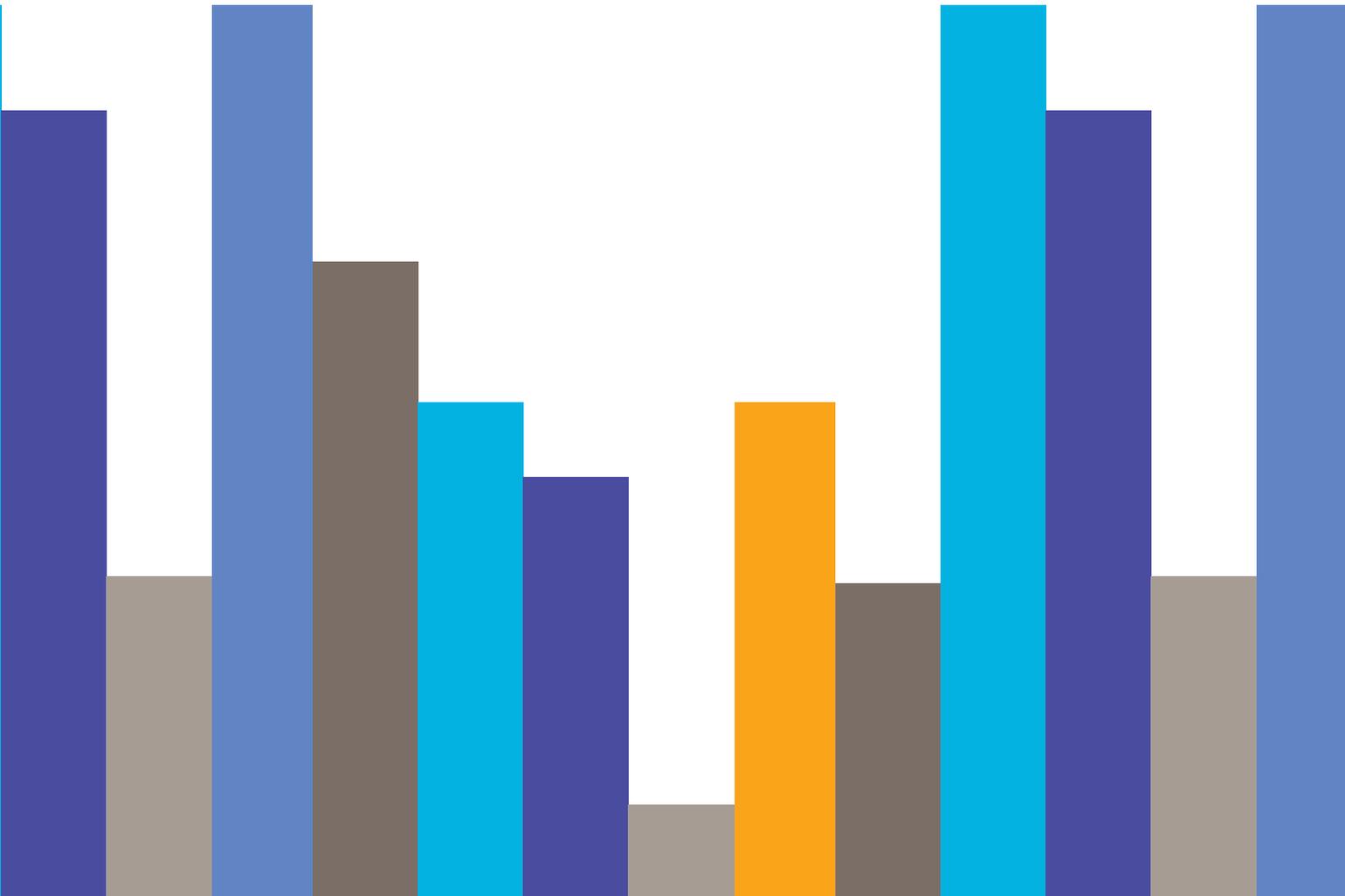




CFA Institute

DUAL-CLASS SHARES: THE GOOD, THE BAD, AND THE UGLY

A Review of the Debate Surrounding Dual-Class Shares
and Their Emergence in Asia Pacific





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1. Executive Summary

— The existence of dual-class shares (DCS) has generated much debate for over a century. Sometimes known as shares with weighted voting rights or unequal voting rights, DCS structures provide owners of certain share classes with superior voting rights, giving them voting control over a company that is disproportionate to their equity shareholding. DCS structures are most common in founder-led companies where:

- the founders are perceived to be instrumental in the success of the company;
- to be able to fund rapid growth, the company has had to raise a significant amount of funding before an initial public offering (IPO); and
- the founders are averse to a change in control and thus use such structures as a poison pill, or defense mechanism.

In these situations, granting the founders super voting rights allows them to maintain control while giving investors an opportunity to participate in the company's growth.

Although DCS structures are not new—having first come into existence in the late 19th century—such structures have become increasingly commonplace in recent times on the back of a wave of high-profile IPOs of technology companies, such as Google LLC (now Alphabet Inc., 2004), LinkedIn Corporation (2011), Facebook, Inc. (2012), Alibaba Group Holding Limited (2014), and Snap Inc. (2017). According to Ritter (2017), in the five years between 2006 and 2010, there were a total of 46 DCS IPOs in the United States.¹ In the following five years (2011–2015), the number rose to 104. The popularity of DCS IPOs has renewed the debate on how these structures affect corporate governance and investor protection.

Proponents like DCS because they protect the founding shareholders and beneficiaries of super voting rights from the vagaries of the stock market. Their voting power ensures them absolute control, giving them the opportunity to carry out their vision and invest in the long term for the benefit of all shareholders.

Another argument for supporting DCS is that many entrepreneurs would simply choose not to take their companies public if they could not retain control; this would deprive investors of opportunities to invest in growth companies.

¹Ritter, Jay R. 2018. Initial Public Offerings: Updated Statistics. Available at https://site.warrington.ufl.edu/ritter/files/2018/07/IPOs2017Statistics_July11_2018.docx

The very reasons that make many DCS companies widely admired are also the same reasons critics use to argue against DCS. Safe from the disciplinary forces of the market, founding shareholders never have to worry about losing their jobs—their voting control sees to that. If they are fitting leaders, all may be well and good. However, if they mismanage the company or make bad decisions, unaffiliated shareholders are powerless to do anything about it. Their only remedy is to sell their shares in a disillusioned market. In addition, given the low equity shareholding these founders typically have, bad decisions proportionally affect them much less. The gap between high voting power and low equity shareholding is often referred to as the “wedge”, and the larger the wedge, the more serious the distortions become.

DCS have a much longer history in Western countries; they are much less prevalent in the Asia-Pacific region (APAC), although this is rapidly changing. As recently as a few years ago, Singapore and Hong Kong, two of the leading financial centers in the region, rejected listings of companies with DCS structures and stood by the one-share, one-vote principle. However, such rejections did not put the DCS argument to bed, and the debate intensified in subsequent years. Both Singapore and Hong Kong are keen to attract IPOs from companies in high-technology, innovative sectors, and founders of such firms have strong preferences for DCS structures. The quest for these IPOs became more urgent as global stock markets reached new highs, propelled by soaring prices of technology stocks (in particular, those listed on the US stock markets).

For Singapore, losing out on Manchester United PLC’s IPO in 2012 prompted the government to undertake a comprehensive review of the country’s Companies Act.² This review made a number of recommendations, including an amendment to the Companies Act to allow for DCS companies. Subsequent endorsement by Singapore’s parliament in 2014 paved the way for IPOs of companies with DCS structures.

In Hong Kong SAR, Charles Li, the Chief Executive of the Hong Kong Exchanges and Clearing Limited (HKEX), the owner of the Stock Exchange of Hong Kong (SEHK), admitted that the IPO of Alibaba on the New York Stock Exchange (NYSE) in 2014 made HKEX reconsider its stance to DCS IPOs.³ HKEX’s first attempt to introduce DCS IPOs in 2014 was unsuccessful. Its second attempt, which began in 2017, proved far more fruitful. The new administration of the Hong Kong Special Administrative Region, led by Chief Executive Carrie Lam and Financial Secretary Paul Chan, voiced their belief that landing DCS IPOs would strengthen Hong Kong’s position as a leading international financial center.

²Ministry of Finance and Accounting and Corporate Regulatory Authority (October 2012) Ministry of Finance’s Responses to the Report of the Steering Committee for Review of the Companies Act.

³NYSE’s company rule allows Alibaba’s partnership—made up of selected management members of the company and Alibaba’s related companies and affiliate—to have outsized influence over the board’s decisions relative to its economic exposure in the company’s stock.

Not unexpectedly, given this background, both HKEX and Singapore Exchange (SGX) amended their listing rules in the first half of 2018 to allow DCS IPOs. A pipeline of DCS IPOs is already in the works, and Xiaomi Corporation, the world's fourth-largest smartphone maker by shipment, became the first DCS IPO in Hong Kong with a value of US\$54 billion. Reportedly, companies from various markets have asked for more information about the revised listing regime, indicating their interests in listing with DCS structures.

Despite these recent developments, CFA Institute remains firm in the belief that “one-share, one-vote” remains the fairest and most optimal market practice. We are concerned that allowing DCS structures will lead to an erosion of corporate governance standards and are worried that we are witnessing the start of a race to the bottom. Unfortunately, given the number of commercial, for-profit stock exchanges in APAC, this trend is unlikely to stop at the Hong Kong and Singapore exchanges. Under this scenario, we ask three questions:

- What are the safeguards that investors can most rely on?
- What are the lessons learned that are most applicable for investors, standard setters, and regulators in APAC?
- Who should investors look to for investor protection?

To answer these questions, we have (1) assessed developments in other markets (notably the United States), (2) conducted a range of literature review on the subject, and (3) interviewed a number of practitioners from different parts of the industry. We also conducted a survey in March 2018 to gauge the views of our members on the introduction of DCS and the necessary safeguards in APAC (CFA APAC Survey). Details of the survey are in Appendix A; we will refer to the CFA APAC Survey throughout this report.

Many exchanges and regulators in the region are watching developments in the Hong Kong and Singapore markets closely and may be deliberating whether to follow suit. As DCS companies become more widespread in APAC, we believe that investors need to become more familiar with such structures, the common safeguards that are being offered, and the limitations of such safeguards. Our study will be a useful point of reference for their policy development.

In Chapter 2, we review the debate for and against DCS as well as look at the performance of DCS companies with the passage of time and examine the implications for policymakers. Chapter 3 focuses on the historic development of DCS in the United States—the rise and fall of the DCS structure in the United States holds interesting lessons for us all. A review of regional APAC developments is found in Chapter 4, followed by an assessment of common safeguards in Chapter 5. Some case studies that illustrate how DCS companies have hurt investors are covered in Chapter 6. In Chapter 7, we conclude by providing recommendations to improve investor protection in the face of the increasing prevalence of DCS companies.

Summary of Findings

Lessons Learned

From the history of DCS usage in the United States, we learned the following:

- The current boom in DCS listings has very similar hallmarks as the previous high watermarks in DCS listings in the United States during the 1920s and 1980s, including increased liquidity and outsized optimism.
- The booms in the 1920s and 1980s were each followed by a prolonged period of market turmoil.
- The rise and fall (and rise again) of DCS listings in the United States shows that the present situation is neither inevitable nor unique, and that there are many more options than a wholesale adoption of DCS structures.
- For stock exchanges contemplating joining the fray, it is perhaps appropriate to reflect on their own unique selling propositions. If and when there is a level playing field in rules, and issuers cannot arbitrage between exchanges, what are the factors that would make one stock exchange more attractive than another?

From the handful of case studies, we learned the following:

- For family businesses with a DCS structure, it is much easier for major shareholders to abuse their position and take advantage of public shareholders, either through massive executive compensation packages or questionable consultancy arrangements.
- Major shareholders are not incentivized to maximize the company's potential—after all, given their low equity ownership, few benefits would accrue to them.
- A company may have an excellent track record, but there is no assurance that such outperformance will continue indefinitely. When things go wrong, public shareholders of listed DCS companies have little influence—without a vote, they cannot provide oversight of boards or management. As the *Financial Times* said, “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.”⁴
- Time is not on our side. Perpetual super voting rights that are transferrable store up trouble for the future.

⁴The FT View. 2018. “A dysfunctional family reunion at CBS/Viacom.” *Financial Times*.

Safeguards

We have considered a range of safeguards and examined their effectiveness in relation to investor protection. Our recommendations are as follows:

- **Mandatory time-based sunset:** We have been urging exchanges that have DCS structures in place to consider mandating time-based sunset provisions, which means super voting rights will automatically convert to regular voting rights on a “one-share, one-vote” basis after a period agreed upon between management and investors.

In our view, the single most important safeguard is a mandatory time-based sunset of not more than five years. On the one hand, this safeguard provides enough time for founding shareholders to execute their strategy and create value without undue worries of market vagaries; on the other hand, it protects public shareholders from entrenchment.

- ▲ We note that five years is the absolute maximum time period, especially because issuers now come to the market at a much later point in their life cycle and are already large, established companies by the time they list on an exchange.
- ▲ We believe the time-based sunset provision should be a “hard stop” for clarity and certainty.
- ▲ Corporate and evergreen entities should not be allowed to benefit from super voting rights without a mandatory time-based sunset provision.
- **Event-based sunset:** Super voting rights attached to beneficiaries’ shareholdings should lapse if such beneficiaries:
 - ▲ are no longer directors of relevant companies; or
 - ▲ die or are incapacitated; or
 - ▲ transfer their shares to another person.
- We believe the event-based sunset provision should be a “hard stop” for clarity and certainty.

We believe the following safeguards are also important when enacted as a “package” together:

- Implement enhanced corporate governance measures.
- Limit the maximum voting differential (to below 10 votes per share).
- Revert to a one-share, one-vote system on related party transactions and large transactions.

Enhancing Investor Awareness

We cannot rely on market forces alone for investor protection. Rather, stakeholders must play an important role in protecting themselves:

- Investors need to perform thorough due diligence.
- Exchanges need to balance the tension between business development and upholding a high corporate governance standard.
- Regulators need to ensure effective monitoring and enforcement.
- The courts in the United States have taken on significant responsibilities in upholding investor rights. However, even in jurisdictions where courts have a history of stepping in and intervening, it can take years for cases to be resolved.

In APAC, legal action against rogue companies or management is not an avenue available to most investors. In markets where direct retail participation is significant, not only does the caveat emptor (i.e., buyer beware) argument offer scant comfort to investors, in times when many investors feel taken advantage of, they inevitably turn to governments and regulators for assistance, which is seldom forthcoming.

Our recommendations, therefore, are as follows:

- Exchanges and regulators should coordinate their efforts and invest in investor education and awareness.
- In jurisdictions where class and derivative actions are unavailable or uncommon, governments and regulators should establish a mechanism to enable small investors to seek recourse.
- Regulators must intervene in a timely manner when investors are taken advantage of or harmed.

DCS structures are a relatively new development in APAC. CFA Institute will continue to remain watchful of market developments and work with stakeholders to raise investor awareness. We will continue to engage with regulators and stock exchanges going forward.

2. What Is Right and Wrong about DCS Structures?

The advantage of a dual-class share structure is that it protects entrepreneurial management from demands of ordinary shareholders. The disadvantage of a dual-class share structure is that it protects entrepreneurial management from demands of ordinary shareholders.

Andrew Hill, *Financial Times*⁵

In the CFA APAC Survey undertaken in March 2018, marginally more respondents (53%) were opposed to DCS structures than in support of them (47%).

In terms of opportunities with regard to the introduction of DCS listings, the three most recognized benefits by respondents include

- boosting the attractiveness of the exchange as a landing spot for IPO issuers (47%);
- attracting companies from technology and other innovative sectors (44%); and
- providing access to funding for preprofit companies (22%).

In terms of the associated risks, the three most recognized concerns include

- insufficient or absence of minority investor protection (53%);
- skewed proportionality between ownership and control (52%); and
- race to the bottom in terms of corporate governance standards (28%).

If the above results appear inconclusive, it is because the use of DCS structures is a polarizing issue. In this chapter, we draw on research and academic studies on this subject and examine the following issues:

- arguments for and against DCS
- performance of DCS companies
- how the passage of time affects the efficiency of DCS structures

⁵Hill, A. 2011. "Enrolment open for an MBA in Murdoch." *Financial Times*.

Last, at the end of this chapter we include three interviews with industry stakeholders who have different perspectives on this issue: that of a stock exchange, an asset owner, and a professional services firm.

2.1 Arguments for DCS Structures: Control, Investor Choice, and Market Breadth

The single most important feature of DCS structures is that they give founders, entrepreneurs, and other corporate insiders voting control of the listed entity, even though their equity stake may be reduced below a simple majority after successive rounds of financing. Proponents for DCS structures argue that such control is desirable because it allows charismatic, visionary founders and entrepreneurs to execute their vision (especially in the early years of a public company) without having to worry unduly about stock market performance. The important assumption here is that the potential gains associated with the founders' expertise and vision would exceed the potential associated drawbacks.

The control inherent in a DCS structure allows founders the freedom to execute their idiosyncratic vision. According to Goshen and Hamdani (2016), there exists "a fundamental tradeoff, stemming from asymmetric information and differences of opinion, between the entrepreneur's pursuit of her idiosyncratic vision and investors' need for protection against agency costs," which is at the center of the debate on DCS.⁶ When the founders' vision is value creating, it would be in everybody's interest for them to stay in power and steer the company.

An example of this argument is Facebook Inc.'s acquisition of Instagram, Inc. in 2012. With 28% of Facebook's equity stake and 57% of its voting rights, founder Mark Zuckerberg could "act independently if he wants." He did, in fact, decide to do so. Without consulting Facebook's board or other unaffiliated shareholders of the company, he decided to purchase Instagram for US\$1 billion. His rationale was that the transaction price was half of the original asking price of Kevin Systrom, cofounder of Instagram.⁷ Given his control position, Zuckerberg was able to move quickly to seal the deal. Fast forward to 2018, Instagram was estimated to be valued at US\$35 billion, proving this to be a significant value-enhancing transaction and seemingly vindicating Zuckerberg's decision.

Indeed, proponents of DCS structures argue that investors very often invest in a company because of the "trust" they have in the founders and entrepreneurs behind such companies.

⁶Goshen, Z. and A. Hamdan. 2016. "Corporate Control and Idiosyncratic Vision." *The Yale Law Journal*. 125(3): 560–795.

⁷Raice, S.R., S.E. Ante, and E. Glazer. 2012. "In Facebook Deal, Board Was All But Out of Picture." *Wall Street Journal*.

They argue that it should be up to investors to decide whether or not to invest in these companies and how they should value such opportunities. In an efficient market, this will thus be an optimal arrangement between investors and issuers: investors who acquire DCS companies are willing to put up with a corporate governance framework that is exposed to potential agency costs (Sharfman, 2017).⁸ In a perfect world, company founders and unaffiliated public shareholders can strike a deal that presents the optimal level of voting differentials and economic benefits for each share class. This explains why Magnan and Khalil (2007) found price differentials between shares in the same companies with different voting rights.⁹ All things being equal, shares with inferior voting rights trade at a discount to those with superior voting rights. Such discounts range between 3% to 10.5% in the United States, 7% to 20% in Canada, 12% in Sweden, 19% in the United Kingdom, and 82% in Italy. In essence, there is a price for everything.

According to Cleary and Alderighi (2018), family firms have a strong desire for long-term control of the company; and such a desire could prevent private family firms from getting publicly listed.¹⁰ Because DCS structures provide a degree of protection from stock market shocks for young and newly listed companies, supporters of DCS argue that the availability of such listing structures would help overcome the reluctance of private firms to list, thereby increasing the breadth and depth of capital markets and allowing more investors to participate in the growth of such companies.

2.2 Arguments Against DCS Structures: Agency Cost, Entrenchment Risk, and Lack of Accountability

The high degree of control that allows founders and entrepreneurs to run their companies unchallenged has its downside. Without the necessary or sufficient number of votes, public shareholders can find it very difficult to exercise stewardship and hold management to account.

DCS structures induce agency costs that hurt general investors by giving more power to insiders who are both management and shareholders the voting power of these insiders is disproportionate to their low equity ownership. Against this backdrop, insiders could be induced to extract private benefits from having control of company decisions (i.e., managerial entrenchment), thereby not acting in the best interest of all shareholders.

⁸Sharfman, B.S. 2017. "How Dual Class Shares in IPOs Can Create Value." Business Law Blog. University of Oxford.

⁹Magnan, M., and S. Khalil. 2007. "Dual-Class Shares: Governance, Risks, and Rewards." *Ivey Business Journal*, May-June.

¹⁰Cleary, S., and S. Alderighi. 2018. "Family Firms and Listing: Opportunities for Public Capital Markets." World Federation of Exchanges.

Nicholas and Marsh (2017) described the issuance of shares with disparate voting rights as creating “a bulwark for managerial entrenchment.”¹¹

Existing literature suggests that DCS structures would reduce the oversight of public, unaffiliated shareholders who have the majority of the economic stake but a minority of votes, thereby reducing management’s accountability to these shareholders. Such structures hinder the ability of the board of directors to exercise their duties as fiduciaries.

This concern is in line with the findings of Grossman and Hart (1988), who suggested that DCS would lower the chance of company management accepting efficiency-improving takeover proposals.¹² Similarly, Holmen and Nivorozhkin (2007) concluded that DCS structures reduce the likelihood of family controlled firms accepting value-enhancing takeover offers.¹³

As Bainbridge (2007) put it, “Incumbents who cannot be outvoted, after all, cannot be ousted.” The presence of such agency costs is typically accompanied by lower firm market valuations.¹⁴ According to Shen (2016), “Other things being equal, an increase in a wedge between voting rights and cash flow rights results in a decrease in firm value.”¹⁵ Claessens and colleagues (2002) argued that agency problems associated with entrenchment and value extraction would be even more pronounced as the divergence between control rights and cash-flow rights grows.¹⁶

Corporate governance advocates also argue that in the absence of adequate investor protection, the permission to issue DCS could hurt the medium- to long-term development of the market. For instance, Martinez (2018) suggested that if corporate governance and investor protection are not properly in place, the reputation and status of the market could be damaged, causing investors to leave.¹⁷ In the long run, companies listed on such stock exchanges would also be hurt because their ability to raise new funds would be diminished.

In a seminal paper, Wen (2014) concluded that the “decoupling of voting rights from economic ownership is detrimental to shareholders because it allows companies to avoid the threat of market mechanism that have traditionally served to keep management in

¹¹Nicholas, B.A., and B. Marsh. 2017. “Dual-Class: The Consequences of Depriving Institutional Investors of Corporate Voting Rights.” Harvard Law School Forum on Corporate Governance and Financial Regulation.

¹²Grossman, S.J., and O.D. Hart. 1988. “One Share-one Vote and the Market for Corporate Control.” *Journal of Financial Economics*, 20: 175-202.

¹³Holmen, M. & E. Nivorozhkin. 2007. “The Impact of Family Ownership and Dual Class Shares on Takeover Risk.” *Applied Financial Economics*, 17:10, 785-804.

¹⁴Bainbridge, S.M. 2007. “The Scope of the SEC’s Authority over Shareholder Voting Rights.”

¹⁵Shen, J. 2016. “The Anatomy of Dual Class Share Structures: A Comparative Perspective.” *Hong Kong Law Journal*, vol. 46 no. part 2, 477-510.

¹⁶Claessens, S., S. Djankov, J. Fan, and L.H.P. Lang. 2002. “Disentangling the Incentive and Entrenchment Effects of Large Shareholdings.” *Journal of Finance*, 57: 2741-2771.

¹⁷Martinez, A.G. 2018. “Should Securities Regulators Allow Companies Going Public with Dual Class Shares?” Blog, University of Oxford.

check. In the long term, this decoupling is incompatible with the principles of corporate governance, and thus stock exchanges should reevaluate their policy of accepting companies with dual-class stock structures.”¹⁸ The position of BlackRock, Inc., the largest investment management company by assets under management globally, is similar to that of Wen:

As a fiduciary managing assets for our clients, BlackRock strongly supports the principle of ‘one-share-one-vote’. It is at the core of corporate governance that, to reduce the agency problem, all shareholders need to effectively monitor companies. DCSs disenfranchise entire class(es) of shareholders and amplify the risk of the controlling shareholders and the management extracting private benefits to the detriment of the company’s and shareholders’ long-term economic interests. Moreover, voting is a core accountability mechanism for investors. In our experience, companies with DCSs have less incentive to engage with those shareholders with inferior voting rights.

Bennett and Pun, 2017¹⁹

According to Klein and Gold (2017), Glass Lewis & Co., a proxy advisory firm, considers that a “one-share, one-vote” structure optimal as it promotes the alignment of all shareholders in a company.²⁰ Glass Lewis believes that investor rights are “severely restricted” in DCS companies. As a result, in its 2018 voting guidelines for the United States, the firm continues to recommend to shareholders that they vote in favor of recapitalization plans that would remove DCS structures and vote against proposals that recommend the adoption of new common classes.

Supporters of DCS structures argue that if investors do not like DCS companies, they do not have to invest in them. This may not be possible for passive investors who cannot deviate from benchmark indices and are therefore forced to invest in DCS firms.

Commenting on Facebook’s voting structure,²¹ Institutional Shareholder Services, Inc. (2012) suggests that it was a “Hobson’s choice” for investors, who were either forced to accept Facebook’s governance structure that had “a defense against everything except hubris” or to “miss out on what appears to be one of the hottest business models of the internet age.”²²

¹⁸Wen, T. 2014. “You Can’t Sell Your Firm and Own It Too: Disallowing Dual-Class Stock Companies from Listing on the Securities Exchanges.” *University of Pennsylvania Law Review*, 162(6): 1495–1516.

¹⁹Bennett, P. and W. Pun. 2017. “RE: Concept Paper on New Board.” BlackRock.

²⁰Klein, E., and B.S. Gold. 2017. “ISS and Glass Lewis 2018 Proxy Guidelines Continue to Expand Shareholder Influence.” Alert. Schulte, Roth & Zabel.

²¹Facebook’s Form S-1 Registration Statement in 2012 suggests that “Mr. Zuckerberg, who after our initial public offering will control more than % of the voting power of our outstanding capital stock, will have the ability to control the outcome of matters submitted to our stockholders for approval, including the election of our directors.”

²²Institutional Shareholder Services. 2012. “The Tragedy of the Dual Class Commons.” *M&A Edge Note: North America*.

This is, an issue asset manager Fidelity Management & Research Co. faced. According to Scott Goebel, in his then-capacity as the general counsel of Fidelity, companies adopting a DCS structure are “less likely to have alignment and less likely to have the accountability” (Kristie, 2012).²³ At the same time, although recognizing that DCS firms’ accountability to shareholders would “at least be mitigated if not completely eliminated,” Goebel argued that he would still invest in such companies.

2.3 Performance of DCS Companies

Fundamental and philosophical arguments aside, most investors are pragmatic—they will pursue an opportunity if they perceive value. So, how have DCS companies performed in the stock market? Unsurprisingly, the answer is not straightforward. Similar to the arguments on both sides of the DCS divide, some studies conclude DCS companies outperform, while other studies conclude the opposite.

Looking into stock price performance of DCS firms, Gompers and colleagues (2008), using US-listed DCS firms’ cash flow and dividend behavior between 1995 and 2002 as their key parameters, found that a firm’s value tends to be positively correlated with insiders’ cash-flow rights and negatively associated with insiders’ voting rights.²⁴ The findings show that firm value would be adversely impacted by a misalignment between voting rights and equity stake.

Although Berger and Hodrick (2018) acknowledged that DCS firms could outperform single-class firms, as shown in other empirical studies, they believe it would be premature to “make a definitive determination from an economic standpoint as to whether having dual-class stock is better or worse for investors in the current market environment, especially for younger companies.”²⁵ According to the Berger and Hodrick, further research on relevant issues, taking into account aspects such as corporate control, liquidity, and capital allocation, is warranted.

Following an examination of Canadian industrial companies, Allaire (2016) suggested that financial performances of these Canadian DCS companies would outperform the peers over 5-, 10-, and 15-year periods (see **Exhibit 1**).²⁶ Allaire considered that the superior financial performance would help these firms maintain their headquarters in Canada and argued that such share structures help important Canadian industrial players fend off hostile takeovers, especially when the country’s currency is weak (e.g., in the early 2000s).

²³Kristie, J. 2012. “Dual-Class Stock: Governance at the Edge.” *Directors & Boards*, Third Quarter 2012.

²⁴Gompers, P.A., J.L. Ishii, and A. Metrick. 2008. “Extreme Governance: An Analysis of Dual-Class Companies in the United States.” AFA 2005 Philadelphia Meetings; Rodney L. White Center for Financial Research Working Paper No. 12-04; Rock Center for Corporate Governance Working Paper No. 39.

²⁵Berger, D.J. and L.S. Hodrick. 2018. “Are Dual-Class Companies Harmful to Stockholders? A Preliminary Review of the Evidence.” Harvard Law School Forum on Corporate Governance and Financial Regulation, 15 April 2018.

²⁶Allaire, Y. 2016. “Enough with the Shibboleth on Dual Class of Shares.” Le MÉDAC.

Exhibit 1: Performance of Canadian Dual-Class Firms, Compared to Single-Class Firms (or Reference Index) Over 5-, 10-, and 15-Year Periods

SOURCES	5-YEAR		10-YEAR		15-YEAR	
	DUAL-CLASS	SINGLE-CLASS OR INDEX	DUAL-CLASS	SINGLE-CLASS OR INDEX	DUAL-CLASS	SINGLE-CLASS OR INDEX
Bloomberg (2016) Dual-class share structure boasts some big gainers. The Globe and Mail.			12%	7.10%		
Fournier, P. and Katsoras, A. (2015) The family advantage. National Bank of Canada.	13.5%	6.1%	11.3%	5.6%		
Modesto, R. (2016) The case for investing in companies with dual-class shares. The Globe and Mail.	4.2%	-0.9%	3.7%	1.1%		
Spizzirri, A. and Fullbrook, M. (2013) The impact of family Control on the share price performance of large Canadian publicly-listed firms (1998-2012). Clarkson Centre for Board Effectiveness.					8.82%	6.6%
Allaire, Y. and Dauphin, F. (2016) Good governance and stock market performance. IGOPP.	8.66%	3.78%				

Source: Allaire (2016)

In a consultation discussion paper published in January 2018, MSCI Inc. found differences in terms of growth and valuation exist between DCS constituents of the MSCI ACWI Index (a global equity index) and those that are not index constituents.²⁷ Covering global members of MSCI indices and focusing on their financial performances between November 2007 and August 2017, the discussion paper illustrates that, as of 1 September 2017, listed DCS companies that are constituents of MSCI indices in general deliver stronger earnings

²⁷MSCI. 2018. "Should Equity Indexes Include Stocks of Companies with Share Classes Having Unequal Voting Rights?" Consultation Discussion Paper, January 2018.

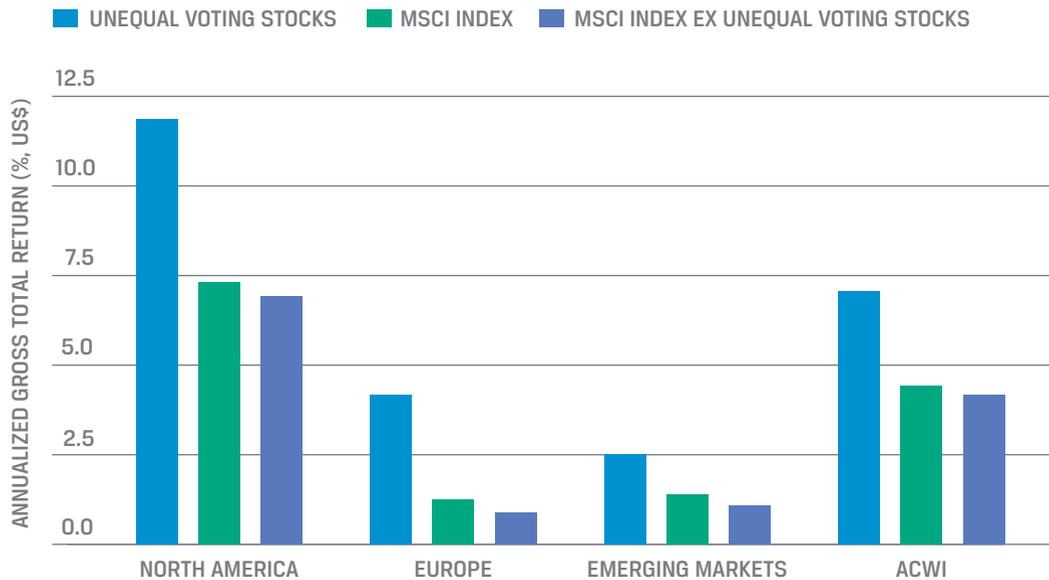
growth, higher profit margins, and stronger returns on equity to investors, although they also have a lower tendency to distribute profits to shareholders (see **Exhibit 2**).

Exhibit 2: Valuations and Profitability of Unequal Voting Rights Stocks, Indicative Data as of 1 September 2017			
Valuation and Profitability Ratios	MSCI ACWI	Unequal Voting Rights Basket	Unequal Voting Rights /ACWI
Long Term Fwd EPS Growth (%)	13.6	17.8	1.31
Price To Book Value	2.32	2.69	1.16
Price To Earnings	20.5	22.9	1.12
Profit Margin (EPS/SPS, %)	7.97	8.35	1.05
Return on Equity (%)	11.3	11.7	1.03
Financial Leverage - Debt to Equity	1.34	1.36	1.02
Dividend Yield (%)	2.33	1.4	0.6

Source: MSCI

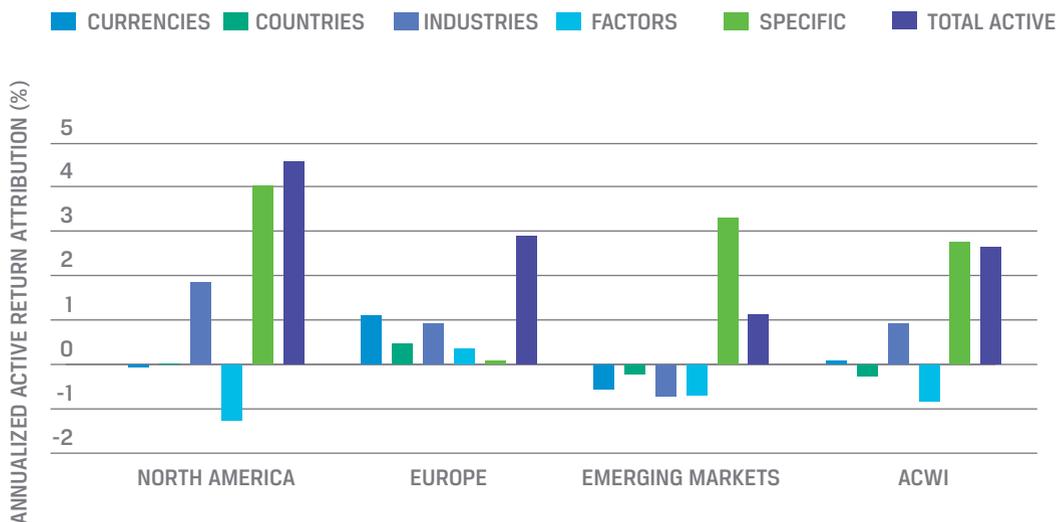
Research from MSCI shows that unequal voting stocks as a group outperformed the market between November 2007 and August 2017.²⁸ Melas (2018) further explained that total returns of MSCI ACWI Index equity indices would have been reduced by around 30 basis points per year over the period between November 2007 and August 2017 if these indices excluded companies with DCS structures (see **Exhibit 3**). Melas acknowledged that the superior performance of the technology sector over the examined period was a key reason for this potential reduction, given the common adoption of DCS structures by tech companies.

²⁸Melas, D. 2018. "Putting the Spotlight on Spotify: Why Have Stocks with Unequal Voting Rights Outperformed?" MSCI Blog.

Exhibit 3: Annualized Gross Total Return by Region and by Category

Source: MSCI

The outperformance can be attributed to a number of systemic factors (e.g., country, sector, and currency) as well as company-specific factors (see **Exhibit 4**). For instance, company-specific factors contributed around 4% of positive return in North America, with industry-factors adding another 2% of positive effect and style-factors (e.g., valuation ratios) dragging performances by 1.5% annually. In emerging markets, all the positive effects were company-specific, and all of the other factors acted as a drag on return. In Europe, company specific factors are relatively muted and return is attributed to a host of common factors.

Exhibit 4: Annual Active Return Attribution by Region and by Category

Source: MSCI

A note of caution, though, before investors leap into the DCS trade. First, not all DCS companies are equal: the DCS companies that are included in benchmark indices do not represent the entire universe of DCS companies. Second, it is unclear if the superior performance comes at a cost, for example, in the form of heightened volatility (or risks), which may or may not be commensurate with the observed returns.

2.4 Value of DCS Companies Over Time

Conversely, a large body of research suggests that companies with DCS structures would underperform companies with dispersed voting power, especially over the long term. A 2012 study from the Investor Responsibility Research Center Institute (IRRCI) and Institutional Shareholder Services, Inc. (ISS) found that firms controlled by a concentrated ownership structure—especially those with DCS structures—tend to underperform over the longer term (Lukomnik and Quinn, 2012).²⁹ Looking into firms in the S&P Composite Index as of the beginning of 2012, the report found that single-class firms would outperform DCS firms with 3-, 5-, and 10-year timeframes. The study suggests that besides their financial

²⁹Lukomnik, J. and S. Quinn. 2012. "Controlled Companies in the Standard & Poor's 1500: A Ten Year Performance and Risk Review." Investor Responsibility Research Center Institute and Institutional Shareholder Services.

underperformance, DCS firms also tend to illustrate more weaknesses in accounting controls and are subject to higher price volatility. Some characteristics of weak corporate governance standards, such as frequent related-party transactions and inconsistent distribution of rights among shareholders, were also considered relatively more common in DCS firms.

An updated version of the IRRCI and ISS study suggested that controlled companies tend to underperform on metrics affecting unaffiliated stakeholders—such as return on equity, growth of turnover, and dividend payout ratios—even though such firms could deliver outperformance on the return on assets (Kamonjoh, 2016).³⁰ Looking into performances of controlled versus noncontrolled entities in the S&P Composite 1500 Index as of the end of July 2015, Kamonjoh suggested that, although the related-party transactions (RPTs) among controlled firms would become less frequent, the size of RPTs would remain larger than that among noncontrolled firms. The author also found that board tenures tend to be longer (i.e., the average board tenure in controlled firms exceeding 15 years was 17 percentage points higher than in noncontrolled enterprises). On the other hand, the author also found that the growth of average and median market capitalization of controlled firms was higher than that of noncontrolled enterprises.

Evidence of underperformance is not limited to the US. In a study of DCS in Brazil, Matos (2017) examined the impact of the Nova Mercado reform in 2000 on the BM&FBOVESPA stock exchange.³¹ Historically, DCS structures were common in Brazil. The Novo Mercado reform was launched to provide a voluntary listing segment with enhanced investor protection, including one-share, one vote. The study found that firms that moved to the Nova Mercado single-class structure “experienced higher firm performance”, including market outperformance, higher return on assets and higher market-to-book ratio.

Bebchuk and Kastiel (2017) found that potential advantages of DCS companies tend to recede over time, while potential costs (such as agency costs) tend to rise from the time of the IPO.³² They found that the beneficiaries of such structures would be inclined to cling to power, even though the structures are inefficient. This is supported by Martinez (2018), who suggested that the value-adding vision and leadership of the founders would become “obsolete or value-destroying” over the longer term. Nonetheless, DCS beneficiaries have perverse motivations to maintain the status quo. As a result, when adopting DCS structures, consideration must be given as to when such privileges should end (see Chapter 5). The unresolved conflict between the Redstone family and the companies that they have voting control over is a clear example of such motivations (see Chapter 6).

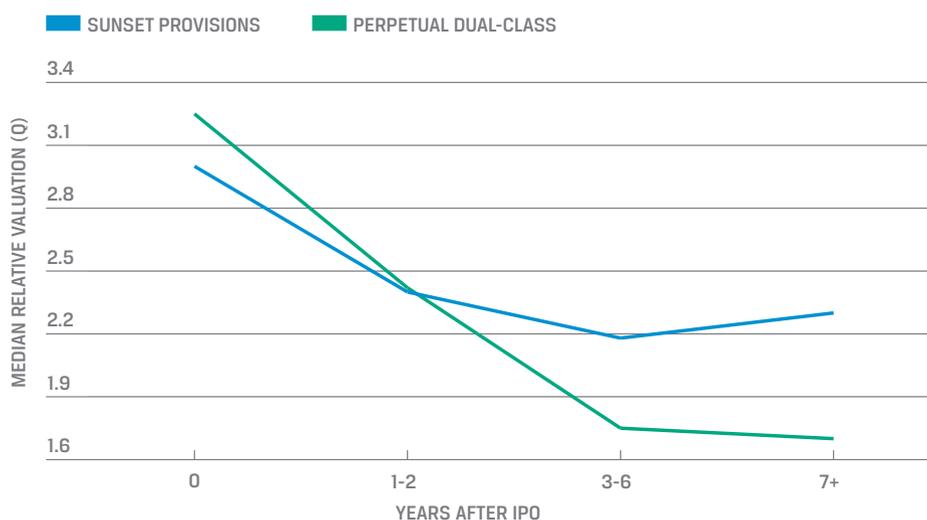
³⁰Kamonjoh, E. 2016. “Controlled Companies in the Standard & Poor’s 1500: A Follow-up Review of Performance & Risk.” Investor Responsibility Research Center Institute and Institutional Shareholder Services.

³¹Matos, P. (2017) An Assessment of Dual-Class Shares in Brazil: Evidence From the Novo Mercado Reform. CFA Institute, Associacao de Investidores no Mercado de Capitais (AMEC) and CFA Society Brazil

³²Bebchuk, L.A. and K.K. Kastiel. 2017. “The Untenable Case for Perpetual Dual-Class Stock.” Harvard John M. Olin Center for Law, Economics, and Business, Discussion Paper, 905.

In February 2018, Robert J. Jackson Jr., Commissioner of the United States Securities and Exchange Commission (SEC) proposed in a speech that companies and their management should not be given preferential voting rights in a perpetual manner.³³ His comment was based on an SEC study covering some 157 DCS IPOs in the United States since the early 2000s.³⁴ Some of these firms had a perpetual dual-class structure, while others incorporated sunset provisions, allowing the super voting rights to lapse (either after a period of time or when certain conditions are triggered). The SEC study examined the valuation of these two different groups of companies over time (**Exhibit 5**). Although the valuations of the two groups were similar at the time of IPO and during the first two years subsequent to the IPO, from the third year onward companies with sunset provisions begin to trade at a valuation premium as compared to those with a perpetual DCS structure. This suggests that whatever advantages a founder or an entrepreneur might bring to a company in its early years would fade over time. Those companies that gave up their DCS share structures saw a significant boost in company valuations.

Exhibit 5: Valuation of Dual-Class Firms over Time



Median predicted values of Tobin's Q of firms from models in Table A.2. Tobin's Q equals the market value of common stock, minus the book value of common stock, plus the book value of assets, minus deferred taxes (or zero if missing), all divided by the book value of assets, at fiscal year-end.

Source: Jackson (2018)

³³Jackson, R.J. 2018. "Perpetual Dual-Class Stock: The Case Against Corporate Royalty." U.S. Securities and Exchange Commission (February).

³⁴Jackson, R.J. 2018. Data Appendix to "Perpetual Dual-Class Stock: The Case Against Corporate Royalty." U.S. Securities and Exchange Commission (February).

Exhibit 6 illustrates some interesting studies in relation to the performance of companies with and without DCS.

Exhibit 6: Selected Academic Studies on Performance of DCS Firms

Year	Author(s)	Title	Time Period/ Sample Size	Key Conclusions
2018	Martijn Cremers, Beni Lauterbach, and Anete Pajuste	The Life Cycle of Dual-Class Firms	DCS IPOs in the United States between 1980 and 2015	DCS firms tend to enjoy premium valuations over single-class firms at the time of IPO. Such premia decline over time and turn into discounts after 6–9 years after the IPO. Given potential agency problems, this results in an increased wedge with less likelihood of voluntarily unification of share classes over time. The authors propose that mandatory sunset provision for multiclass structures be adopted as a solution.
2018	Lindsay Baran, Arno Forst, and M. Tony Via	Dual Class Share Structure and Innovation	DCS IPOs between 2000 and 2008 (domestic, nonfinancial companies in the United States)	Insider control at DCS firms shows positive relationships where innovation output would tend to exceed the costs associated with the misalignment of voting power. Nonetheless, the positive impact changes over time. The authors conclude that phasing out the differentiated voting right structure over time via the adoption of sunset provisions would be a useful tool to mitigate risks.
2018	Robert J. Jackson	Perpetual Dual-Class Stock: The Case Against Corporate Royalty	157 DCS IPOs in the United States, of which, 71 have adopted sunset provisions	Over the life cycle of DCS firms, firms with sunset provisions appear to outperform those without. The study shows that firms with sunset provisions show valuations notably higher than those with perpetual DCS structures after 7 years since the initial IPO.
2018	Hyunseob Kim and Roni Michaely	Sticking Around Too Long? Dynamics of the Benefits of Dual-Class Structures	DCS firms in the United States between 1971 and 2015, covering some 142,576 single-class firm years and 8,445 multiclass firm years	As firms mature, significant valuation discount appears to be associated with the DCS listings. The study finds that the discount could be a result of the benefits of privatized control through the means of holding voting premium.
2017	Gabriel Morey	Multi-Class Stock and Firm Value	1,629 single-class firms and 133 DCS firms incorporated in the US	The study finds no significant relationship on the return on invested capital, positive or negative, associated with the share capital structure. Therefore, the author questions whether it is correct to argue that a DCS structure would lead to superior performance over the long run.

Year	Author(s)	Title	Time Period/ Sample Size	Key Conclusions
2008	Paul A. Gompers, Joy Ishii, and Andrew Metrick	Extreme Governance: An Analysis of Dual-Class Firms in the United States	Over 6,000 single-class firms and over 350 DCS firms listed on major stock exchanges in the United States	The study finds that a firm's value would be positively linked to the equity ownership of the beneficiaries of DCS structures, and negatively related to the voting right distribution, as well as the difference between the two. In short, although control of insiders would not have a high degree of negative impact on the firms' value, it would require the beneficiaries be adequately invested in the firms for the company to benefit.
2008	Renee Adams and Daniel Ferreira	One Share-One Vote: The Empirical Evidence	A broad-based literature review on disproportional ownership, how the adoption of mechanisms separating voting rights from cash-flow rights would impact value	The literature review suggests that the impact of proportionality of ownership on firms' value is difficult to identify empirically. However, the majority of the studies that performed valuation regressions points to "the existence of a disproportional ownership discount on the market value of outside equity.
2016	Edward Kamonjoh	Controlled Companies in the Standard & Poor's 1500: A Follow-up Review of Performance and Risk	The study focuses on firms in the S&P Composite 1500 Index as of 31 July 31 2015	The study finds that controlled companies with DCS structures tend to underperform in various financial metrics over the long run and are associated with a higher degree of financial risks. The study also suggests that external shareholders do not always benefit from giving up their voting power to insiders.
2009	Scott B. Smart, Ramabhadran S. Thirumalai, and Chad J. Zutter	What's in a Vote? The Short- and Long-Run Impact of Dual-Class Equity on IPO Firm Values	2,622 IPOs in the United States from 1990 through 1998, including 253 DCS firms, with offer prices ranging from \$5 to \$35	The study finds that DCS firms would trade at lower valuations than those having single-class only, both at the time of IPO and for the subsequent 5 years after IPO.

Source: CII,³⁵ MSCI, and CFA Institute

³⁵Council of Institutional Investors. 2018. "CII Summaries of Key Academic Literature on Multi-Class Structures and Firm Value." 18 July 2018.

Views of Industry Stakeholders: Part 1

Interview 1. A Recipe of Poor Corporate Governance—An Asset Owner’s Viewpoint

According to Yoo-Kyung Park, Director of Global Responsible Investment and Governance for the Asia Pacific region at APG Group N.V., signs are that exchanges in APAC are motivated to amend their listing rules to lure more IPOs. APG is the largest pension provider in the Netherlands, servicing approximately 25,000 employers, and administering pensions for one in four people in the country (about 4.5 million participants). As of the end of 2017, APG manages approximately €470 billion in pension assets for its Dutch pension fund clients.

Park acknowledged some advantages of DCS structures beyond IPOs. Family businesses and company founders can remain in power. “This is particularly the case in light of the rise of activist investors in the region. For instance, in [South] Korea where chaebols make up a huge portion of the stock market—in terms of capitalization and trading volume of the exchange—the use of DCS can help prevent potential hostile takeovers and shield founders from criticisms,” Park pointed out.

But Park does not consider this as a strong enough reason to justify bringing DCS IPO to the market.

“The existence of DCS deviates from the fundamental concept of equity. Exchanges and governments are compromising corporate governance standards to accommodate DCS IPOs. The trends in the Hong Kong and Singapore markets have implications within the region and will spill over to Malaysia, Korea, and a few other markets.”

As one of the Netherlands’ leading pension providers, APG values its voting rights and exercises them consistently. “APG has a set of voting policies that apply to over 4,000 companies it invests in globally. Such voting policies highlight the need for companies to act in accordance with stakeholder interests, while adequate attention is also given to sustainability issues,” Park said. “Our clients demand that we participate in shareholders’ meetings, and exercise our clients’ rights to cast votes on company decisions. By using the proxy voting platform, we vote on clients’ behalf on close to 100% of these decisions. This is why ‘one-share, one-vote’ is so important to us.”

Interview 2. Adding Vibrancy to the Financial market—View from the Singapore Exchange

In June 2018, two months after the final round of consultation, Singapore Exchange (SGX) launched the DCS listing framework. We discussed the rationale behind the decision and some safeguards adopted with Michael Tang, Head of Listing Policy & Product Admission at Singapore Exchange Regulation (SGX RegCo).

“Based on the feedback to our public consultations on DCS structures, a majority of the respondents supported the introduction of the DCS framework. Some respondents viewed the introduction of the DCS framework as a sign of a more mature market. It also provides investors and companies seeking a listing with more choices. The DCS framework was implemented with effect from 26 June 2018,” Tang said.

Tang explained that the decision was in line with, and in part, due to, a call for a new growth engine by Singapore’s Committee on the Future Economy (CFE). The CFE was convened by the Singapore government in January 2016 to review Singapore’s economic strategies. “The CFE suggested introducing a DCS framework as one form of capital-raising in the face of significant structural shifts and rapid technological advancement. SGX recognizes that some entrepreneurs who have long-term strategies would need a capital structure that supports a swift scaling up of businesses, while retaining control of their companies. DCS listings, which are increasingly being considered globally by new economy companies—such as those in information technology and life sciences—is one way to do so.”

“Further, the independent SGX Listings Advisory Committee, which comprises individuals with practitioner experience in the securities market, advised in 2016 that DCS structures with appropriate safeguards will be beneficial to the Singapore market,” Tang added. “Investors who understand and agree with the business model and management of DCS companies will also enjoy more investment choices.”

The downside of permitting insiders to hold onto the control of the company via multiple voting shares (MV shares) is that it could lead to abuse by these shareholders. Tang identified “management entrenchment of owner-managers” and “owner-managers seeking to extract excessive private benefits to the detriment of other noncontrolling shareholders” as the most common risks. Therefore, he pointed out that SGX has incorporated some safeguards to mitigate such risks.

3. History of DCS Structures in the United States

As controversial as they may sound today, DCS structures have been available in a number of developed markets for decades, including but not limited to the United States, the Netherlands, Sweden, Denmark, and Canada. Laws and regulations in different jurisdictions suggest three key approaches toward DCS structures:³⁶

- Jurisdictions where companies are permitted to adopt DCS structures under company laws, but where firms are prohibited from listing in the public markets, such as Australia.
- Jurisdictions where both company law and listing rules permit DCS structures, such as the United States, Canada, Sweden, Hong Kong SAR (since April 2018), and Singapore (since June 2018).
- Jurisdictions prohibiting both listed and unlisted companies from adopting DCS structures, such as Spain, Germany, and China.

The development of DCS structures in US markets has undoubtedly drawn the most attention, given the country's sheer size and significance as a capital market. This chapter provides a brief overview of the historic developments of DCS listings in the United States.

The previous high watermarks of DCS listings in the United States were in the 1920s and 1980s, both of these milestones were preceded by a period of increased liquidity and outsized optimism, and followed by a prolonged period of market turmoil. The current boom in DCS listings has similar hallmarks: liquidity has surged since the global financial crisis of 2007–2008; and the US stock market has been in bull-market territory for about a decade, yet the number of listed companies in the United States and Europe has declined. In short, too much money is chasing too few opportunities. Consequently, issuers can dictate their terms in the market. What will happen to the DCS “party” when liquidity tightens?

The rise and fall (and rise again) of DCS listings in the United States shows that the present situation is neither inevitable nor unique, and that there are many more options than a wholesale adoption of DCS structures.

³⁶Hong Kong Stock Exchange. 2014. “Weighted Voting Rights.” Concept Paper, August 2014.

3.1 Late 1800s to 1920s: The Early Stages of DCS Listings

According to Howell (2017),³⁷ the issuance of shares with differential voting rights was first seen in 1898, when the International Silver Company issued 20 million shares of common stock with no voting rights.³⁸ The issuance of shares with differential voting rights became increasingly popular in the 1920s, with a combination of shares with and without voting rights being the norm. Citing the work of the late Arthur S. Dewing (1953), Howell suggested that over 183 firms with DCS structures were listed prior to 1926.³⁹

The popularity of DCS listings ran into a wall in the mid-1920s, due in part to the 1925 proposed listing of Dodge Brothers on the New York Stock Exchange (NYSE). Through its proposal to issue non-voting shares, the automaker intended to retain total voting control of the company, despite having little skin in the game (i.e., an equity stake of 1.7%). The company's total market capitalization was US\$130 million; the company's decisions, however, were controlled by Dillon, Read & Co., an investment bank, with less than US\$2.25 million invested, leading to a public outcry.

Amid investors' complaints and protests, efforts to prohibit DCS listings, led by Harvard Professor William Ripley, gathered momentum in the mid-1920s. Ripley argued that issuers of unequal voting rights would permit management to maintain full voting control of the companies without an economic commitment. He envisioned that through the issuance of shares with super voting rights to insiders and non- or regular-voting shares to the investing public, these issuers would be eligible to take profits and raise capital at low cost without losing control of their companies.⁴⁰

As a result, the NYSE began an unannounced effort to forbid the issuance of shares with no voting rights in 1926. In response to widespread criticism, the NYSE stated that "without at this time attempting to formulate a definite policy, attention should be drawn to the fact that in the future the committee, in considering applications for the listing of securities, will give careful thought to the matter of voting control," effectively putting on hold any listing with DCS structures for roughly 14 years before a formal announcement was made in 1940.⁴¹

³⁷Howell, J.W. 2017. "The Survival of the U.S. Dual Class Share Structure." *Journal of Corporate Finance*. 44, 440–450.

³⁸ According to the author, the company issued 9 million preferred shares and 11 million nonvoting common shares in 1898; the company later issued shares that were entitled to reduced voting rights (i.e., one vote for every two shares) in 1902.

³⁹Dewing, A.S. 1920. *The Financial Policy of Corporations*. Volume II: Promotion. New York: Ronald Press Co.

⁴⁰Ripley, W.Z. 1927. *Main Street and Wall Street*. Boston: Little, Brown and Co.

⁴¹Bainbridge, S.M. 2007. "The Scope of the SEC's Authority over Shareholder Voting Rights." UCLA School of Law.

3.2 1926 to 1980: A Lull in DCS Listings

For the next six decades, the NYSE virtually eliminated DCS listings. Only a handful of exceptions were granted, such as Ford Motor Company, J.M. Smucker, and American Family.

Figures vary from different studies, largely because of the differences in parameters (e.g. nonvoting rights versus unequal voting rights), but the declining trend is observable and consistent. For instance, according to Seligman (1986), only 10 firms listed on the NYSE had DCS structures attached as of 1985.⁴² According to Lease, McConnell, and Mikkelson (1983), only 30 issuers with nonvoting or DCS structures were listed on secondary markets in the United States between 1940 and 1978.⁴³

Although the NYSE was quite responsive to activists' calls for better governance before eventually succumbing and giving in to the call for DCS listings in 1980s, other exchanges in the United States were far more welcoming. For instance, the American Stock Exchange (AMEX) did not have a clear policy stance on the issuance of nonvoting rights and DCS companies until 1972.⁴⁴ Karmel (2011) suggested that, contrary to its stated policy (which was to prohibit any issuance of nonvoting common shares), AMEX's practice was to consider listing applications on a case-by-case basis.⁴⁵ Karmel also pointed out that AMEX did not reject the listing of issuers with disproportionate voting rights during the years when there were ongoing debates on the appropriateness of DCS structures.

AMEX's favorable stance toward the listing of DCS structures became clear in 1976, when it issued its own policy statement on the eligibility for listing of companies with DCS structures that had the following features:⁴⁶

- 1) the limited voting class must have the ability to elect at least 25% of the board;
- 2) the voting ratio should not be greater than 10-to-1 in favor of the superior voting class;
- 3) no additional stock could be issued that diluted the limited voting shareholders' stake;
- 4) superior voting rights would be lost if the number of shares fell below a certain percentage; and

⁴²Seligman, J. 1986. "Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy." *George Washington Law Review*, 54, 687-724.

⁴³Lease, R.C., J.J. McConnell, and W.H. Mikkelson. 1983. "The Market Value of Control in Publicly-Traded Corporations." *Journal of Financial Economics*, 11, 439-471.

⁴⁴Ibid, Howell (2017).

⁴⁵Karmel, R.S. 2001. "The Future of Corporate Governance Listing Requirements." *SMU Law Review*, 54(1).

⁴⁶The list of requirements published by the AMEX has been generally known as the "Wang formula," due largely to the company affiliated.

5) dividend preference was strongly recommended for limited-voting stock.

This prompted “a race to the bottom between exchanges with regard to a voting rights listing standard” (Karmel, 2011).

3.3 The 1980s: A Renaissance in DCS Listings

After several decades of dormancy, DCS listings picked up remarkably in the early 1980s. Partch (1987) found that 37 of the 44 publicly traded listed companies with DCS structures between 1962 and 1984 implemented the structure after January 1980.⁴⁷

The DCS comeback was due to the takeover frenzy prevailing in the mid-1980s. DCS structures became “a defensive measure to ensure that a company was protected against hostile takeovers.”⁴⁸ The increased demand and the rise in competition for listings and trading businesses from other stock exchanges (e.g., AMEX) meant that the NYSE was under pressure to revisit its stance. New IPOs were lost to other stock exchanges that had a more flexible approach, and already-listed companies sought to convert midstream to fund acquisitions, as was the case of General Motors Company, which decided to issue a class of shares with inferior voting rights in connection with its acquisition of the Hughes Aircraft Company and Electronic Data Systems.

The NYSE’s capitulation signaled that DCS companies had come full circle, with the structure accepted again by all the major US exchanges at the time, including the NYSE, the then-AMEX, and NASDAQ, a situation that soon attracted regulatory attention from the SEC.

3.4 Late 1980s: The SEC's Attempt to Regulate DCS Listings

As exchanges sought to compete by allowing DCS listings, the SEC waded into the situation and asked the stock exchanges to collaborate with each other and come up with a uniform set of measures to guard voting rights. In July 1988, the SEC implemented Rule 19c-4, which was, in essence, an attempt to unify the listing rules of all exchanges in their treatment of the listing of companies with DCS structures:

No rule, stated policy, practice, or interpretation of this exchange shall permit the listing, or the continuance of the listing, of any common stock or other equity security of a domestic issuer, if

⁴⁷Partch, M.M. 1987. “The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth.” *The Journal of Financial Economics*, 18(2), 313–339.

⁴⁸Wen, T. 2014. “You Can’t Sell Your Firm and Own It Too: Disallowing Dual-Class Stock Companies from Listing on the Securities Exchanges.” *University of Pennsylvania Law Review*, 162(6), 1495–1516.

the issuer of such security issues any class of security, or takes other corporate action, with the effect of nullifying, restricting or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock of such issuer registered.

Cornell Law School, 2005⁴⁹

The SEC's move faced significant opposition from the Business Roundtable, an influential business association made up of large businesses in the United States. According to Bentel and Walter (2016), the Securities Exchange Act does not grant the SEC the authority to regulate issues related to corporate governance, but instead empowers the SEC to regulate over trade and pricing; in principle, it would be the authority of state legislative bodies to maintain control over corporate governance issues (Bainbridge, 2007). Indeed, the Business Roundtable argued that the primary responsible party for corporate governance regulations should be the state legislature and not the SEC. In a landmark ruling, the United States Court of Appeals for the District of Columbia Circuit revoked Rule 19c-4, which, in its opinion, had gone beyond the SEC's delegated regulatory authority.⁵⁰ This ruling effectively ended the SEC's attempt to rein in DCS listings.

Given that the SEC's ability to regulate shareholder voting rights has been, and still is, judicially bound; any push for greater government-drive regulations will need to be driven by Congress or company shareholders. As a result, DCS IPOs have remained available to issuers.

3.5 The 2010s: Rise of the Planet of the Techs

Bebchuk and colleagues (2000) suggested that DCS structures would sometimes be adopted as a means to ensure that control of such companies is centralized to the insiders (e.g., key family members), although "controlling minority structures" (e.g., pyramid schemes, cross-ownership structures) that obscure such a tight grip are more favored.⁵¹ Berger and Hodrick (2018) pointed out that family businesses, as well as media companies that sought to maintain publication and editorial independence, were historically the main issuers adopting such listing structures.⁵²

⁴⁹Legal Information Institute. "17 CFR 240.19c-4—Governing Certain Listing or Authorization Determinations by National Securities Exchanges and Associations." Legal Information Institute, Cornell Law School, 29 June 2005.

⁵⁰Bainbridge, S.M. 1991. "The Short Life and Resurrection of SEC Rule 19c-4." *Washington University Law Quarterly*, 69, 565–634.

⁵¹Bebchuk, L., R. Kraakman, and G. Triantis. 1999. "Stock Pyramids, Cross-Ownership, and the Dual Class Equity: The Creation and Agency Costs of Separating Control from Cash Flow Rights." NBER Working Paper No. 6951.

⁵²Berger, D.J., and L.S. Hodrick. 2018. "Are Dual-Class Companies Harmful to Stockholders? A Preliminary Review of the Evidence." *Harvard Law School Forum on Corporate Governance and Financial Regulation*, 15 April 2018.

Amidst the new wave of startups and the emergence of advanced technologies, technology company founders also hoped to have control over company decisions, even after they went public. An increasing number of high-tech companies have been listing on exchanges where more favorable voting terms for founders and management teams are allowed. For instance, many major tech companies—such as Google LLC, Facebook Inc., LinkedIn Corporation, and Alibaba Group Holding Limited—that are listed in the United States have been granted rights to issue DCS, because major stock exchanges in the United States do allow DCS listings so long as such structure is already in place at the time of listing (Bentel and Walter, 2016⁵³; Wen, 2014⁵⁴).

Robertson and Tan (2018) illustrated that although overall DCS listing have been gaining traction since the early 2000s, the magnitude of growth of the technology companies adopting DCS structures has outpaced that of the nontechnology companies.⁵⁵ Ritter (2018) illustrated that 200 of 3,046 (6.6%) of the technology IPOs between 1980 and 2017 in the United States—and 498 of 5,314 (9.4%) non-tech IPOs—have adopted DCS structures (see **Exhibit 7**).⁵⁶ He suggested that the likelihood of technology IPOs adopting DCS structures has become higher in recent years, with 23.8% and 43.3% of the firms in the sector listing in DCS structures in 2016 and 2017, respectively, compared with 9.4% and 21.8% of those not in the technology sector. Note that Ritter’s dataset was limited to include company listings (i.e., IPOs) with an offer price of US\$5 or above, while “ADRs, unit offers, closed-end funds, REITs, natural resource limited partnerships, small best efforts offers, banks and S&Ls, and stocks not listed on CRSP [the Center for Research in Security Prices] (CRSP includes AMEX, NYSE, and NASDAQ stocks)” were not included.

⁵³Bentel, K., and G. Walter. 2016. “Dual Class Shares.” *Comparative Corporate Governance and Financial Regulation*. Paper 2, Spring 2016.

⁵⁴Wen, T. 2014. “You Can’t Sell Your Firm and Own It Too: Disallowing Dual-Class Stock Companies from Listing on the Securities Exchanges.” *University of Pennsylvania Law Review*. 162(6), 1495–1516.

⁵⁵Robertson, B., and A. Tan. 2018. “Quicktake: Dual-Class Shares.” Bloomberg.

⁵⁶Ritter, J. 2018. “Initial Public Offerings: Updated Statistics.” 14 May 2018.

Exhibit 7: US IPO Data Since 1980

Year	Tech IPOs			Non-tech IPOs		
	Dual-class	Total	%	Dual-class	Total	%
1980	0	22	0.0%	1	49	2.0%
1981	2	73	2.7%	4	120	3.3%
1982	0	42	0.0%	0	35	0.0%
1983	3	173	1.7%	3	278	1.1%
1984	2	50	4.0%	5	121	4.1%
1985	1	36	2.8%	6	149	4.0%
1986	3	77	3.9%	21	316	6.6%
1987	1	58	1.7%	23	227	10.1%
1988	3	28	10.7%	6	77	7.8%
1989	1	35	2.9%	6	81	7.4%
1990	0	31	0.0%	7	79	8.9%
1991	7	70	10.0%	16	216	7.4%
1992	2	113	1.8%	16	299	5.4%
1993	3	126	2.4%	30	383	7.8%
1994	8	116	6.9%	25	286	8.7%
1995	8	204	3.9%	22	257	8.6%
1996	16	274	5.8%	46	403	11.4%
1997	10	173	5.8%	41	301	13.6%
1998	9	113	8.0%	21	168	12.5%
1999	22	370	5.9%	19	106	17.9%

Dual-Class Shares: The Good, The Bad, And The Ugly

Year	Tech IPOs			Non-tech IPOs		
	Dual-class	Total	%	Dual-class	Total	%
2000	19	260	7.3%	7	120	5.8%
2001	2	23	8.7%	5	56	8.9%
2002	2	20	10.0%	12	46	26.1%
2003	3	18	16.7%	5	45	11.1%
2004	3	61	4.9%	10	112	8.9%
2005	9	45	20.0%	13	114	11.4%
2006	1	48	2.1%	10	109	9.2%
2007	4	75	5.3%	14	84	16.7%
2008	0	6	0.0%	3	15	20.0%
2009	2	14	14.3%	3	27	11.1%
2010	2	33	6.1%	7	58	12.1%
2011	5	36	13.9%	9	45	20.0%
2012	5	39	12.8%	11	54	20.4%
2013	5	43	11.6%	23	114	20.2%
2014	6	53	11.3%	18	153	11.8%
2015	13	36	38.9%	8	79	10.1%
2016	5	21	23.8%	5	53	9.4%
2017	13	30	43.3%	17	78	21.8%
1980-2017	200	3,046	6.6%	498	5,314	9.4%

Source: Ritter (2018)

These findings are largely in line with others. For instance, Huston (2017) opined that DCS listings appear to be picking up, with DCS IPOs comprising 18% of all IPOs in the United States in 2017, compared with 12% in 2010 (**Exhibit 8**)⁵⁷. Lebovitch, Uslaner, and Johnson (2018) provide affirmation of Huston’s findings and suggest that although only 1% of US companies went public with DCS structures in 2005, close to 20% of US companies adopted such ownership structures as they went public in 2017.⁵⁸

Exhibit 8: Number and Percentage of US Dual-Class IPOs Compared with Total Number of Listed IPOs

Year	Number of US dual class IPOs	Number of US listed IPOs	Percentage of dual class IPOs
2010	20	170	12%
2011	20	146	14%
2012	18	145	12%
2013	39	229	17%
2014	36	292	12%
2015	27	174	16%
2016	17	111	15%
9M2017	20	112	18%

Source: Huston (2017)⁵⁹

⁵⁷Huston, C. 2017. “Snap Backlash, Facebook Capitulation Won’t Stop Founder-Friendly Stock Structures.” MarketWatch.

⁵⁸Lebovitch, M., J. Uslaner, and J. Johnson. 2018. “When One Share Does Not Mean One Vote: The Fight Against Dual-Class Capital Structures.” Lexology.

⁵⁹Hutson, C. 2017. “Snap Backlash, Facebook Capitulation Won’t Stop Founder-Friendly Stock Structures.” MarketWatch.

As we bring this chapter to a close, it is important to note that DCS structures are not the exclusive prerogative of technology companies, nor are technology companies necessarily DCS structured. Many tech companies thrived and grew to become large and successful companies without the crutch of such structures, including household names such as Apple Inc., Microsoft Corporation, Amazon.com, Inc., and Netflix, Inc.

4. The Rising Popularity of DCS Structures in Asia

Although DCS structures have been available in a number of developed markets in the West, they have not been widespread in the Asia Pacific region until recently. In this chapter, we take a look at why DCS structures have gained traction in this region, including the motivations of the stock exchanges.

In Japan, the Tokyo Stock Exchange (TSE) has allowed the listing of DCS companies since 2008 as part of a number of amendments made to the Japan Companies Act. The aim of these amendments was to “permit greater flexibility to company management” (Osaki, 2015).⁶⁰ In 2014, Cyberdyne Inc. became the first and only DCS IPO listed on the TSE. Cyberdyne was established by Yoshihuki Sankai at the University of Tsukuba to develop the hybrid assistive limb, the only autonomously controlled wearable robot that uses bioelectric signals from the human brain. Cyberdyne adopted the DCS structure to “ensure [its] advanced technologies are used for peaceful purposes and prevent the misuse of these technologies to harm humans or to create military weapons.”⁶¹ Sankai directly and indirectly held some 85.3% of the total voting rights as of 31 March 2018.

In Hong Kong, after frustrations following Alibaba’s choice of NYSE as a listing venue in 2014, HKEX was finally able to amend its listing rules in April 2018 to allow companies to issue shares with unequal voting rights.⁶² Xiaomi Corporation, the world’s fourth-largest smartphone maker by shipment,⁶³ was listed in early July 2018, making it the first DCS IPO listed on the SEHK since therefrom.

Similarly, in Singapore, the Singapore Exchange (SGX) concluded the second round of consultations in April 2018, and announced its conclusions shortly thereafter in late June that DCS firms will be eligible for listings on the SGX going forward.⁶⁴ SGX had begun its push for the adoption of DCS structures to capture opportunities presented by the new-economy companies in 2016, when its Listings Advisory Committee provided ground rules of DCS listings that were largely in line with the government’s direction of future development. Since then, the Future Economy Council recommended that

⁶⁰Osaki, S. 2015. “Toyota to Issue Class Shares.” *Iakyara*, vol. 218, Nomura Research Institute, Ltd.

⁶¹Cyberdyne. 2018. “Stock Information.” Investor Relations.

⁶²HKEX. 2018. “Consultation Conclusions: A Listing Regime for Companies from Emerging and Innovative Sectors.” April 2018.

⁶³IDC. 2018. “Smartphone Vendor.”

⁶⁴Singapore Exchange. 2018. “Responses to Comments on Consultation Paper: Proposed Listing Framework for Dual Class Share Structures.” 26 June 2018.

for listed companies, the Government should permit dual class share (DCS) structures while instituting appropriate safeguards to promote market transparency and mitigate governance risks. DCS listings are increasingly being considered, for example, in industries such as information technology and life sciences. DCS should be permitted for companies seeking a listing on the Singapore Exchange (SGX) while instituting appropriate safeguards to promote market transparency and mitigate governance risks.

Committee on the Future Economy, 2017⁶⁵

The moves by Hong Kong and Singapore, two of the key financial centers in APAC, are creating a ripple effect and are being closely watched by other players in the region.

For example, in China, although DCS listings are not currently permitted, it could be only a matter of time before they are. According to a report on Xinhua, China's official press agency, on 8 March Wang Jianjun, General Manager of the Shenzhen Stock Exchange, made a proposal to the National People's Congress that the Company Law in China be amended to allow for DCS companies.⁶⁶ This would provide more incentives for Chinese companies to seek listings on domestic stock exchanges.

Such a development would also be in line with recent financial market developments, such as the launch of the Chinese Depository Receipt (CDR) scheme. It is expected that this pioneering scheme would allow large Chinese firms (i.e., those with market capitalization no less than RMB200 billion) that are primarily listed overseas to be secondarily listed in China by way of CDRs, without changing their governance or share structures. According to a news report by *China Daily* in May 2018, Baidu, Inc. and NetEase, Inc. have already been working on details of their CDR listings, and JD.com, Inc. and Alibaba are expected to return to the A-share markets in the form of CDRs.⁶⁷ The CDR scheme is widely considered as a lab test before a multiple-share structure is introduced to the market.

Other Asian markets are making similar considerations. In South Korea, Kim Sang-jo, Chairman of the Fair Trade Commission, said in January 2018 that the South Korean government might consider the eligibility for certain firms—such as small businesses and startups—to issue DCS, citing the government's intention to encourage more of such companies to be listed on the KOSDAQ (a trading board of the Korea Exchange), the country's second board that is utilized as a financing platform for SMEs with growth

⁶⁵Committee on the Future Economy. 2017. "Report of the Committee on the Future Economy: Pioneers of the Next Generation" Ministry of Communications and Information [SG].

⁶⁶Xuyu, L. 2018. "Wang Jianjun: Proposal to Protect the Capital Market Reform and Development Proposal by Law." Xinhuanet.com (2018)

⁶⁷Tan, X. 2018. "Baidu, NetEase finalize sponsors for CDRs ahead of domestic listing." *China Daily*.

potential.⁶⁸ According to a news report by Burugula and Modak (2018), the Securities and Exchange Board of India (SEBI) discussed “a proposal of allowing companies to sell differential voting rights” in July 2018, with the intention of facilitating listings of Indian start-ups.⁶⁹ In Sri Lanka, although the Colombo Stock Exchange already allows DCS firms to list, members told us that some organizations have recently demanded the exchange consider further relaxing its listing rules to attract IPOs of high-technology companies.

Many exchanges see permitting DCS firms to list as a necessary step to stay relevant in a time of relentless competition in the cross-border IPO business. As capital becomes increasingly global, issuers are no longer limiting themselves to their domestic exchanges. Rather, they can “shop around” for the best listing venue. The recent pivot to DCS listings in APAC was motivated by the need for exchanges to stay competitive and attract technology and so-called “new-economy” companies, even though companies in other industries may be able to take advantage of this in some markets.

What does a good listing venue look like? From an issuer’s perspective, a number of considerations are involved, including, for example, the liquidity of the exchange; its infrastructure (e.g., speed of the network); credibility and prestige; ease of future fundraising; regulatory framework; fees (both for the initial listing and for subsequent maintenance); availability of highly experienced, relevant professionals; and the size and valuation of its peer group on that exchange.

Another critical aspect for potential issuers is the investor and analyst community covering the issuers’ sector on that exchange. Issuers want to be sure they will get the attention they need and that their business models are thoroughly understood by investors so they can obtain the best valuation.

Equally importantly, issuers will look at the rules of the relevant exchange. How strongly is the market regulated? Are the rules clear? Are the rules robust and well enforced, yet at the same time, business friendly?

Changing the rule book to allow DCS IPOs may appear a quick and easy way to win market share. However, it is but one of many considerations from an issuer’s perspective. In itself, allowing DCS listings does not provide a sustainable competitive advantage—after all, it is a step that is easy for other exchanges to replicate. If all exchanges have the same rules, what makes one exchange stand out from another? What is the unique selling proposition (USP)? Are we not back to fundamentals such as liquidity, valuation, investors, analysts, the regulatory framework,

⁶⁸Korea Times. 2018. “Dual Voting Structure: Startups Need Protection from Hostile Takeovers.” https://www.koreatimes.co.kr/www/opinion/2018/02/202_243492.html.

⁶⁹Brugula, P., and S. Modak. 2018. “Sebi Mulls Snapchat Model to Boost Start-up Listings.” Business Standard.

and the ecosystem? If the fundamentals do not work, accepting DCS listings will not help in the competitiveness stakes. If they do, then DCS is a red herring beyond the initial IPO.

Spotify Technology, a music streaming company based in Sweden, listed on the NYSE in April 2018 with a DCS structure. DCS companies are widely available in Sweden,⁷⁰ so a lack of access cannot possibly be why Spotify chose New York over Stockholm. In APAC, the Australian Securities Exchange (ASX) has seen a large number of technology company IPOs in recent years—a total of 43 in 2016 and 2017, including companies from Israel, New Zealand, Singapore, and the United States—and the ASX has attracted such cross-border technology listings without allowing DCS IPOs. Instead, ASX focuses on its own USPs and the attractions of the Australian market—a robust legal and regulatory framework that is business friendly, an investor community that understands the technology space, and, of course, one of the largest pension fund systems in the world.

Many exchanges argue that allowing DCS listings would give investors more choices. Most investors already have access to many equity investments worldwide. Few are limited to only investing in companies listed on their domestic exchanges. Therefore, we have doubts with regard to the “choice” argument. There is no shortage of investment opportunities. What investors want are robust companies with sound investor protections and high corporate governance standards, backed by exchanges focused on providing a regulatory framework that balance all competing interests and are consistent with investors’ needs.

Ultimately, investors investing in a DCS company are taking the risk that powerful insiders could make poor decisions for minority shareholders, and that minority shareholders would have no way to hold them accountable. Some investors are willing to overlook this issue when share prices are rising and the market is liquid. Since the global financial crisis, it has been by and large an issuer’s market, with more money chasing fewer opportunities. But what happens when the liquidity dries up? Might we not see a flight to quality and outperformance of companies with strong governance?

⁷⁰Hägg, E., and Marcellius, P. (2017) pointed out that the Swedish Companies Act would allow listing of shares with differentiated voting rights; ISS’s analysis on differentiated voting rights in Europe shows that “64 percent of Swedish QuickScore companies maintain two share classes with unequal voting rights”; MSCI’s consultation discussion paper, entitled “Should Equity Indexes Include Stocks of Companies with Share Classes having Unequal Voting Rights,” suggested that companies with unequal voting structures “represent 68% of the weight in Sweden.”

Views of Industry Stakeholders: Part 2

Interview 4. Staying Relevant in a Competitive World—View from a Government Official

Following the reform to allow DCS IPOs, HKEX entered into a new era. We interviewed Joseph Chan, Under Secretary for Financial Services and the Treasury of the Hong Kong Special Administrative Region Government (HKSARG). Chan is a CFA® charterholder, and prior to his tenure with the HKSARG was a former vice chair of the Hong Kong Society of Financial Analysts, the CFA® Society in Hong Kong.

The decision to permit DCS listings was driven by the desire to strengthen Hong Kong’s position in innovation and technology (I&T). Chan explained. “This administration, led by Carrie Lam, Chief Executive, is embracing I&T as the engine of growth. Hong Kong has been a leading international financial center, but we cannot rest on our laurels. With Industrial Revolution 4.0 already underway, it is vital for us to capture opportunities presented by the emergence of sizable new-economy companies that have emerged around the world. In China alone, it is estimated that there are over 150 unicorns (i.e., startups that are valued at over US\$1 billion). Hong Kong, as the most developed and sophisticated capital market in the region, is well positioned to capture this opportunity, especially now that DCS IPOs are now available to innovative growth companies. Not only will we be able to diversify our economy, [we can] create wealth as well as provide more opportunities for our young people.”

However, Chan emphasized that it is not the HKSARG’s intention to make DCS listings commonplace. Under the recently adopted listing rules, only sizable companies with DCS structures that are regarded as innovative and have been invested in by notable institutional investors are permitted to apply for listing.

Firms that are currently listed will not be allowed to switch to a DCS structure. “The revised Listing Rules will make Hong Kong an attractive listing venue for new tech companies,” Chan explained.

At the same time, Chan emphasized the importance of protecting the investing public. Although other jurisdictions take a *laissez faire* approach, the list of safeguards imposed by the HKEX signals its commitment to investor protection.

Interview 5. The Importance of Choice—View from the Tokyo Stock Exchange

Until 2018, the Tokyo Stock Exchange (TSE) has been one of the few stock exchanges in APAC that allows DCS IPOs. We spoke to Yasuyuki Konuma, Executive Managing Director of TSE, about recent developments in the region. Konuma joined TSE in 1984 and is currently leading TSE's efforts to strengthen corporate value in the market and to encourage more domestic and overseas companies to list.

The rationale of allowing DCS IPOs on TSE is to provide investors with more choices. “The Companies Act in Japan states that corporations may create different classes [of] shares in their company, and there is demand for fundraising using DCS. Additionally, as an exchange, we want to provide a range of options to investors. Therefore, as long as the rights of minority shareholders are respected, TSE would permit such DCS listings,” Konuma said.

It is, however, noteworthy that it remains rare for Japanese companies to be listed with such structures. “We have had some inquiries and discussions, but as of now there has been only one IPO approved for using a DCS structure,” Konuma said.

The TSE has limited the ability of companies to list with several classes of shares with voting rights; this is designed to ensure that the company structure could be understood by investors and, thereby, ensure that investor protection would not be abandoned.⁷¹ For instance, even the amendments to the TSE listing rules made in 2008 would allow firms to list with DCS structures, it did not allow currently listed companies to issue shares with higher voting rights. Indeed, only newly listed companies were permitted to adopt DCS structures. In addition, the TSE rules set a number of safeguards against the abuse of the DCS, including enhanced corporate governance measures to protect noncontrolling shareholder interest.⁷²

Besides limiting DCS listings to newly listed firms, TSE also appear to approve DCS listings carefully. TSE has and will continue to examine the necessity and appropriateness of this structure on a case-by-case basis. It is important that DCS is not used to provide undue benefits to holders of stocks with higher voting rights,” Konuma added.

⁶⁷Tokyo Stock Exchange. 2017. New Listing Guidebook. <http://www.jpx.co.jp/english/equities/listing-on-tse/new/guide/tvdivq0000002g9b-att/bv22ga0000001ugk.pdf>.

⁶⁸Toshima, K. 2014. Cyberdyne's Dual-Class IPO. IFLR 1000, 9 December 2014.

5. Safeguards

As a result [of the DCS structure], investors holding the class of shares with inferior voting rights have limited voice to get themselves heard by the management team when there are signs of corporate mismanagement... Additional safeguards should also be made mandatory to provide a certain level of protection for investors in DCS companies.⁷⁴

Blackrock, Inc., Letter to HKEX, August 2017

Given the heated debate surrounding the issue of DCS listings, it is unlikely that a new DCS regime will be introduced without safeguards. In the CFA APAC Survey, regardless of whether respondents were for or against DCS structures, nearly all respondents (97%) thought that additional safeguards must be put in place if DCS structures are introduced.

We begin this chapter by reviewing some of the most common safeguards in other exchanges. Although there is no defined categorization in academic literature, we take a deeper look at the following safeguards:

- mandatory corporate governance measures
- mandatory sunset provisions
 - ▲ time-based sunset provisions
 - ▲ event-based sunset provisions
- maximum voting differentials
- limitation of share classes
- specific admission and investor requirement
- event-driven temporary reversion to “one-share, one-vote.”

A thorough understanding of the effectiveness and limitations of safeguards would provide policymakers and regulators with a framework for designing proper safeguards if and when DCS listings are considered in the future. For investors, this knowledge will be useful in helping them evaluate DCS companies, and in the event that they have an

⁷⁴Bennett, P. and W. Pun. 2017. “RE: Concept Paper on New Board.” 21 August 2017.

opportunity to negotiate with issuers, encouraging them to go beyond the minimum standards prescribed by stock exchanges.

It is important to remember that safeguards are only one piece in the investor protection jigsaw puzzle. In this big picture, there are multiple stakeholders, each of whom has an important role: investors need to perform due diligence; exchanges need to balance the tension between business development and upholding high corporate governance standards; and regulators need to ensure effective monitoring and enforcement, and must intervene in a timely manner when things go wrong. In addition, in the United States in particular, the judicial system has taken on significant responsibilities in upholding investor rights. As we shall see in this chapter, legal action against rogue companies or management is not an avenue available to most investors in APAC. In markets that have significant direct retail participation, not only does the caveat emptor (i.e., buyer beware) argument offer scant comfort to investors, in times when many investors are taken advantage of or harmed, they inevitably turn to governments and regulators for assistance.

5.1 NYSE

A review of the literature suggests that the existing landscape on the effectiveness of mandatory safeguards appears relatively muted. This, in our view, is a result of the absence of mandatory safeguards in US and European exchanges.

For instance, in terms of mandatory safeguards, the NYSE's listing rules (Section 313.00) merely require that (1) the rights of the holders of the nonvoting common stock should, except for voting rights, be substantially the same as those of the holders of the company's voting common stock; and (2) holders of shares of listed nonvoting common stock must receive all communications, including proxy material, sent generally to the holders of the voting securities of the listed company.⁷⁵

The safeguards set by the NYSE are ineffective in protecting minority shareholders. Meanwhile, although the NYSE generally does not permit an existing issuer to change into a DCS structure that would reduce or restrict the interests of existing shareholders,⁷⁶ there are circumstances when this may be permissible, as the NYSE suggests that

in evaluating a transaction, the Exchange 'will consider, among other things, the economics of [the issuer's] actions,' and that the Exchange's interpretations 'will be flexible, recognizing that both the capital markets and the circumstances and needs of listed companies change over time.' (NYSE, 2013⁷⁷)

⁷⁵NYSE. 2013. "Section 3 Corporate Responsibility."

⁷⁶Pong, C.Y. 2016. "Will Singapore Allow Dual-Class Shares on the SGX?" Baker McKenzie Publications.

⁷⁷NYSE. 2013. "Voting Rights Interpretations Under Listed Company Manual Section 313. Regulation."

Similarly, although the issuance of a new class of stock in addition to existing share classes is generally restricted, “companies with existing dual-class capital structures would generally be permitted to issue additional shares of the existing super voting stock without conflict with [Para. 313].” As it is stated, these elaborations of the regulations have granted much flexibility to issuers when they shape up their companies’ capital and voting structures.

5.2 HKEX and SGX

In publishing their consultation conclusions, HKEX noted that “a majority of respondents did not support migration to a US-style disclosure-only model, and most respondents thought that [DCS] should be accompanied by safeguards that provide minimum shareholder protections against long-term entrenchment of founders and/or key management, and against the risk of expropriation by holders of [DCS].”⁷⁸

Similar remarks were made by Boon Gin Tan, CEO of Singapore Exchange Regulation, who said that the DCS structure was not designed for all companies or all investors.⁷⁹ “As it is associated with the risks of entrenchment and expropriation, we have proposed specific safeguards to mitigate these risks,” Tan suggested.

Exhibit 9 sets out the key mandatory safeguards in the revised listing regimes in Hong Kong and Singapore.

⁷⁸Hong Kong Stock Exchange. 2017. “Consultation Conclusions: New Board Concept Paper.” December 2017.

⁷⁹Singapore Exchange. 2018. “SGX Consults Public on Proposed Safeguards for Dual Class Share Listings.” News & Updates, 28 March 2018.

Exhibit 9: Highlights of Mandatory Safeguards Required in Hong Kong and Singapore

Mandatory Safeguards	HKEX	SGX
Enhanced corporate governance measures	Yes	Yes
Automatic conversion on share transfers	Yes	No*
Restriction to new issuers	Yes	Yes
Minimum market capitalization	HK\$10 billion (US\$1.3 billion)	S\$300 million (US\$214 million)
Minimum equity threshold held by founders or others	10%	None
Automatic conversion on retirement/incapacity/ death of founder	Yes	No
Maximum voting differentials	Yes; 10-to-1	Yes; 10-to-1
Time-based sunset provisions	No	No
Unique stock code	Yes	Yes
Restriction to particular industries	Yes	No

Source: HKEX and SGX disclosures, CFA Institute

*The SGX consultation conclusion suggests that an issuer with a DCS structure must have automatic conversion in place; however, it could be vetoed if approved by shareholders on a "one-share, one-vote" basis.

Research has identified the legal system—such as the availability of class action or litigation in the jurisdiction—as a key factor guiding a market’s corporate governance framework, especially when DCS structures are available in the market (Mak, 2015⁸⁰ ; Wang, 2016⁸¹;

⁸⁰Mak, Y.T. 2015. “Say ‘No’ to Dual Class Shares.” Governance for Stakeholders, 28 November 2015.

⁸¹Wang, O. 2016. “The Dual-Class Share Structure.” Emory Corporate Governance and Accountability Review, vol. 2, issue 1, essays.

Webb, 2013⁸²). Although litigation could be a useful tool, it is not widely available in most Asian jurisdictions.

Realistically, it would require a lengthy law reform process for class actions to become available. Using Hong Kong as an example, after an initial consultation in 2009, and the subsequent report published in 2012 by the Law Reform Commission of Hong Kong (proposing a class action regime be permitted), class actions have still not been introduced.⁸³ Therefore, as DCS structures are introduced in markets where class actions are not available, investors will need help from regulators to mitigate risks.

In cases where risks cannot be prevented, proper investor protections must be in place to alleviate relevant problems. The establishment of an independent organization in various markets for investor protection, in our view, may be considered. In the United States, under New York State's Martin Act (which empowers the state attorney general to conduct investigations of potential fraud related to securities transactions), the Investor Protection Bureau (charged with enforcing the New York State securities law) is tasked with protecting the public from fraud.⁸⁴ In the case when fraud is identified, the state attorney general could commence either civil or criminal prosecutions as a means to protect investors.

In Taipei, the Securities and Futures Investors Protection Center (SFIPC) was set up to provide mediation services when disputes arise from securities and futures trading, as well as litigation services on behalf of investors. If fraud related to company management materializes within DCS companies, the independent organization can help investors sue companies and their management for wrongdoings. These functions are particularly important in APAC because retail investors tend to be more vulnerable to risks associated with managerial entrenchment, and they also represent a significant and, perhaps, growing portion of the total trade in their respective exchanges.⁸⁵ Therefore, the role of the SFIPC and other institutions as a provider of legal expertise and services is instrumental in investor protection.

5.3 Mandatory Corporate Governance Provisions

Corporate governance has been widely recognized as an important topic, especially after the global financial crisis. For instance, former US SEC Commissioner Luis Aguilar suggested that weak risk management in financial institutions was a key reason for the 2008 global financial

⁸²Webb, D. 2013. "Alibaba's Spotlight on HK Regulation." Webb-site Reports, 18 September 2013.

⁸³The Law Reform Commission of Hong Kong. 2012. "Report: Class Actions." May 2012.

⁸⁴New York State Attorney General. "Investor Protection Bureau."

⁸⁵According to the World Federation of Exchanges report published in 2017, entitled "Enhancing Retail Participation in Emerging Markets," retail investors represent 89% of total trade in Taiwan, 84% in Thailand, and 79% in Sri Lanka.

crisis.⁸⁶ Hawas and Tse (2015) found that the connection between corporate governance and major shareholdings has shifted from being insignificant before the financial crisis to becoming significant during the crisis, revealing that major shareholders would tend to consider that corporate governance was especially important during periods of financial turmoil.⁸⁷

CFA Institute considers good corporate governance regimes as essential elements of a sound foundation for capital markets and investor protection. The issue becomes more important in DCS situations. Respondents to the CFA APAC Survey were in broad agreement (see **Exhibit 10**).

Exhibit 10: Results of CFA APAC Survey Regarding Mandatory Corporate Governance Measures

Mandatory Corporate Governance Measures	Should Be Required	Somewhat Appropriate	Not Appropriate
Separation of CEO and Chairman roles (N = 386)	71%	26%	3%
Majority of independent directors on the board (N = 395)	72%	25%	4%
Composition of some/all of the key committees to be at least made up of mostly independent directors (N = 395)	70%	27%	3%
The key committees to be chaired by independent directors (N = 392)	68%	29%	3%

Source: CFA Institute

In general, corporate governance standards in APAC have room for improvement. According to the Organisation for Economic Co-operation and Development (OECD) “White Paper on Corporate Governance in Asia” in 2003, although Asian jurisdictions have made considerable progress in raising awareness of the importance of good corporate governance, more work needs to be done.⁸⁸ As a key priority, governments need to “ensure that non-controlling shareholders

⁸⁶Aguilar, L.A. 2014. “Looking at Corporate Governance from the Investor’s Perspective.” Harvard Law School Forum on Corporate Governance and Financial Regulation, 24 April, 2014.

⁸⁷Hawas, A. and C.B. Tse. 2015. “How Corporate Governance Affects Investment Decisions of Major Shareholders in UK Listed Companies.” *Journal of Accounting, Auditing & Finance*, vol. 31, issue 1.

⁸⁸Organisation for Economic Co-operation and Development. 2003. “White Paper on Corporate Governance in Asia.” 4 Decembe 2003.

are protected from exploitation by insiders and controlling shareholders.” Following up on such positions, Jesover and Kirkpatrick (2011) of the OECD argued that, given the rising economic impact of APAC and the importance of some important emerging economies (such as China, India, and Indonesia), the quality of disclosure, both financial and nonfinancial, should be enhanced and be disclosed in a timely and transparent manner.⁸⁹

Although APAC has a wide range of corporate governance practices, most of the region’s codes and provisions are on a “comply or explain” basis. It is therefore our view that companies with DCS structures should adopt the following mandatory commitments in order to maintain high corporate governance standards, and set a more accountable, proshareholder agenda:

- separation of the roles of chairperson and chief executive
- appointment of an independent chairperson
- appointment of a majority of independent nonexecutive directors (INEDs) to the board
- appointment of a majority of INEDs on key committees such as audit, nomination, and remuneration

Both HKEX and SGX require DCS firms to commit to enhanced corporate governance measures by strengthening the elements of independence on their boards. Although this is welcomed, a challenge is in developing the talent pool of and finding suitably qualified independent directors.

At the same time, while the adoption of these enhanced corporate governance measures is considered best practice, this alone would not be sufficient. Founders and top management team members with super voting shares have tremendous power, and board directors may not be effective in standing up to them.

Cossin and Lu (2017) considered that powerful management, especially those holding both CEO and chairperson positions, could lead to weakened independence of independent directors, because these directors are empowered to adjust board members’ compensation.⁹⁰ Ma and Khanna (2013) found that board directors associate with each other through social networks and business connections, and, as a result, how they behave would depend on their relationships with each other.⁹¹ According to Bebchuk (2017), independent directors

⁸⁹Jesover, F., and G. Kirkpatrick. 2011. “Reform Priorities in Asia: Taking Corporate Governance to a Higher Level. OECD, Asian Roundtable on Corporate Governance.

⁹⁰Cossin, D., and A.H. Lu. 2017. “The Four Tiers of Conflict of Interest Faced by Board Directors.” IMD Global Board Center.

⁹¹Ma, J. and T. Khanna. 2013. “Independent Directors’ Dissent on Boards: Evidence from Listed Companies in China.” Harvard Business School Strategy Unit Working Paper, 13-089.

are incentivized to submit to the decisions of the controlling shareholders because these controlling shareholders tend to have much more influence on the election and retention of independent directors.⁹² Therefore, these independent directors may be unwilling to challenge the status quo for the protection of public investors.

5.4 Mandatory Sunset Provisions

As seen in Chapter 2, even when DCS structures may be a sensible choice at the time of an IPO, they may not make sense forever, as the potential costs of such structures outweigh the benefits over time. Thus, we strongly believe that super voting rights must not be perpetual. A sunset provision prescribes certain conditions when such super voting rights would lapse and ensures that only those who have contributed to the establishment and the subsequent success of the company benefit from such super voting rights. In our view, sunset provisions are of critical importance in any DCS regime.

⁹²Bebchuk, L.A., and A. Hamdani. 2017. “Independent Directors and Controlling Shareholders.” *University of Pennsylvania Law Review*, vol. 165, issue 6(1):1271. https://scholarship.law.upenn.edu/penn_law_review/vol165/iss6/1.

Respondents to the CFA APAC Survey were largely supportive of mandatory sunset provisions, as shown in **Exhibit 11**.

Exhibit 11: Results of CFA APAC Survey Regarding Sunset Provisions			
Sunset Provision	Should Be Required	Somewhat Appropriate	Not Appropriate
Introducing a time-based sunset clause (N = 343)	49%	45%	6%
Automatic conversion of higher voting right shares to ordinary shares when they are traded (N = 364)	59%	33%	9%
Automatic conversion of higher voting right shares to ordinary shares if/when the DCS beneficiary dies or ceases to be a director for personal/regulatory reasons (N = 362)	65%	29%	6%
Forbidding sunset clauses to be overridden by the controlling shareholder (N = 339)	70%	22%	8%

Source: CFA Institute

5.4.1 Time-Based Sunset Provisions

Mandatory time-based sunset provisions are considered by CFA Institute and other corporate governance advocates as the most effective safeguard. Under such provisions, super voting rights would lapse upon an agreed anniversary of the IPO, and the company would revert to a one-share, one-vote structure. Time-based sunset provisions limit preferential voting rights to a defined period, and, in turn, relieve minority stakeholders of permanent exposure to moral hazard.

CFA Institute considers a mandatory sunset that automatically converts super voting rights to regular voting rights in no more than five years to be appropriate. This number is consistent with the various academic research highlighted, such as, Cremers, Lauterbach, and Pajuste (2018), who found that discounts on DCS counters usually start to appear between six and nine years after the IPOs.⁹³ It is important to note that the five year limit is the proposed

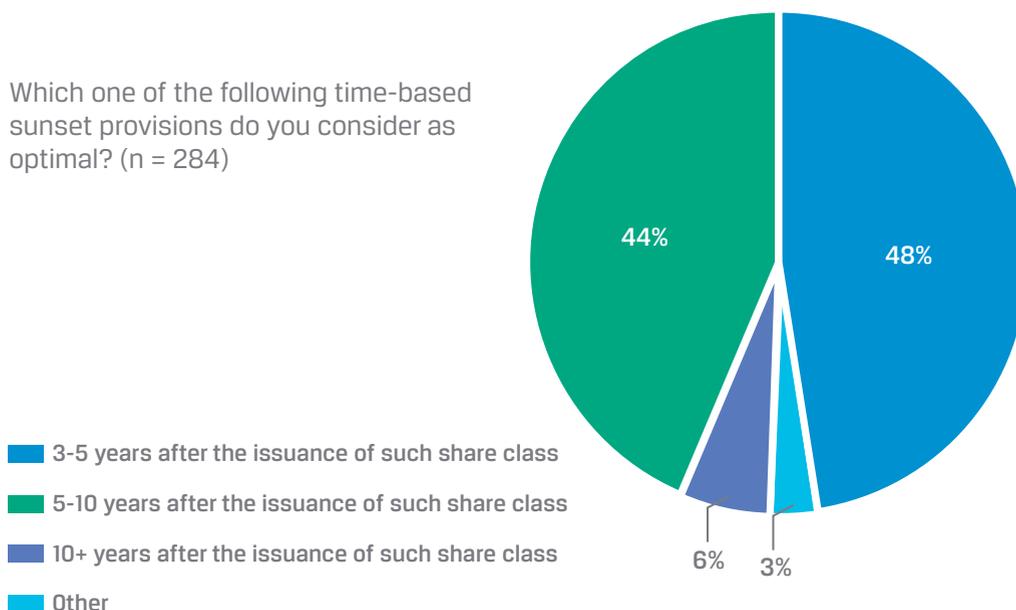
⁹³Cremers, M., B. Lauterbach, and A. Pajuste. 2018. "The Life-Cycle of Dual Class Firms." European Corporate Governance Institute (ECGI)—Finance Working Paper, 550.

maximum length, and issuers can always select a shorter period. This is especially pertinent, given that issuers now come to the market at a much later point in their life cycle and are already large, established companies by the time they list. Further, we believe this should be a “hard stop” for clarity and certainty.

In the CFA APAC Survey, to those respondents who considered it appropriate to have a time-based sunset provision in place (94% of all respondents), we asked them what they thought would be an optimal time. Over 90% of our members in APAC suggested that the limit should be set at under 10 years, with 48% of them considering an appropriate timeframe to be between three to five years appropriate. These findings, in our view, justify a stronger push by the investment community for a mandatory time-based sunset provision (**Exhibit 12**).

Exhibit 12: Results of CFA APAC Survey Regarding Optimal Time for Time-Based Sunset Provisions

Which one of the following time-based sunset provisions do you consider as optimal? (n = 284)



Source: CFA Institute

As **Exhibit 13** shows, even in the United States where mandatory time-based sunsets are not mandatory, a growing number of technology companies have imposed such provisions voluntarily. In jurisdictions where corporates are eligible to be the beneficiaries of super voting rights, or where shares bearing super voting rights are transferable, the potential perpetuity of super voting rights makes the need for time-based sunsets even more acute.

Exhibit 13: Time-Based Sunset Approaches to Dual-Class Stock

Company	IPO Year	Sunset Trigger
EVO Payments	2018	3 years
Texas Roadhouse	2004	5 years (converted in 2009 to one share, one vote)
Groupon	2011	5 years (converted in 2016 to one share, one vote)
MuleSoft	2017	5 years (acquired in 2018 by Salesforce)
MaxLinear	2010	7 years (converted in 2017 to one share, one vote)
Yelp	2012	7 years or superclass falls below 10% of outstanding common (converted in 2016 to one share, one vote)
Kayak Software	2012	7 years (acquired in 2013 by Priceline, now Booking Holdings)
Mindbody	2015	7 years
Apptio	2016	7 years or superclass falls below 25% of outstanding common
Twilio	2016	7 years
Smartsheet	2018	7 years or superclass falls below 15% of outstanding common
Veeva Systems	2013	10 years
Castlight Health	2014	10 years
Pure Storage	2015	10 years or superclass falls below 10% of outstanding common

Company	IPO Year	Sunset Trigger
Castlight Health	2014	10 years
Pure Storage	2015	10 years or superclass falls below 10% of outstanding common
Stitch Fix	2017	10 years or superclass falls below 10% of outstanding common
Alteryx	2017	10 years or superclass falls below 10% of outstanding common
Hamilton Lane	2017	10 years or founders and employees hold less than 25% of voting power
Okta	2017	10 years
Zuora	2018	10 years or superclass falls below 5% of outstanding common
Altair Engineering	2017	12 years or "executive holder" position falls below 10% of outstanding common
Fitbit	2015	12 years
Nutanix	2016	17 years
Workday	2012	20 years or superclass falls below 9% of outstanding common

Source: CII⁹⁴

⁹⁴Council of Institutional Investors. 2018. "Time-Based Sunset Approaches to Dual-Class Stock." 14 February 2018.

5.4.2 Event-Based Sunset Provisions

Along the same line that shareholders should not be entitled to preferential treatment perpetually—even if they are founders—CFA Institute considers it appropriate for super voting rights to lapse if the beneficiaries of those rights stop contributing to the companies.

We believe DCS beneficiaries should be restricted to those who carry out directorate functions for the issuers. This is based on our belief that founders should only be entitled to super voting rights when they are creating outsized value and hold fiduciary duties. As a result, in conjunction with a time-based sunset provision, super voting rights attached to beneficiaries' shareholdings should lapse if such beneficiaries

- are no longer directors of relevant companies; or
- die or are incapacitated; or
- transfer the shares to another person.

Some firms in the United States would permit the transfer of super voting rights from a founder to family members as a part of estate planning (see the CBS Corporation and Viacom Inc. case studies in Chapter 6). This allows the founders' families to retain outsized voting control, while keeping low equity stakes. Such a practice, however, is unfair to other unaffiliated shareholders who have most likely invested in the company because of the founder and not because of his or her family members.

These concerns are justified, given that businesses owned by families with varying competencies would tend to fail (Stalk and Foley, 2012⁹⁵; Greubel, 2004⁹⁶). A 2004 Family Business Institute's study shows that only a third of family owned businesses could transition to the next generation successfully.⁹⁷ Therefore, we believe mandatory event-based sunset provisions that cannot be voted down by beneficiaries of DCS structures should be in place for firms listing with DCS structures.

⁹⁵Stalk, G. Jr., and H. Foley. 2012. "Avoid the Traps that Can Destroy Family Businesses." *Harvard Business Review*, January–February 2012.

⁹⁶Greubel, J. 2004. "The Third Generation Isn't Always A Charm." *Pittsburg Business Times*, 20 September 2004.

⁹⁷Family Business Institute. 2004. "Succession Planning."

5.5 Maximum Voting Differentials

This safeguard seeks to impose the maximum number of votes a super voting share can have. Zynga Inc., a maker of games for mobile phones, had three classes of shares at the time of its IPO, one of which had as many as 70 votes per share. The higher the voting differential, the bigger the wedge is between control and equity ownership. Placing a cap on this number will ease this distortion.

Exhibit 14: Results of CFA APAC Survey Regarding Share Classes and Maximum Voting Differentials			
Classes of Shares/Voting Right Differential	Should Be Required	Somewhat Appropriate	Not Appropriate
Introducing a maximum voting differential (N = 356)	66%	28%	7%
Prohibiting the issuance of shares with no voting rights (N = 361)	50%	27%	24%
Prohibiting the issuance of dual- or multiple-share classes by a company that is already listed (N = 357)	55%	27%	18%

Source: CFA Institute

Snap Inc., for instance, made history by being the first and only company that issued only nonvoting shares in its IPO. By doing so, Snap implemented a DCS structure where founders retain super voting shares, while denying public shareholders any voting rights. According to regulatory filings, the founders of the maker of the vanishing message application Snapchat are keeping a 22.4% stake each in Class C shares; these shares have 10 votes each, giving the founders 88.5% of the voting power. “Mr. [Evan] Spiegel and Mr. [Robert] Murphy, and potentially either one of them alone, have the ability to control the outcome of all matters submitted to our stockholders for approval, including the election, removal, and replacement of directors and any merger, consolidation, or sale of all or substantially all of our assets. If Mr. Spiegel’s or Mr. Murphy’s employment with us is terminated, they will continue to have the ability to exercise the same,” Snap said in the filings.

Shares with zero voting rights may sound similar to preference shares, or preferred stocks, but they are fundamentally different. Preferred stocks give holders a higher priority in (usually fixed) dividend payments. Moreover, if a company should liquidate, preferred stockholders

are entitled to claim assets from the company before common shareholders. Thus, the loss of voting rights is compensated for with other economic benefits.

In a nutshell, shares with zero voting rights function more similar to fixed income or other financial products that allow investors the exposure to the performance of such investment vehicles but no impact on company decisions. In some sense, it may explain part of Snap's performance since its launch in mid-2017 (**Exhibit 15**).

Exhibit 15: Snap Share Price Performance Relative to NASDAQ Composite



Indexed performance; closing price or index level on 2 March, 2017 = 100

Source: Yahoo Finance, CFA Institute

If there was a silver lining from the Snap IPO, that would be the re-affirmation of the important role that index compilers play in investor protection. As a result of the ensuing uproar, all major index compilers (including S&P Dow Jones Indices, FTSE Russell and MSCI) re-examined if and how stocks with unequal voting rights should be included in benchmark indices by consulting the market. Both S&P Dow Jones Indices and FTSE Russell have since set stricter guidelines for IPOs and stopped allowing new issuers with poor DCS structures in their indices, although companies that were already index constituents were grandfathered.

Unlike S&P and FTSE, MSCI is still in the consultation phase. Their proposed approach is arguably more nuanced: firstly, while they would continue to include stocks with unequal voting rights, the weights of such stocks would be adjusted to reflect both their free float and their “company level listed voting power”.⁹⁸ The gap between free float and the voting power that free float represents would thus be key: for issuers with high free float, but low level of voting power, the index weightings of these issuers will be adjusted downwards to reflect the lower aggregate voting power. The larger the gap, the bigger the downward adjustment. Secondly, and more importantly, the weight adjustments would be applicable to both existing and new index constituents, although a grace period of three years is proposed for existing constituents. If the proposal goes through as is, there will be significant ramifications for some large index constituents. MSCI is set to complete their consultation by the end of September 2018, with results expected by the end of October 2018.

According to the Global Governance Principles of the International Corporate Governance Network, the misalignment of economic interests and voting rights could result in managerial entrenchment.⁹⁹ Similarly, the OECD suggests that a higher degree of economic involvement by management could lead to lower transaction costs and discourage opportunistic behaviors.¹⁰⁰

As such, imposing a maximum level of voting differentials should be considered as a measure to reduce entrenchment issues; setting such a maximum is a common practice in some European markets.¹⁰¹ Although some investors consider a 10-to-1 maximum voting differential appropriate, a shareholder with super voting rights only needs 9.1% of equity to have 50% of voting rights (see **Exhibit 16**).

⁹⁸MSCI (2018) Consultation Discussion Paper: Should Equity Indexes Include Stocks of Companies with Share Classes Having Unequal Voting Rights?

⁹⁹International Corporate Governance Network. 2017. “Differential Share Ownership Structures.” February 2017.

¹⁰⁰Maher, M., and T. Anderson. 1999. “Corporate Governance: Effects on Firm Performance and Economic Growth.” OECD.

¹⁰¹Shearman & Sterling LLP. 2007. “Proportionality between Ownership and Control in EU Listed Companies: Comparative Legal Study.” External Study Commissioned by the European Commission, 18 May 2007.

Exhibit 16: Minimum Economic Stake Required for a Majority Vote Under Different Voting Differentials

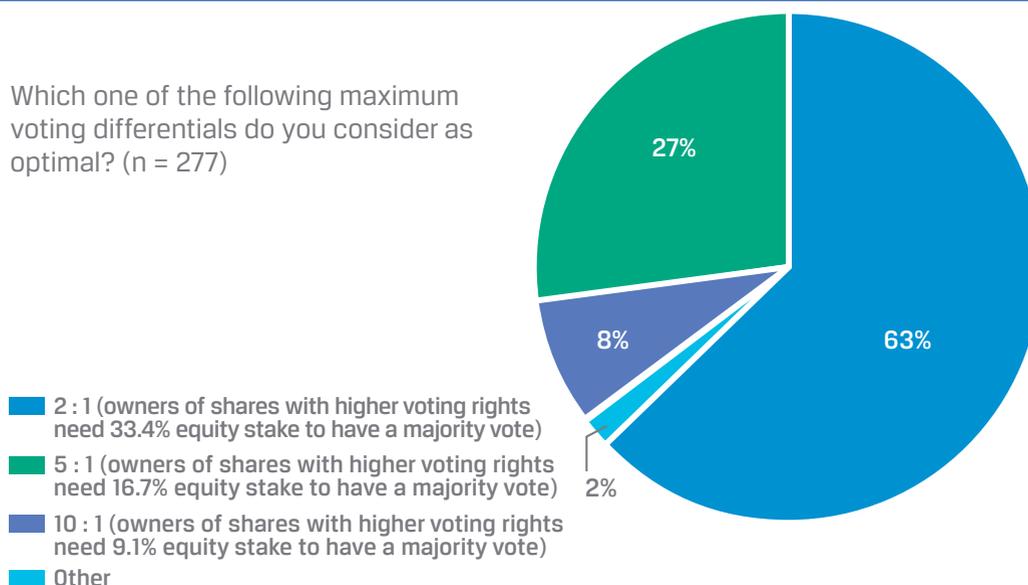
Voting Differentials	Minimum Economic Stake Required for a Majority Vote
100:1	1.0%
70:1	1.4%
10:1	9.1%
5:1	16.7%
3:1	25.1%
2:1	33.4%

Source: CFA Institute

CFA Institute thus advises exchanges to mandate a maximum voting differential at 3:1—or at most 5:1, which is agreed upon by 90% of the CFA APAC Survey respondents (see **Exhibit 17**)—would be more effective in holding company management properly accountable for their actions (i.e., they would need to have higher economic stake in the companies), thereby mitigating some of the expropriation and entrenchment risks.

Exhibit 17: Results of CFA APAC Survey Regarding Maximum Voting Differentials

Which one of the following maximum voting differentials do you consider as optimal? (n = 277)



Source: CFA Institute

5.6 Limitation of Share Classes

Generally speaking, management executives of DCS firms are not allowed to further entrench themselves by issuing any other additional classes of shares.¹⁰²

As an example, in 2012, Google (now Alphabet Inc.), which was originally listed with two classes of shares: ordinary Class A shares with one vote per share and Class B shares with 10 votes per share, announced plans to issue a new Class C of shares—that carry no voting rights—as “dividends” to all shareholders. This was seen as a way to dilute the voting power of Class A shareholders and cement control of the founders. Public shareholders filed a lawsuit against the executives for breach of fiduciary duty. Just before the trial, the parties agreed to settle by letting the market decide the value of the Class A shares, subject to the volume-weighted average trading price differentials between Class A and Class C shares

¹⁰²Section 313.10 of NYSE’s listing rules suggests that “the restriction against the issuance of super voting stock is primarily intended to apply to the issuance of a new class of stock, and companies with existing dual class capital structures would generally be permitted to issue additional shares of the existing super voting stock without conflict with this Policy.”

for 12 months after the issuance of Class C shares.¹⁰³ The payment was subject to a formula that took into account the size of the premium or discount of Class C shares relative to Class A shares.

In the end, the Class C nonvoting shares traded at a discount (at about 2% of the price of Class A shares), and Google had to pay approximately US\$560 million to the plaintiffs as compensation.

The extent of the effectiveness of this safeguard depends on the attitude of the stock exchange in question. According to NYSE, “the restriction against the issuance of super voting stock is primarily intended to apply to the issuance of a new class of stock, and companies with existing dual class capital structures would generally be permitted to issue additional shares of the existing super voting stock.”¹⁰⁴

A case in point is Facebook Inc., which also wanted to issue Class C nonvoting shares in 2016.¹⁰⁵ After Facebook founder Mark Zuckerberg, and his wife pledged in 2015 to give away 99% of the couple’s Facebook shares to the Chan Zuckerberg Initiative—which would potentially weaken Zuckerberg’s control over the company—the social media giant set up a special committee in August 2015, composed of independent, nonmanagement directors to evaluate a potential restructuring of Facebook’s capital structure. The objective of this proposal was to allow Zuckerberg to retain control of Facebook while funding his philanthropic initiatives.

Eventually, the special committee unanimously recommended, and the board of directors unanimously approved, the proposal to reclassify the share structure, issuing a separate Class C share as a one-time dividend. According to the original plan, each outstanding Class A and Class B share held by stockholders would be entitled to two shares of the new Class C stock.

Two Facebook investors, Eric McGinty and Eric Levy, filed two separate class action lawsuits, followed by another suit filed by Sjunde AP-Fonden, a Swedish pension fund. Each lawsuit stated that Zuckerberg and the Facebook board of directors had breached their

¹⁰³Delaware Chancery Court. 2013. “Memorandum of Understanding: In Re Google Inc. Class C Shareholder Litigation.”

¹⁰⁴NYSE Listing Rules, Section 313.10.

¹⁰⁵Stretch, C. 2016. “Preserving Founder-Led Structure to Focus on the Long Term: Proposal to Create New Class of Publicly Listed, Non-voting Class C Capital Stock.” US SEC.

“fiduciary duties of loyalty, good faith, and candor.”^{106,107,108} They also emphasized that the proposed transaction would impose a substantial entrenchment effect, allowing Zuckerberg to benefit from selling his Class C stock while maintaining his control over the company. In the end, Zuckerberg and Facebook withdrew the proposal several days before the founder of the social media giant was scheduled to appear in court.¹⁰⁹

This example shows that investors could be hurt if management decides to introduce a new nonvoting share class, which would concurrently reduce investor say in the company. The aforementioned example is a rare case where investors won, and the ability of investors to sue was key. That is, if super shareholders decide to further entrench themselves, it would be difficult for ordinary shareholders to protect against such actions in the absence of class-action lawsuits (La Monica, 2017).¹¹⁰

Therefore, we believe that the prohibition of issuing any new share classes is especially appropriate in the APAC context.

5.7 Specific Admission and Investor-Mix Requirement

At both HKEX and SGX, a common theme during their respective consultations was to set certain criteria to restrict the type of issuers that are eligible for a DCS IPO, including:

- new listings only;
- a minimum size requirement (i.e., market capitalization);
- an industry requirement (e.g., innovative industries); and
- the presence of institutional investors.

¹⁰⁶*Eric McGinty v. Mark Zuckerberg, Sheryl Sandberg, Marc Andreessen, Erskine B. Bowles, Susan Desmond-Hellmann, Reed Hastings, Jan Koum, Peter A. Thiel, and Facebook, Inc.* 2016. Verified Class Action Complaint.” In the Court of Chancery of the State of Delaware, Transaction ID 58934286, Case No. 12282.

¹⁰⁷*Eric Levy, for the Coverdell Education Savings Plan FBO Dash Redding Levy, individually and on behalf of all others similarly situated v. Mark Zuckerberg, Sheryl Sandberg, Marc Andreessen, Erskine B. Bowles, Susan Desmond-Hellmann, Reed Hastings, Jan Koum, Peter A. Thiel, and Facebook, Inc.* 2016. Verified Class Action Complaint. In the Court of Chancery of the State of Delaware, Transaction ID 58934286, Case No. 12282.

¹⁰⁸Rudy, L.D. 2018. “Zuckerberg Forced to Capitulate on Plan to Unlawfully Extend His Voting Control Over FB.” Commentary. *The Legal Intelligencer*, 19 February 2018.

¹⁰⁹Frier, S. 2017. “Facebook Scraps New Share Class in Rare Win for Investors.” Bloomberg Technology, 22 September 2017.

¹¹⁰La Monica, P. 2017. “Oh, Snap? You Get NO Say in How Snapchat Is Run.” The Buzz, CNN Money.

However, in the end, the actual rules between HKEX and SGX diverged. After two rounds of consultations, HKEX revised its listing rules as follows:

- new issuers only—a general anti-avoidance rule is in place to protect shareholders from companies already listed to circumvent this restriction;¹¹¹
- a minimum market capitalization threshold of HK10 billion (US\$1.3 billion), subject to further revenue testing for suitability; and
- “Innovative” companies only.

Although SGX has also restricted DCS IPOs to new issuers only, it set a much lower minimum market capitalization requirement at S\$300 million (US\$214 million) and removed the need for sophisticated investor participation, citing the differences of views from consultation respondents. Similar to HKEX, SGX banned any further managerial entrenchment through setting a requirement that the ratio of votes with super and ordinary voting rights be fixed at the time of the IPO, with no subsequent changes allowed.

From our perspective, neither size nor having a predetermined investor mix is an effective safeguard against managerial entrenchment and other risks inherent in DCS companies.

For instance, although 84% of the CFA APAC Survey respondents considered it appropriate to set a minimum market capitalization threshold for companies to list with DCS structures (**Exhibit 18**), in a statement issued in June 2015, the Hong Kong Securities and Futures Commission (SFC) stated that

size offers no assurance that a company would treat its shareholders fairly. Any corporate misconduct by an issuer with a large market capitalisation will likely affect more investors and have a greater impact on our markets. For example, these issuers are more likely to become index components which will compel index funds and other types of “passive” institutional investors (which invest public money) to buy and hold their stocks even if fund managers disagree with their WVR structures.

(SFC, 2015¹¹²)

¹¹¹HKEX. 2017. “Consultation Conclusions: New Board Concept Paper, December 2017.

¹¹²Securities and Futures Commission. 2015. “SFC Statement on the SEHK’s Draft Proposal on Weighted Voting Rights.” News and Announcements.” 25 June 2015.

Exhibit 18: Results of CFA APAC Survey Regarding Specific Admission and Investor-Mix Requirement			
Specific Admission and Investor-Mix Requirement	Should Be Required	Somewhat Appropriate	Not Appropriate
Setting a minimum market capitalization threshold (N = 340)	44%	40%	16%
Setting a requirement for the listed firm to have been substantially invested by institutional investors, who would have undertaken proper due diligence (N = 336)	35%	46%	19%

Source: CFA Institute

In terms of having institutional or sophisticated investors present in DCS companies, both HKEX and SGX retreated from this initial requirement. Although having such investors' endorsement may offer additional comfort for public shareholders, always open to question is whether the institutional or sophisticated investors' interests are aligned with those of public shareholders. In addition, the practical barriers involved may have stopped the exchanges from pushing forward.

5.8 Event-Driven Temporary Reversion to "One-Share, One-Vote"

Concerns over DCS structures are mostly related to managerial entrenchment and self-profiting the key management team members. To counter this, both HKEX and SGX requested that voting revert to "one-share, one-vote" over certain matters, so that DCS beneficiaries could not exercise super voting rights (**Exhibit 19**).^{113,114}

¹¹³HKEX. 2018. "Consultation Conclusions: A Listing Regime for Companies from Emerging and Innovative Sectors." April 2018.

¹¹⁴SGX. 2018. "Consultation Paper: Proposed Listing Framework for Dual Class Share Structures." 28 March 2018.

Exhibit 19: Issues to Be Decided on a "One-Share, One-Vote" Basis

	HKEX	SGX
Changes to the issuer's legal documents	Yes	Yes
Variation of rights attached to any class of shares	Yes	Yes
Appointment or removal of an independent non-executive director	Yes	Yes
Appointment or removal of an auditor	Yes	Yes
Winding up of the issuer	Yes	Yes
Delisting of the issuer	Not mentioned	Yes

Source: HKEX and SGX disclosures, CFA Institute

At CFA Institute, although we believe these conditions are suitable, an important—and arguably, the most relevant—provision overlooked by both exchanges is a coattail provision, which requires DCS companies' voting decisions to be made on a one-share, one-vote basis if and when a takeover offer is received.¹¹⁵

The purpose of the coattail provision is to ensure that every shareholder will be entitled to equal voting rights if the issuer receives a takeover offer. This provision would mitigate the risk of exploitation by company executives who might act out of self-interest instead of in the interests of shareholders as a whole (e.g., rejecting an offer with huge premiums to maintain their managerial power in the company). The adoption of such a coattail provision in jurisdictions such as Sweden (where DCS listings of are permitted), demanding voting decisions be made on a one-share, one-vote basis, ensures that all shares would be on an equal footing.

In the absence of such a provision, owners of shares with inferior voting rights could be deprived of the right to have their views counted for important decisions (such as a premium

¹¹⁵We note that SGX has acknowledged the demand for a coattail provision, and has “informed that Securities Industry Council to consider the implications of a DCS structure in the context of a takeover under the Take-over Code” (Section 4.15).

offer). Therefore, exchanges considering the acceptance of DCS listings should contemplate the adoption of a coattail provision, as agreed by a vast majority (97%) of respondents in the CFA APAC Survey (see **Exhibit 20**).

In addition to the coattail provision, we propose that considerations should also be given to including (1) connected-party transactions, and (2) very substantial transactions, which were also required for non-DCS firms. We believe these matters should be voted on a one-share, one-vote basis, where DCS beneficiaries would not be able to exercise super voting rights. This would prevent a full-fledged confiscation of non-DCS shareholders' rights to vote on issues that have a substantial effect on their interests.

Chemmanur and Jiao (2012) proposed having strict regulations against managerial entrenchment and privatization of corporate benefits.¹¹⁶ Among others, the authors suggested requiring management to relinquish the shares with super voting rights if such firms constantly underperform against industry peers.

¹¹⁶Chemmanur, T.J., and Y. Jiao. 2012. "Dual Class IPOs: A Theoretical Analysis." *Journal of Banking & Finance*, 36 (2012), 305–319.

Exhibit 20: Results of CFA APAC Survey Regarding Other Specific Provisions and Requirements to Strengthen Investor Protection			
Provisions	Should Be Required	Somewhat Appropriate	Not Appropriate
Introducing a coattail provision, which will allow ordinary shareholders to have an equal footing in the case of a company takeover offer (N = 348)	68%	29%	3%
Reverting to "one share, one vote" for related parties or substantial transactions (N = 360)	65%	28%	7%
Only allowing individuals to hold shares with super voting rights (i.e., no corporate shareholders) (N = 342)	43%	30%	27%
Requiring DCS stocks to contain specific stock codes as identifiers (N = 345)	72%	24%	4%
Establishing a separate board for the listing of such stocks (N = 315)	32%	37%	31%
Prohibiting DCS stocks to be included in major benchmark indices (N = 332)	37%	30%	33%

Source: CFA Institute

5.9 Other Suggested Protection Measures

Other suggested protection measures include the following:

- **Unique identifiers:** As an attempt to raise awareness of the DCS structures that are new to their respective markets, both HKEX and SGX have requested that DCS shares have a unique symbol prominently displayed in the stock name to help investors differentiate DCS firms from those with regular voting structures.
- **Separate listing board:** HKEX and SGX had considered forming a new board specifically for DCS new-economy stocks, but the idea was not welcomed by consultation respondents and, thus, abandoned.
- **Disclosure:** Risks associated with the structure should be displayed in investor communication materials, such as the listing documents (e.g., prospectus), quarterly/annual reports, circulars, notifications, and announcements.

To this end, we wish to note that some of the aforementioned safeguards may not fit one market but may be desirable for others. Thus, exchanges must engage practitioners via consultation for related matters. It is also important for regulators and lawmakers to enact necessary reforms, including, for example, introduction of class action rights.

Views of Industry Stakeholders: Part 3

Interview 6. You Can't Have Your Cake and Eat It Too—An Institutional Investor's Perspective

Gerard Lee How Cheng, CFA, Chief Executive Officer of Lion Global Investors Ltd. (LGI), shared his views on DCS safeguards.

Headquartered in Singapore, LGI, a member of the Oversea-Chinese Banking Corporation Limited (OCBC) Group, is one of the largest asset management companies in Southeast Asia, with group assets under management of S\$49.9 billion (US\$37.3 billion) as of 31 December 2017. LGI employs a team of over 40 fund managers and analysts, more than half of whom are CFA charterholders. LGI invests in Asian companies listed on any stock exchange, including those listed outside of Asia.

In principle, Lee does not agree with DCS structures.. “DCS should not exist in the first place. If these people want control, then they should just stay private. By going public, their companies enjoy a higher valuation, more liquidity, and better access to financing, but you need to give up some control. You can't have your cake and eat it too.”

In reality, as an institution, LGI does invest in DCS companies. Lee acknowledges that the availability of such a shareholding structure could provide more incentives for companies to go public, since they do not need to relinquish control.

Lee pointed out that the desire to maintain an exposure to Chinese internet stocks is one of the key reasons why LGI allows DCS investments. “The Chinese economy is one of the fastest growing in the world. Given the rising penetration of the internet and e-commerce there, we cannot afford to sit out.”

Despite Lee's stance on DCS, LGI does not restrict its portfolio managers from investing in stocks that are listed with such structures.

Clients expect good performance from their investment managers. Thus, “there is this dilemma between what you think should be the gold standard and commercial considerations,” Lee explained.

Interview 7. The Importance of Safeguards –View from an Association of Asset Owners and Institutional Investors

We spoke to Ken Bertsch and Amy Borrus, Executive Director and Deputy Director of the Council of Institutional Investors (CII), respectively, to learn more about CII's position on DCS structures. CII is a nonprofit, nonpartisan association of pension funds, other employee benefit funds, endowments, and foundations, with voting members' combined assets exceeding US\$3.5 trillion. CII's associate (i.e., nonvoting) members include asset management firms with more than US\$25 trillion under management.

CII has been vocal about its opposition to the DCS structure. It considers companies adopting DCS structures as having poor governance. “Core to CII founding, one of the first—if not the first—corporate governance best practices that CII has ever advocated is to uphold the principle of ‘one share, one vote.’ Although some members are slightly more open to DCS, our core members are overwhelmingly against DCS structures,” said Bertsch.

In general, although shares with inferior voting rights trade at a discount, Bertsch believes that it may be difficult for asset owners or managers to value such discounts consistently and systematically.

“We can use Alphabet as an example, on pricing effects. Alphabet Class A shares are held by the founders, not publicly traded, and carry 10 votes per share. Class B and C shares are publicly traded. Class B shares with one vote per share persistently trade at a 2% premium to Class C shares with no voting rights,” Bertsch said. “However, as a fundamental investor, if you take the view that the fundamentals of a particular DCS company are strong—and maybe other investors are overdoing the discount—it could become an interesting investment opportunity. In general, it is said that people would ascribe a 5%–10% discount to low-voting shares where super voting shares control the company, but it varies significantly. So as a general proposition, it is difficult to come up with a generic discount for DCS stocks.”

Noting the high degree of uncertainty, Borrus believes that mandatory safeguards must be put in place. “There are a lot of sunset provisions that the US companies have in place, but given [that] many of them can be amended by the controlling shareholders, these safeguards are rather meaningless,” she explained. “Therefore, having some firm safeguards that cannot be changed by the holders of high-voting shares built in to the rules may reduce uncertainty.”

6. Case Studies

One may question the difference between a company with a large majority shareholder and one that has a controlling shareholder under a DCS structure: in both instances, voting is concentrated in the hands of one, or a few, shareholders, and it would be difficult for public, minority shareholders to call management to account.

Despite the fact that the minority would be subject to decisions of these controlling shareholders in both cases, the majority shareholder in a single-class company retains such power with respect to his or her proportionate economic interest in the company. Under such circumstances, the ability of this shareholder to steward the company is, in our view, market oriented, which would reduce the agency costs described earlier in this report.

Charles Elson, the Edgar S. Woolard, Jr., Chair in Corporate Governance and the director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, suggested that boards of companies with DCS structures essentially shift the monitoring function externally to governments and regulators—creating additional costs to the public and the loss of accountability.¹¹⁷ And when management accountability is low or ignored, it presents a real risk of scandals.¹¹⁸

In this chapter, we include three case studies that illustrate the harm of low managerial accountability arising from DCS structures.

¹¹⁷Ibid, Kristie (2012).

¹¹⁸Heady, L. 2017. “Protecting Our Purpose: How Low Accountability Is Leaving Impact Investing Open to Attack.” Nesta, 25 January 2017.

6.1 Case Study 1: Magna International Inc.

Speed Read

- Magna International Inc., a Canadian auto parts company, initially had two classes of shares. Class A shares had one vote per share, and Class B shares had 500 votes per share. The founder, Frank Stronach, held Class B shares and controlled 75% of the voting rights with 3% of equity.
- The company founder and his family were richly rewarded through a combination of executive pay packages, option schemes, and consultancy arrangements during their tenure, despite operational setbacks and share price corrections.
- In a special meeting in 2010, shareholders voted to revert to a single-class share company. The company paid the founder a combined cash and shares package of US\$870 million as compensation. Stronach remained as a consultant to the company until 2014.
- Since the abolition of Class B shares, Magna's share price soared from C\$25.96 at the end of 2010 to C\$76.46 at the end of June 2018.

What happened between Magna, a major auto parts firm headquartered in Canada, and its founder, Frank Stronach, is often cited as an example of how DCS structures can hurt investors.

According to Magnan and Khalil (2007), Stronach's family controlled 75% of the voting rights at Magna but held only 3% of the company's equity stake. Each Class B share carried 500 votes, whereas Class A shares were entitled to one vote per share. The company founder held the super voting shares until the breakup in 2014.

As a result of the disparate equity stake and voting structure, the founder managed to obtain C\$52 million in consulting fees, salaries and bonuses on top of some C\$6 million worth of stock options, despite a 30% correction of the company's stock price in 2002. During the same year, compensation more than doubled for Belinda Stronach, daughter of the chair and the chief executive officer of Magna.¹¹⁹ The compensation arrangements led to a number of complaints from investors, who were powerless given the DCS structure.

¹¹⁹Keenan, G. 2003. "Magna Boss Took Home \$58.1-million." *The Global and Mail*, 18 April 2018.

The company called for a special meeting in mid-2010 to “consider and vote upon a special resolution to approve a reorganization of Magna that would result in the elimination of Magna’s dual class share structure by way of a court-approved plan of arrangement.”¹²⁰ One of the potential benefits of such arrangement was that “the trading price of the Class A Subordinate Voting Shares may increase relative to the preannouncement trading price to the extent that the trading price reflected a discount attributable to the dual class share structure.”

The meeting culminated in an agreement whereby Frank Stronach would leave the company that he founded in 1957 and be paid C\$870 million as part of the arrangement. According to Reuters, Stronach was paid US\$47 million in 2012 and US\$38 million in 2011 for consulting services under the agreement for him to give up the control of the company. It was suggested that Stronach, while he would no longer serve as the chair of Magna, would enter into a consulting agreement with the company. The fees payable to Stronach and his affiliated entities would be “determined on the basis of 3% of Magna’s Pre-Tax Profits Before Profit-Sharing” (see **Exhibit 21**).

Exhibit 21: Consulting Agreement between Magna and Frank Stronach

Consulting Agreement	2010	2011	2012	2013	2014
New Magna Investments Consulting Agreement*	1.00%	0.92%	0.83%	0.75%	0.67%
Magna Investments Business Development Agreement*	1.00%	0.92%	0.83%	0.75%	0.67%
Magna Business Services Agreement	1.00%	0.92%	0.83%	0.75%	0.67%
Total Percentage	3.00%	2.75%	2.50%	2.25%	2.00%

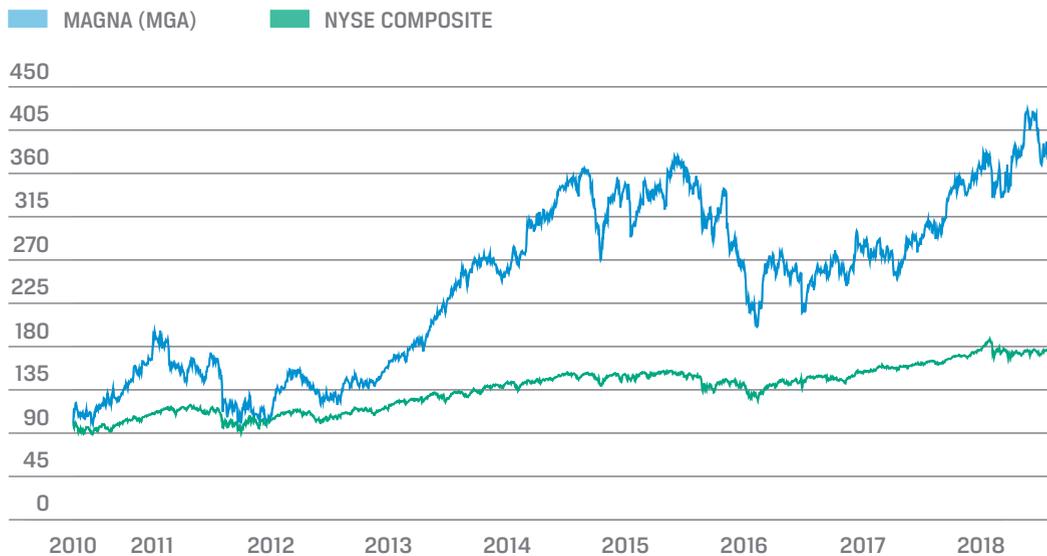
The aggregate fees payable under each of these Amended Consulting Agreements will be determined with reference to the applicable percentage of Magna's Pre-Tax Profits Sharing less \$1,150,000.

Source: Magna

¹²⁰Magna. 2010. “Notice of Special Meeting of Holders of Class A Subordinate Voting Shares and Class B Shares of Magna International Inc.”

In 2014, the company declared that “the Stronach compensation arrangements will not be renewed, extended, or replaced with any other form of compensation,” effectively ending the relationship with the founder of the company.¹²¹ Although such a breakup came with an expensive price tag, it was applauded by investors, and the company’s stock price has taken off since the breakup (see **Exhibit 22**).

Exhibit 22: Magna Share Price Performance Relative to NYSE Composite



Indexed performance; closing price or index level on 5 May, 2017 = 100

Source: Yahoo Finance, CFA Institute

¹²¹Magna. 2014. “Management Proxy Circular.”

6.2 Case Study 2: Facebook, Inc.

Speed Read

- Under Facebook, Inc.'s shareholding structure, founder Mark Zuckerberg controls the majority of voting rights because his shares have 10 times the voting power of publicly traded shares. This is increasingly viewed as the source of Facebook's recent problems, including the data breach scandal involving Cambridge Analytica Ltd.
- The scandal highlights certain risks, including data privacy and the threat of new regulation, that may threaten Facebook's business model.
- Concerned investors have views as to what steps should be taken, but all proposals made during Facebook's 2018 annual meeting failed. Without the votes, there is nothing public shareholders can do.

Facebook, Inc., arguably the most popular and successful global social media platform, generates the bulk of its revenue from placing targeted advertisements to its users that are based on data and behavior gathered by the platform. This is enabled by the large client database that Facebook has accumulated for over a decade. In short, it is the users' data, experiences, and behaviors that make the company valuable.

Since March 2018, the social media giant has been trying hard to mend its damaged image as a result of a massive data scandal involving Cambridge Analytica Ltd., after Christopher Wylie, a whistleblower, told reporters that the London-based political consulting firm CA had engaged in a "grossly unethical experiment" by sharing data of Facebook users without their knowledge.¹²²

It is estimated that 87 million Facebook users' information might have been compromised, according to Mike Schroepfer, Facebook's Chief Technology Officer.¹²³ The data breach raised the ire of US and European governments and regulators as well as investors, who are increasingly concerned with Facebook's corporate governance structure.

In an interview with the *Financial Times*, Michael W. Frerichs, State Treasurer of Illinois, asserted that "in essence, Mr. Zuckerberg is not accountable to anyone...not

¹²²Cadwalladr, C., and E. Graham-Harrison. 2018. "Revealed: 50 Million Facebook Profiles Harvested for Cambridge Analytica in Major Data Breach." *The Guardian*.

¹²³Schroepfer, M. 2018. "An Update on Our Plans to Restrict Data Access on Facebook." Newsroom, Facebook.

the board, nor the shareholders. Right now, Mr. Zuckerberg is his own boss and it's clearly not working."¹²⁴ In an interview with CNBC, Scott M. Stringer, New York City Comptroller, called for Zuckerberg to step down from the executive chairman position in the company: "[the Cambridge Analytica incident] is going to hurt the brand, and it's a brand I have invested close to \$1 billion in on behalf of people who rely on our investments for their retirement security."¹²⁵

Zuckerberg, as Chairman, CEO, and owner of 51% of the voting rights (through 14% of an equity stake of the company), has absolute control of the company. In an interview with American journalist Ezra Klein in April 2018, he suggested that "one of the things that I feel really lucky we have is this company structure where, at the end of the day, it's a controlled company. We are not at the whims of short-term shareholders. We can really design these products and decisions with what is going to be in the best interest of the community over time."¹²⁶

However, investors do not appear to see it the same way. Some have likened it to a "corporate dictatorship." At its annual meeting, activist investors forced votes on six proposals, including, among others, changes to its voting structure and the establishment of a risk oversight committee. Unsurprisingly, none of these proposals went through. According to Facebook's SEC filing submitted on 5 June 2018,¹²⁷ it is estimated that the stockholder proposal regarding simple majority vote—which requested company decisions to be voted on a "one-share, one-vote" basis—received support from some 60% of the votes from holders of ordinary shares (see **Exhibit 23**).¹²⁸ Commenting on investors' support for the senior management, Professor Charles Elson of the University of Delaware suggested that "people are upset, but there's nothing they can do about it."¹²⁹

¹²⁴Kuchler, H. 2018. "Zuckerberg's Dual Role at Facebook Helm Draws Fresh Fire." *Financial Times*.

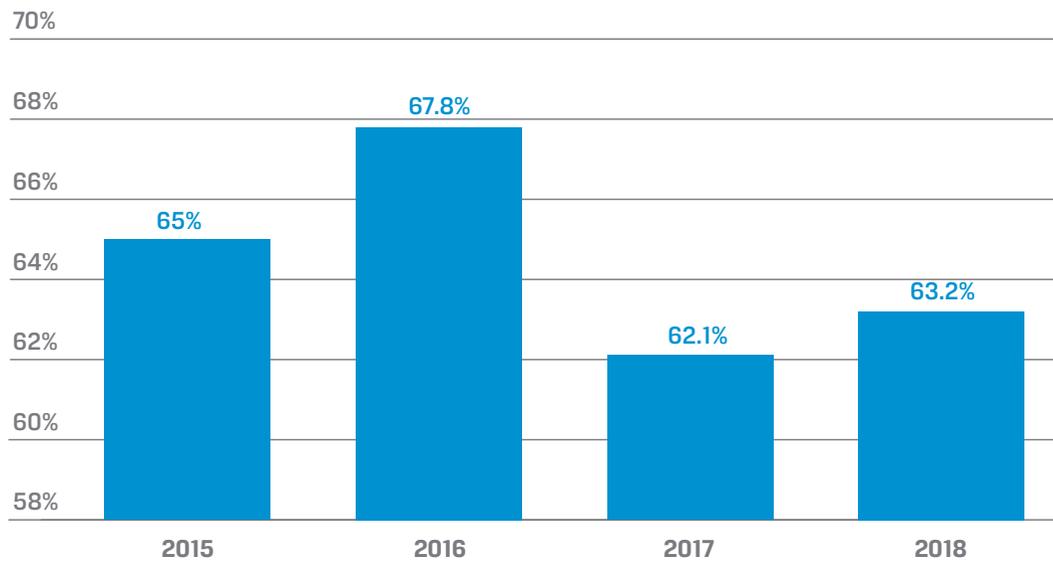
¹²⁵CNBC. 2018. "NYC Comptroller: Why We're Calling for Board Changes at Facebook." 2 April 2018.

¹²⁶Klein, E. 2018. "Mark Zuckerberg on Facebook's Hardest Year, and What Comes Next." *Vox*, 2 April 2018.

¹²⁷Facebook, Inc.. 2018. "Form 8-K." United States Securities and Exchange Commission, 31 May 2018.

¹²⁸Ibid, Kuchler (2018).

¹²⁹Kerber, R. 2018. "Outside Investors Rebuke Facebook Vote Structure, Tallies Show." *Reuters*, 5 June 2018.

Exhibit 23: Over 60 Percent of Ordinary Shareholders Wanted to Change Facebook, Inc.'s Voting Structure to "One-Share, One-Vote"

Source: Financial Times

6.3 Case Study 3: Redstone Family and CBS Corporation/Viacom Inc.

Speed Read

- Sumner Murray Redstone created a US\$40 billion media and entertainment behemoth by combining Viacom Inc., Paramount Pictures Corporation, and CBS Corporation back in the 1990s. A dual-class structure was adopted in 1990 and today, he and his family continue to control Viacom and CBS with approximately 80% of the votes and 10% of equity.
- As a result of his advancing years, questions have been raised over his competence in managing his shareholding, which resulted in a lawsuit in 2016. Regardless, his shares give him perpetual super voting rights, and such rights will be passed on to his estate, even when he is no longer around.
- In recent years, his daughter Shari Redstone became increasingly involved with Viacom and CBS, proposing transactions that would have benefited the family but not to public shareholders. Lawsuits and countersuits have been ongoing in 2018 and are still unresolved. The uncertainty has hurt investors.
- The courts in the United States have taken on significant responsibilities in upholding investor rights. However, even in jurisdictions where courts have a history of stepping in and intervening, it can still take years for cases to be resolved.

Another notable case is the ongoing disputes between National Amusements Inc., a holding company privately owned by the Redstone family and the management of CBS and Viacom, two separately listed media companies in the United States. Through a dual-class structure, the Redstones own roughly 10% of equity in each company but control about 80% of the votes.

There is a long history between the Redstone family and the companies. Sumner Redstone acquired Viacom in 1987 and Paramount in 1994 and created a media and entertainment behemoth by merging them with CBS in 1999. In an attempt to generate more wealth, Sumner Redstone broke up CBS and Viacom (with Paramount) in 2005, which became two separate listed entities.

Sumner Redstone is now in his nineties, and questions have been raised over his competence in making decisions regarding the companies. In 2016, he faced a lawsuit filed by Viacom's former CEO and a long-time company director, "alleging that Redstone suffered from 'profound physical and mental illness; has not been seen publicly for nearly a year...can no

longer stand, walk, read, write or speak coherently...cannot swallow; and requires a feeding tube to eat and drink.”¹³⁰

His daughter Shari Redstone became increasingly involved in the listed companies. In 2016, the Redstone family called for a CBS-Viacom merger, and initiated the process by replacing several directors and the top management team in Viacom.^{131,132} Such an attempt was eventually called off, as Shari Redstone “would not agree to the combined CBS/Viacom entity [being] managed as a noncontrolled public company with a majority-independent board for at least the next five years.”

In January 2018, it was reviewed in an exclusive report that Shari Redstone was looking to restart the merger process again. In February 2018, a special committee made up of independent directors was set up by CBS to evaluate the potential merger with Viacom.¹³³

The special committee determined that a merger between CBS and Viacom would not be in the best interests of other CBS shareholders, except for National Amusements, Inc.¹³⁴ However, the voting control of National Amusements, and owing to some previous actions that Shari Redstone has taken against other company executives (e.g., talking to CEO replacements without board authority, deriding the chief operating officer, and threatening to change the board of directors), the special committee considered it likely that Shari Redstone could force the merger:

The Special Committee believes that once Ms. Redstone learns of this determination, she could assert her power, as she did at Viacom, to immediately replace members of the Board and use the new directors to force through the merger on terms favorable to herself and NAI [National Amusements, Inc.] but harmful to CBS—a merger the Special Committee determined is not in the best interests of the Company—and make other

¹³⁰Bebchuk, L.A., and K. Kastiel. 2017. “The Untenable Case for Perpetual Dual-Class Stock.” *Virginia Law Review*; Harvard University John M. Olin Center for Law, Economics, and Business.

¹³¹Bouchard, A.G. 2018. “Re: *CBS Corporation, et al. v. National Amusements, Inc., et al.* Civil Action No. 2018-0342-AGB.” Court of Chancery of the State of Delaware, 16 May 2018.

¹³²National Amusements. 2016. “National Amusements, Inc. Calls for Changes to Viacom’s Top Leadership in Response to Third Quarter 2016 Earnings.” Press Release, 4 August 2016.

¹³³CBS Corporation. 2018. “CBS Corporation Forms Special Committee To Evaluate Potential Combination with Viacom.” Press Release, 1 February 2018.

¹³⁴CBS Corporation, Gary L. Countryman, Charles K. Gifford, Bruce S. Gordon, Linda M. Griego, and Martha L. Minow v. National Amusements, Inc., Shari Redstone, Sumner M. Redstone, NAI Entertainment Holdings LLC, and Sumner M. Redstone National Amusements Trust. 2018. “Verified Complaint.” In the Court of Chancery of the State of Delaware.

changes to the CBS organizational documents that will adversely impact the ability of the CBS Board to exercise its fiduciary duties and protect CBS stockholders.

Countryman et al., 2018

Together with Shari Redstone's reported desire to appoint Robert Marc Bakish—current president and CEO of Viacom (as of the completion of the report)—to take up a senior position and to ultimately succeed Les Moonves, chairman and CEO of CBS, the special committee recommended the CBS board to consider issuing dividends in the form of Class A voting to all stockholders of both Class A (voting) and Class B (nonvoting) stockholders as a means to protect the long-term interests of CBS's stockholders, as it would dilute National Amusements' voting control at CBS from approximately 80% to 17%.

As this would be unacceptable to the Redstone family, CBS and the board filed a lawsuit against National Amusements, Sumner Redstone, Shari Redstone, and/or the Sumner M. Redstone National Amusements Trust on (1) breach of fiduciary duty, (2) estoppel, and (3) aiding and abetting breach of fiduciary duty. The suit was launched in the hope to, at least temporarily, restrain Shari Redstone and National Amusements' attempt to force a merger with Viacom, before a general meeting that would take place shortly after the meeting notice.

The court considered the allegations "sufficient to state a colorable claim for breach of fiduciary duty against Ms. Redstone and [National Amusements] as CBS's controlling stockholder," but a temporary restraining order was not granted. Eventually, the attempt to dilute the Redstone family's voting control was also blocked, given the Redstone family's superior voting rights.

Responding to the situation, National Amusements announced that it had delivered written consents to CBS to modify CBS' Amended and Restated Bylaws "to safeguard against unlawful action by CBS and its special committee in derogation of their fiduciary obligations to shareholders," citing "irresponsible action taken by CBS and its special committee [to] put in motion a chain of events that poses significant risk to CBS."¹³⁵ National Amusements filed a nother lawsuit a gainst C BS's b oard a nd management in late May 2018, claiming that, "in fact, prior to CBS's action, Shari Redstone had already determined and advised a special committee of Viacom's board that NAI no longer supported a merger."¹³⁶

¹³⁵National Amusements, Inc. 2018. "Amends CBS' Bylaws: Changes Protect Against Significant Risk to CBS and Shareholders." Press Release, 16 May 2018.

¹³⁶Williams, T. 2018. "National Amusements Says It 'No Longer Supported' CBS-Viacom Merger Before CBS' 'Unlawful' Move." TheWrap, 29 May 2018.

Although the actions of both the CBS board and the Redstone family are still ongoing as of the completion of this report, as a result of the events, investors have been hurt, most notably through the decline in stock prices from close to \$70 to \$56 per share at the end of June 2018, despite “excellent” financial results.¹³⁷

Former NBCUniversal Media, LLC CEO Bob Wright commented in an interview with CNBC that “there's no benefit that Shari [Redstone] is bringing to the table with 10% ownership and trying to control all the board. It doesn't make sense anymore.... The reality of it is [that] this exposes [the DCS structure] as negative to shareholder values.... This is probably going to go down in history as the beginning of the end of that whole type of ownership,” he added.¹³⁸

¹³⁷Countryman et al. 2018. “Verified Complaint, Paragraph 3.” CBS Corporation.

¹³⁸Aiello, C. 2018. “CBS Fight Is 'The Beginning of the End' of Dual-Share Structures, Says Former NBCUniversal Media, LLC CEO.” CNBC, 18 May 2018.

7. Conclusions and Recommendations

Companies listing with a DCS structure are becoming more common in APAC. Although CFA Institute considers the “one-share, one-vote” system as the most potent form of investor protection, it is important to appreciate the implications of such changes as the allowance of DCS listings so that our stakeholders can make informed decisions. In this conclusion, we review our findings, especially in relation to the questions we first asked in Chapter 1 regarding lessons learned, safeguards, and investor protection.

Lessons Learned

From the history of DCS usage in the United States, we learned the following:

- The current boom in DCS listings has very similar hallmarks as the previous high watermarks in DCS listings in the United States during the 1920s and 1980s, including increased liquidity and outsized optimism.
- The booms in the 1920s and 1980s were each followed by a prolonged period of market turmoil.
- The rise and fall (and rise again) of DCS listings in the United States shows that the present situation is neither inevitable nor unique, and that there are many more options than a wholesale adoption of DCS structures.
- For stock exchanges contemplating joining the fray, it is perhaps appropriate to reflect on their own unique selling propositions. If and when there is a level playing field in rules, and issuers cannot arbitrage between exchanges, what are the factors that would make one stock exchange more attractive than another?

From the case studies, we learned the following:

- For family businesses with a DCS structure, it is much easier for major shareholders to abuse their position and take advantage of public shareholders, either through massive executive compensation packages or questionable consultancy arrangements.
- Major shareholders are not incentivized to maximize the company’s potential—after all, given their low equity ownership, few benefits would accrue to them.

- A company may have an excellent track record, but there is no assurance that such outperformance will continue indefinitely. When things go wrong, public shareholders of listed DCS companies have little influence—without a vote, they cannot provide oversight of boards or management. As the *Financial Times* said, “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.”¹³⁹
- Time is not on our side. Perpetual super voting rights that are transferrable store up trouble for the future.

Safeguards

We have considered a range of safeguards and examined their effectiveness in relation to investor protection. Our recommendations are as follows:

- *Mandatory time-based sunset:* We have been urging exchanges that have DCS structures in place to consider mandating time-based sunset provisions, which means super voting rights will automatically convert to regular voting rights on a “one-share, one-vote” basis after a period agreed upon between management and investors.

In our view, the single most important safeguard is a mandatory time-based sunset of not more than five years. On the one hand, this this safeguard provides enough time for founding shareholders to execute their strategy and create value without undue worries of market vagaries; on the other hand, it protects public shareholders from long-term entrenchment.

- ▲ We note that five years is the absolute maximum time period, especially because issuers now come to the market at a much later point in their life cycle and are already large, established companies by the time they list on an exchange.
- ▲ We believe the time-based sunset provision should be a “hard stop” for clarity and certainty.
- ▲ Corporate and evergreen entities should not be allowed to benefit from super voting rights without a mandatory time-based sunset provision.

¹³⁹The FT View. 2018. “A dysfunctional family reunion at CBS/Viacom.” *Financial Times*.

- *Event-based sunset*: Super voting rights attached to beneficiaries' shareholdings should lapse if such beneficiaries:
 - ▲ are no longer directors of relevant companies; or
 - ▲ die or are incapacitated; or
 - ▲ transfer their shares to another person.

Again, we believe the event-based sunset provision should be a “hard stop” for clarity and certainty.

We believe the following safeguards are also important when enacted as a “package” together:

- Implement enhanced corporate governance measures.
- Limit the maximum voting differential (to below 10 votes per share).
- Revert to a one-share, one-vote system on related party transactions and large transactions.

Enhancing Investor Awareness

We cannot rely on market forces alone for investor protection. Rather, stakeholders must play an important role in protecting themselves:

- Investors need to perform thorough due diligence.
- Exchanges need to balance the tension between business development and upholding a high corporate governance standard.
- Regulators need to ensure effective monitoring and enforcement.
- The courts in the United States have taken on significant responsibilities in upholding investor rights. However, even in jurisdictions where courts have a history of stepping in and intervening, it can take years for cases to be resolved.

In APAC, legal action against rogue companies or management is not an avenue available to most investors. In markets where direct retail participation is significant, not only does the caveat emptor (i.e., buyer beware) argument offer scant comfort to investors, in times when many investors feel taken advantage of, they inevitably turn to governments and regulators for assistance, which is seldom forthcoming.

Our recommendations, therefore, are as follows:

- Exchanges and regulators should coordinate their efforts and invest in investor education and awareness.
- In jurisdictions where class and derivative actions are unavailable and/or uncommon, governments and regulators should establish a mechanism to enable small investors to seek recourse.
- Regulators must intervene in a timely manner when investors are taken advantage of or harmed.

Next Steps

DCS structures are a relatively new development in APAC. CFA Institute will continue to remain watchful of market developments and work with stakeholders to raise investor awareness. We will continue to engage with regulators and stock exchanges going forward.

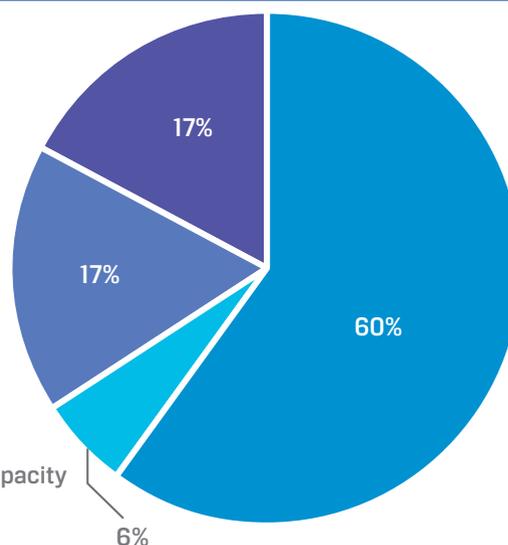
Appendix A: CFA APAC Survey

Noting that listings of DCS stocks had not been the norm in APAC, CFA Institute conducted a survey in March 2018 to gauge the views of our members on the introduction of DCS listings and the necessary safeguards in APAC (“CFA APAC Survey”). The survey found that 60% of respondents had not had any experience in investing in DCS stocks, either in their professional or personal capacities (see **Exhibit 24**). Considering that the survey was only circulated to and answered by CFA Institute members whom we would regard as relatively better equipped with financial knowledge than the general public, we suspect the percentage of general investors who have investment experience in DCS stocks could be even lower, signifying the need for action by governments and regulators if or when DCS listings are introduced to the markets.

Exhibit 24: Results of CFA APAC Survey Regarding Experience with Investing in Dual- or Multiple-Class Share Structures

Do you have any experience, in your professional or personal capacity, in investing in equities with dual- or multiple-class share structures? (N = 412)

- Yes; in my professional capacity
- Yes; in my personal capacity
- Yes; in both my professional and personal capacity
- No; I do not have such experience



Source: CFA Institute

With the introduction of DCS structures to the Hong Kong and Singapore markets, two major international financial centers in APAC, other markets have been closely watching the ongoing development.

Prior to the introduction of DCS structures in Asia, regulators and market participants have gone through some emotive debates. On the one hand, corporate governance experts and advocates have been—and continue to be—steadfast in the belief that the “one-share, one-vote” principle that has served the markets well in the past decades should not be scrapped, and that regulators should remain vigilant in protecting shareholders' rights.

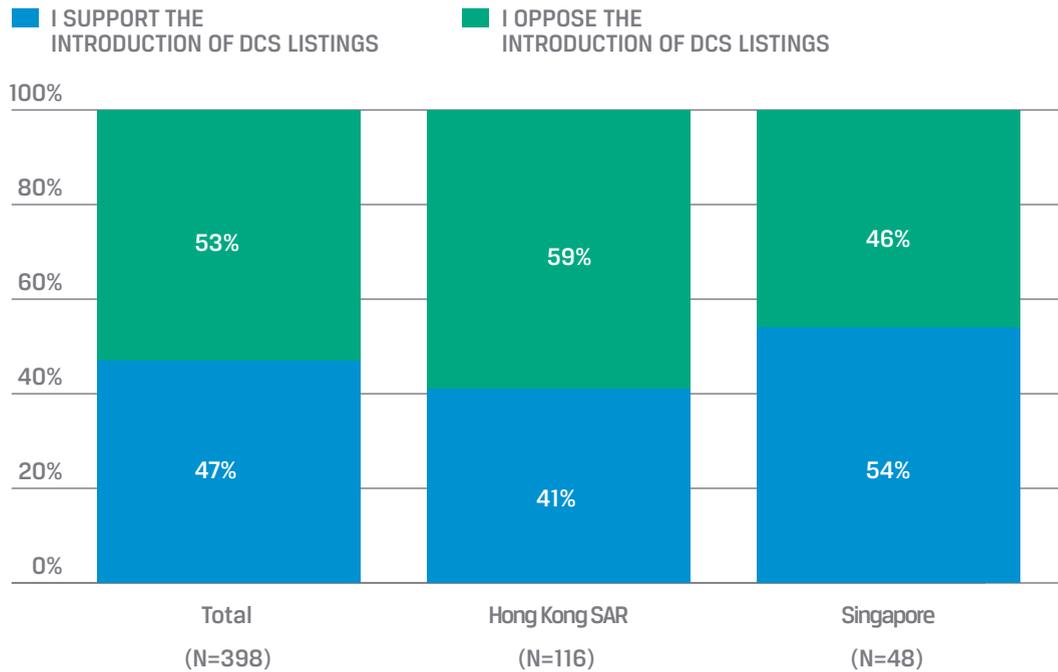
On the other hand, comparing to their initial reluctance to introduce the DCS structure to their respective markets earlier this decade, government and exchange officials in Hong Kong and Singapore have shown a notable change of heart, citing the importance of remaining relevant in the competitive IPO business landscape. Indeed, when they released consultation conclusions in early 2018, both HKEX and SGX claimed that they had gained support for the introduction of DCS structures from a “majority” of the stakeholders from the previous round of consultation in their respective markets.

Although such a claim appears to be reasonably grounded, according to the exchanges' announcements—despite the fact that some quite generic responses were submitted by anonymous respondents—such findings deviated somewhat from what our members told us. According to the CFA APAC Survey, support for and opposition to the introduction of the survey was split down the middle, leading us to believe that it remains an emotive debate.

The survey also revealed that respondents were divided when asked if DCS structures should be introduced to the market, with 53% opposing the introduction and 47% in favor (see **Exhibit 25**). Regardless of their position on DCS, almost all (97%) respondents considered it necessary to enact additional safeguards in the event DCS structures are permitted. This, in our view, also reaffirmed the need for more in-depth research on the subject.

Exhibit 25: CFA APAC Survey Opinion Regarding Whether DCS Listings Should Be Introduced into Markets

What is your opinion on the introduction of DCS listings to the market you primarily cover and/or are based?



Source: CFA Institute

The CFA APAC Survey was conducted between 8 March and 16 March 2018. With an objective to gather views from CFA Institute members on the appropriate safeguards in the likely scenario that DCS will be permitted in the region, the survey was sent to 28,334 members in the APAC region, of which 454 members responded. The overall response rate was 1.6%, with a margin of error of $\pm 4.6\%$ at a 90% confidence level.

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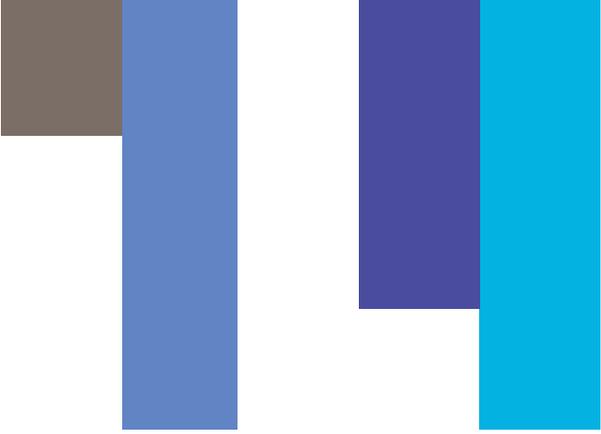
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Glossary

AMEX	American Stock Exchange
APAC	Asia-Pacific region
ASX	Australian Securities Exchange
CDR	Chinese Depository Receipts
CFE	Committee on The Future Economy in Singapore
CII	Council of Institutional Investors
CRSP	The Center for Research in Security Prices in the United States
Dual class shares (DCS)	Companies with dual class shares confer different voting rights to shares in different share classes. Typically, ordinary shares have one vote per share, while shares with super voting rights have more than one vote per share
Event-based sunset	Refers to when shares with super voting rights convert Event-based sunset HKEX HK\$ INED IOSCO IPO IOSCO IRRCI ISS KOSDAQ MV shares NASDAQ NYSE to ordinary shares as a result of specific, pre-determined events
HKEX	Hong Kong Exchanges and Clearing Limited
HK\$	Hong Kong Dollar
INED	Independent non-executive director
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
IOSCO	International Organization of Securities Commissions
IRRCI	Investor Responsibility Research Center Institute
ISS	Institutional Shareholder Services
KOSDAQ	A trading board of the Korea Exchange
MV shares	Multiple voting shares
NASDAQ	NASDAQ Stock Market
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development

One-share, one-vote	A corporate governance principle that each share of a publicly listed company has one vote, and that shareholders' voting rights are commensurate with their equity stakes
SEBI	The Securities and Exchange Board of India
SEC	Securities and Exchange Commission in the United States
SEHK	The Stock Exchange of Hong Kong Limited, wholly owned by HKEX
SFC	Securities and Futures Commission of Hong Kong
SFIPC	Securities and Futures Investors Protection Center in Taipei
SGX	Singapore Exchange
SGX RegCo	Singapore Exchange Regulation Pte. LTD., set up in August 2017 to undertake all regulatory functions on behalf of SGX and its regulated subsidiaries.
Sunset provision	A sunset provision describes the circumstances when shares with super voting rights convert to ordinary shares
Super voting rights	Extra voting rights that come with a particular class of shares in a company.
S\$	Singaporean Dollar
Time-based sunset	Refers to when shares with super voting rights convert to ordinary shares after a pre-determined, specific time frame
TSE	Tokyo Stock Exchange
WVR	Weighted voting rights; considered as having the same meaning as DCS in this report



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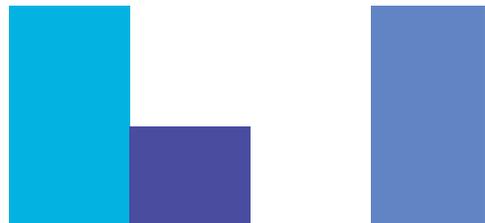
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