CAPITAL MARKETS
DUAL CLASS SHARES

The revival of dual class shares

A number of high profile listings including Facebook, Snap, Alibaba and LinkedIn have thrust dual class shares back into the spotlight. Baker McKenzie lawyers consider the model in various jurisdictions

With household names such as Pinterest, Lyft, Xiaomi, Snap, Alphabet, Facebook, Alibaba and LinkedIn opting for dual class share structures and grabbing media headlines with their blockbuster initial public offerings (IPO) over the past few years, you might be forgiven for thinking that such structures are a relatively recent phenomenon. But dual class share structures, also referred to as weighted voting rights (WVR), have been around since the inception of the corporate form.

The controversy surrounding such structures first began in 1925 when the motor vehicle company Dodge Brothers Inc., proposed issuing non-voting stock to the public while the voting stock was retained by the shareholder, investment group Dillon Read & Co. At the time, the Harvard University professor of political economy William Ripley described non-voting stock as the "crowning infamy" of the developments taking place to disenfranchise investors. The resulting public protests led the New York Stock Exchange (NYSE) to declare that "the committee, in considering applications for the listing of securities, will give careful thought to the matter of voting control." The NYSE updated its policy in 1940 to limit the listing of non-voting common stock, although the Ford Motor Company was permitted to list with a dual class share structure in 1956. The basic prohibition remained in place until the 1980s, when companies successfully pressured the NYSE to relax its stance by threatening to move to an alternative market without such restrictions.

The spate of recent high-profile dual class share listings – and the decision in 2018 by both the Hong Kong SAR and Singapore stock exchanges to permit dual class shares – has thrust the subject once more into the public eye. While it brings opportunities for some companies to list on their preferred exchange, it also effectively paints a target on their back as both investors and regulators call for legislative and regulatory change. Will the competition among global exchanges offset growing pressure to limit disparate voting arrangements?

1 MINUTE READ

In 2018 both the Hong Kong SAR and Singapore stock exchanges revised their listing rules within months of each other to permit the listing of companies with dual class or weighted voting right shares and last year the Shanghai exchange launched a new board that permitted this structure. At the same time, a number of high profile listings have reignited the corporate governance debate as institutional investors and index funds begin a campaign to see further limits and protections imposed on their use. This article considers the dual class share landscape and the strategy adopted by Asian and other global stock exchanges.

US scrutiny

In the US, offerings by companies with dual class structures and proposed restructurings which seek to implement similar arrangements following an IPO have served to reinvigorate a corporate governance debate that has been ongoing since the 1980s. Perhaps the market's voice is getting louder with the critical spotlight recently thrown on WeWork's super voting rights structure, which would have entrenched the voting power of its founder and CEO Adam Neumann. Concern over this was a key reason for the precipitous fall in the company's valuation, which eventually led to WeWork abandoning its IPO plans. The debate has also been joined by a US Securities and Exchange Commission (SEC) advisory panel, a Trump-appointed SEC commissioner, the investment management industry, and Congress. While proponents continue to emphasise the benefits of private ordering and opponents decry the agency costs that such structures may bring, evolving market dynamics and global competition may ultimately determine the continuing viability of disproportionate governance structures for listed companies.

The last ten years has seen a dramatic increase in the level of capital allocated to passively-managed, pooled investment vehicles. Over the corresponding period and as a consequence of enhanced scrutiny following the Great Recession, a number of significant institutional investors and asset managers in the US have adopted stewardship codes and are becoming more active and engaged in the oversight function associated with their investment activities. Several large institutional investors and asset managers, as an element of their stewardship codes, have advocated for modifications to the current permissive environment that allows companies to adopt dual class voting structures. The concerns related to disparate voting rights are particularly acute for index funds, which cannot sell a security that forms a part of an index even if the company is being badly managed. For such funds, meaningful voting rights are a critical enabler of their stewardship function. While there may be support for a change to the current environment permitting dual class structures, any such change would potentially result in a competitive disadvantage for the US exchanges.

Other exchanges have signaled some flexibility in addressing the issue of dual class voting structures endorsing sunset provisions, or the potential for the non-affiliate shareholders to vote periodically to eliminate the dual class structure. In any event, with passive investment vehicles projected to exceed 50% of assets under management in the US by 2024, asset managers will play an increasingly important role in all aspects of shareholder rights, including voting rights.

With the growth of assets in passively-managed funds, the developers of popular indexes – including S&P, MSCI and FTSE Russell – have taken notice of the growing concerns regarding weighted voting. These groups have solicited the views of the asset management industry regarding potential selection criteria for companies being considered for inclusion in an index based on a company's voting structure. The Council of Institutional Investors (CII) responded in line with several other organisations, confirming its commitment to proportional voting rights and proposing that dual class companies only be included in an index provided they adopt a sunset provision. The CII proposal would allow a company to maintain its dual class structure for a period of years, and then the higher voting stock would have voting rights identical to the other class of common stock – provided the unaffiliated shareholders could vote to extend the dual class arrangement for an additional period without jeopardising inclusion in the index.

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Other views relating to dual class structures

In February 2018, the SEC's Investor Advisory Committee issued a paper regarding dual class and other "entrenching governance structures" and made a series of recommendations to the Division of Corporation Finance. The proposals included additional disclosures relating to risks that may accompany dual class structures, as well as enhanced information regarding the difference between the economic ownership of the control group versus the voting rights that accompany the super voting shares owned by that group. The recommendations reflect the traditional approach of the SEC to focus on disclosure as a means of addressing issues rather than mandating governance modifications, as in the case of some Asian stock exchanges such as the Hong Kong Stock Exchange (HKEX). While the recommendations were limited principally to disclosure items, the subcommittee's report was animated by serious reservations regarding the growing use of dual class structures by companies going public in the US.

In response to the recommendations of the Investor Advisory Committee, a bill has been introduced in Congress (the Enhancing Multi-Class Share Disclosures Act) that would enhance the disclosure obligations of issuers with respect to disparate voting structures. The enhanced disclosure would require companies to clearly show the difference between the voting power and economic rights of a shareholder or group of shareholders owning super voting shares.

The draft legislation is most notable for what it does not address. In its current form it does not authorise the SEC to adopt new rules relating to voting structures, nor does it seek to amend the federal securities laws to otherwise mandate a one-share, one-vote standard of corporate governance which, in any event, would likely be subject to constitutional challenge.

While the SEC's rule-making authority in the context of voting rights is constrained by a 1990 DC Circuit Court decision which struck down a prior SEC rule making intended to eliminate disparate voting arrangements, Commissioner Robert Jackson has urged US exchanges to adopt rules designed to preclude companies with perpetual dual class voting structures from listing on the exchanges. Instead, Commissioner Jackson proposed that the exchanges should require companies with dual voting classes to adopt sunset provisions as a condition to listing. In his comments regarding current practice, Commissioner Jackson noted that perpetual super voting shares that put "eternal trust" in the hands of insiders is "antithetical to our values as Americans".

Evolving position in Hong Kong SAR

As widely reported, Alibaba chose the NYSE for its 2016 IPO in part because the HKEX would not grant an exception to its rule prohibiting disproportionate voting arrangements. Following a public consultation in early 2018, on April 30 2018, the HKEX began accepting applications for the listing of innovative companies with WVR structures under the new Chapter 8A of the Main Board Listing Rules. Under the HKEX's reforms, only innovative companies are permitted to adopt the WVR structure for stock listings in Hong Kong SAR.

The HKEX's new rules reference the ability of companies with weighted voting rights structures to list, subject to certain limitations. To limit applicants to well-established and high-profile companies, the expected market capitalisation of a WVR company is proposed to be at least HK$10 billion (approximately $1.28 billion) and at least HK$1 billion of revenue if expected market capitalisation is less than HK$40 billion. In addition to a minimum market cap, the exchange has indicated that it will consider factors including the nature of the business of the applying company (it must be an "innovative company" with significant value and substantial expected R&D activities). Importantly, the holder of the weighted voting shares must be a person who has been responsible for the growth of the business and have an active role as an executive and director of the enterprise.

Safeguards

A basket of safeguard measures will need to be incorporated in a WVR company's constitutional documents to allow shareholders to take civil actions against the company if needed. The HKEX has also imposed other limitations intended to protect minority shareholders, such as requiring the holders of the weighted shares to hold at least 10% of the economic interests of the company, requiring a natural sunset clause. This generally dictates that the weighted voting arrangement will cease upon the transfer of the beneficial ownership of the shares or cessation of directorship in the company, and permits the non-controlling shareholders to cast at least 10% of the votes on matters presented to a general meeting.

The higher voting shares may not have voting power that is greater than 10 times that of the ordinary shares: a ratio that is commonly, although not universally, adopted among US-listed companies with dual class share structures. Additionally, resolutions relating to modifications to the constituent documents of the entity, changes to voting rights of any class of shares, the appointment of auditors and the dissolution of the entity require a vote of all shareholders on a one-vote-per-share basis.

The draft legislation is most notable for what it does not address

The HKEX is selective in opening up this new weighted share regime to new issuers. It has indicated that it will review applications on a case-by-case basis and apply the new rules subjectively, with a view towards providing additional guidance in the future. It has also made clear that satisfying the requisite listing criteria for weighted share structures does not automatically give a tech company an entry ticket to listing on the HKEX. The HKEX must also be satisfied that such issuer is the type of tech company that the HKEX wishes to attract to list in Hong Kong SAR. While the HKEX has made an unprecedented move to adopt a dual class regime to cater to market needs and increase its competitiveness in the global capital markets, it is evident that the HKEX is cautious in opening up and revolutionising its traditional one-share-one-vote regime; and safeguarding investors' interests remains one of its priorities and main focus areas.

In contrast to the US listing regime that adopts a disclosure-based regime with fewer restrictions on the WVR structure, Hong Kong SAR has adopted an enhanced disclosure and an enhanced corporate governance structure. WVR companies are required to display warnings and a distinctive W stock marker on listing documents and corporate communications.

For qualifying international companies already listed on the NYSE, Nasdaq, and the premium market of the London Stock Exchange (LSE), and for qualifying Chinese companies already listed on those stock exchanges before December 15 2017, their secondary listing in Hong Kong SAR may not require any changes to their existing WVR structures and constitutional documents. Most importantly, Chinese companies that were previously prohibited from secondary listing in Hong Kong SAR due to so-called centre of gravity restrictions are now permitted to have a secondary listing in the jurisdiction, provided they are eligible tech companies that are already listed on those qualifying stock exchanges. Some commentators suggest that this is an attempt by the HKEX to lure tech companies listed on other major stock exchanges – such as Alibaba – to return. In the context of spinoffs of WVR companies, the HKEX launched a separate consultation on corporate WVR beneficiaries in January 2020.

Singapore plays catchup

In June 2018, after two rounds of consultation, the Singapore Exchange (SGX) followed the HKEX and also introduced new rules permitting dual class share structures. Announcing the rule change, Loh Boon Chye, CEO of SGX said: "SGX…joins global exchanges in Canada, Europe and the US where companies led by founder-entrepreneurs who require funding for a rapid ramp-up of the business while retaining the ability to execute on a long-term strategy, are able to list." In doing so, Loh highlighted the increasing global acceptance of the structure, premised on the desire by exchanges to meet the demands of new economy companies with strong founder-led businesses.

Similar to the HKEX, the SGX introduced a number of safeguards intended to mitigate the risk of disparate voting structures on a non-WVR shareholder. These require an enhanced voting process where all shares carry one vote each regardless of class for the appointment and removal of independent directors and/or auditors, variation of rights attached to any class of shares, a reverse takeover, winding-up or delisting; the majority of the audit committee, the nominating committee and the remuneration committee, and each of their respective chairs, must be independent directors; multiple voting shares are capped at 10 votes a share with holders of such share limited to named individuals, or permitted holder groups whose scope must be specified at the time of the

IPO, and the multiple voting shares must include sunset clauses where such shares will auto-convert to ordinary voting shares under circumstances the company must stipulate at the time of the IPO. The new rules adopted by both exchanges attempt to reach a middle ground, permitting flexibility for high-growth companies while mitigating the governance risks associated with dual class structures.

China's rapid capital market reforms

China's company law stipulates the principle of one-share, one-vote for joint stock companies and places emphasis on equal protection for all holders of ordinary shares, in particular, equal voting rights. Against the backdrop of the Chinese government's legislative changes on company law, foreign exchange relaxation and the goal of developing a mature capital market, the WVR structure in the PRC has now been accepted as public policy. Equity securities with unequal voting rights have historically been prohibited from listing on domestic Chinese stock exchanges, and fast-growing new economy companies in China with WVR structures have faced restrictions on listing their equity securities.

When these companies have advanced to a stage that requires large-scale capital fundraisings, listing their equity securities outside of China becomes an attractive option. In the past, these companies either had to abolish their WVR structures to be eligible to list their equity securities in Hong Kong SAR, or (for those who refuse to compromise on the founders' control over the company), choose other listing venues such as those in the US. Faced with the continued loss of such companies to overseas exchanges, the Chinese government has responded. On November 3 2018, President Xi Jinping announced the decision to launch a science and technology innovation board (STAR Market), drawing immediate comparisons with the Nasdaq exchange in the US.

Moving quickly to implement this policy decision, on March 1 2019, the China Securities Regulatory Commission and the Shanghai Stock Exchange (SSE) issued a series of immediately-effective listing rules and guidance materials for the new board. One of the stated targets of the STAR Market is to attract companies with WVR structures. Such a structure must be adopted before listing and comes with other preconditions: (i) a minimum expected market cap of CNY10 billion (approximately $1.4 billion); or (ii) a minimum expected market cap of CNY5 billion and at least CNY500 million operating income for the most recent year. UCloud Technology, which operates a cloud computing service platform, became the first company to list on the STAR Market with a WVR structure in January 2020.

As with Hong Kong SAR and Singapore, certain protections have been built in for shareholders of non-WVR shares listed on the STAR Market. The proportion of voting rights of ordinary shares shall not be less than 10%; shareholders individually or in aggregate holding more than 10% of the issuer's voting shares can convene an extraordinary general meeting; and shareholders individually or in aggregate holding more than three percent of the issuer's voting shares can propose a resolution at a general meeting.

> London remains an attractive option for many issuers even while it retains its limits on dual class share structures

Can the UK hold out?

The Financial Conduct Authority has on several occasions over recent years conducted consultations with respect to potential changes to the Listing Rules that would have allowed companies with a premium listing on the Main Market of the LSE to have shares with equal economic rights, yet disproportionate voting rights, admitted to trading. The premium listing principles, set out in rule 7.2.1A, state that "all equity shares in a class that has been admitted to premium listing must carry an equal number of votes in any shareholder vote" (premium listing principle 3) and, perhaps equally importantly, that "where a listed company has more than one class of securities admitted to premium listing, the aggregate voting rights of the securities in each class should be broadly proportionate to the relative interests of those classes in the equity of the listed company" (premium listing principle 4). It is noted that the admission of non-voting shares to trading is permitted for companies with a (less prestigious) standard listing on the Main Market, although very few companies have taken that option and those which have are excluded from such indices as the FTSE.

Interestingly although the AIM rules, which apply to the LSE's junior market, do not explicitly prohibit the admission of a class of shares with restricted or no voting rights, it has been made clear in the past that AIM regulation would be highly unlikely to consider such shares eligible for admission. There is continued strong support in the UK among institutional investors for the one-share, one-vote principle to be preserved for premium-listed and AIM-quoted companies, and so far this market pressure seems to have prevailed in the corporate governance argument as to whether to allow dual class shares.

Despite pressure and the changes to the listing rules seen in Asia, London remains an attractive option for many issuers even while it retains its limits on dual class share structures. A premium listing on the LSE remains prestigious and sends a strong signal to investors about the high level of disclosure, corporate governance and regulation.

In April 2019, the Dubai-based digital payments provider Network International obtained a premium listing on the Main Market without dual class shares in the LSE's largest tech IPO since 2015. While exchanges in other money centres are relaxing regulations to encourage new economy and technology companies to list, London, for now, appears to be taking the principled stance that the dilution to its brand that it perceives would come from such a relaxation is not worth it. Arguably, the Network International listing shows that, even in otherwise dire market conditions, London remains able to attract technology companies to its board even without offering up the carrot of a dual class share structure. The question remains as to how long London's regulators and investor community will retain this confidence.

A continental perspective

While the corporate governance debate in many countries around the world has centered on the costs and benefits of allowing companies to issue multiple share classes, in recent years one line of discussion that has emerged in mainland Europe focuses on short-termism and the risk that some market participants, including shareholders, may prioritise short-term profiteering to the detriment of the company. To counter the perceived harm of the activities of certain investors such as hedge funds, some countries, including France and Italy, have adopted tenured voting (also known as time-phased voting rights or loyalty shares). These reforms are based on an argument that the long-term interests of the company are best served by long-term shareholders. To align these interests and ensure good corporate governance, long-term shareholders are rewarded with enhanced voting rights in the belief that this will defend against myopic corporate actions and promote a greater level of responsible corporate governance.

Following an earlier decision by the steel company ArcelorMittal to close its operations in Florange in France in 2014, the French government passed a new law – the *Loi Florange* – to give double voting rights to shareholders holding shares for a period of more than two years. A French company that does not wish to provide for differentiated voting rights in this manner must specifically disapply this in its constitutional documents.

There are a number of question marks that hang over this approach to long-termism. BlackRock's investment stewardship team recently released a commentary paper on the topic, in which they argue that a number of assumptions about the benefits of differentiated voting rights need to be revisited. Blackrock cites research that "introducing enhanced voting rights…will not lead to a material change to the time-horizon of investment in that company. Rather, these measures are simply control mechanisms and may be counterproductive, entrenching a core group of shareholders to the detriment of minority shareholders." It is also argued that such shareholder entrenchment produces less engagement and may raise the cost of capital.

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Implications for dual class structures

A 2007 report issued by the OECD states the issue well: "…discrepancies between ownership and control can exacerbate the misalignment of incentives of controlling and non-controlling shareholders and… a separation of voting and cash flow rights may compromise the efficiency of markets for corporate ownership and control. The questions facing authorities is whether these potential drawbacks actually manifest themselves and, if so, whether their economic costs are sufficiently large to justify regulation." There is no global consensus with respect to this issue and it remains to be seen whether competition among the major exchanges can be reconciled with evolving views of corporate governance in the asset management and institutional investor community.

No matter the outcome, the growing engagement and influence of institutional investors and asset managers with respect to the exercise of their stewardship undertakings has the potential of increasing pressure on legislators, regulators and the exchanges in the US and elsewhere to eliminate or restrict disparate voting structures. The question is whether any resulting modifications to the existing permissive private ordering approach in the US will allow for some flexibility, such as sunset provisions, or a modified listing structure like that adopted by Asian bourses as a means of protecting the competitive position of the exchanges while responding to the demands of large institutional investors and fund managers.

While a consensus may be developing in the US for the imposition of limitations on dual class voting structures, the same is not the case in other countries, with the opposite direction of travel often seen. Many foreign countries permit disproportionate voting arrangements and the stewardship codes adopted in countries outside the US do not include a one-share, one-vote principle. Moreover, the launch of the STAR Market on the SSE and the relaxation of the listing standards by the Hong Kong SAR and Singapore exchanges, to permit the listing of companies with disproportionate voting rights subject to certain conditions, presents a competitive challenge for the US exchanges seeking listings of the emerging Chinese tech giants.

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