming short-termism in financial markets. Constructive dialogue is one place to start, and this has begun. ICGN will continue to contribute to this debate with the exchange community, in the spirit of making a race to the top, not the bottom.

About ICGN Viewpoints

This ICGN Viewpoint was drafted by ICGN Policy Director George Dallas. While not defining a formal ICGN position on the subject, ICGN Viewpoints provide opinion on emerging corporate governance issues and are intended to generate debate. ICGN Viewpoints are produced by Secretariat and by our member-led Policy Committees, and we encourage dialogue with the ICGN Secretariat as follows:

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