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Let sleeping dogs sleep: On why we should not revisit regulation on dual class shares

Dual class shares are mentioned as the solution to revive moribund IPO markets. That investors should have more flexibility in raising money and investors in deploying funds is a given. But to argue that dual class shares alone can bring the zip back to the IPO markets is dubious as their deleterious impact far outweighs their advantages.

Every once in a way an idea takes hold which is supposed to be the panacea for a specific problem plaguing the local equity markets. Share buy-backs were seen to be the perfect tonic for reviving anaemic secondary markets in the late 90's: but markets began their secular uptick not when buy-backs were permitted in 1998, but a few years later when earnings picked-up steam. Dual class shares are seen to be an answer to moribund IPO markets today. That investors should have more flexibility in raising money and investors in deploying funds is a given. But to argue that dual class shares alone can bring the zip back to the IPO markets is dubious.

Dual class shares refer to different types of shares issued by the same company. These shares typically differ with respect to voting rights (-hence these are also called DVR's) or right to dividends. Their rationale is that they allow a set of shareholders – usually the founders, to control boardroom (and voting) decisions, even as they dilute their economic interest in the firm to raise growth capital – and investors get to participate in the company's expansion.

Indian regulations permit such issuances (see Annex A), and four companies issued these – Tata Motors, Jain Irrigation, Pantaloon Retail and Gujarat NRE Coke. Tata Motors, the most credible name, offers a 5% higher dividend to compensate for the one tenth voting right these shares carry vis-à-vis ordinary shares. These were issued at a 10% discount to the shares, but now trades at 45% discount to these. Liquidity too is much lower; it is no surprise that these don't find favour with investors (refer to Annex B for terms and price charts).

In contrast, in the US, the discount is shallow at about 2%. Further, the US market is replete with marquee names that have issued DVR's – Google/Alphabet, Facebook, Alibaba, Berkshire Hathaway have all issued shares with DVR's. Today so strong is the link between DVR's and technology companies, that Snap Inc., was able to get away with issuing shares without any voting rights. And so high has the clamour for such technology shares been, that both the Hong Kong and the Singapore exchanges have recently changed regulations to permit listing of DVR's.

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Ajay Tyagi, chairman SEBI, in a question and answer session, with Prithvi Haldea at the recently concluded Association of Investment Bankers of India summit, has made clear the Board is reviewing DVR's and may well come out with a comprehensive set of guidelines, to help companies issue such shares. Afterall, PayTM, Ola and Flipkart are just the dose the primary market could do with. And if the 'promoters' in US and China can eat their cake and have it too, then why not those in India? But thankfully, he was circumspect as there are intractable issues at hand.

First, is the separation of ownership and control. A founder with 10% equity and 10 votes per share, has more say than all other shareholders put together (Exhibit 1).

Exhibit 1: Economic Interest vs Control

Shares	Vote per share	Total Votes	Economic Interest	Control
10	10	100	10.0%	52.6%
90	1	90	90.0%	47.4%

The cushion that the DVR provides encourages managements to step down from the quarterly treadmill to focus on the long-term. This freedom, it is believed, is what encourages founders to list their company rather than keep them private. But conversely it can be argued that this can just as well lead to entrenched managements who are unchecked when they undertake value destroying transactions. The PE investors in Flipkart shuffled the management deck. How can the DVR shareholders effect such a change if they have no vote?

Two, how do you contain this only to technology? The old economy firms are all embracing technology – car manufacturers are gravitating towards electric cars, oil majors at fracking, banks sophisticated analytics, and the lines between the new and the old is rapidly blurring. If regulations can't, what prevents a towel manufacturer from taking advantage? And that cannot be the purpose.

Three, the appropriate safeguards in the form of a sun-set clause are seen as striking the right balance between letting founders run their businesses, and the dissipating benefits that such shares offer. These are structured to convert a superior vote share into an ordinary share at a pre-determined period (say five years from listing) or event (say the founder stepping aside). But a fixed period assumes that industries mature in a specific year or that their business model will not change or that the founder alone is responsible for its success: Paypal has done wonderful after its promoters stepped down.

Further the sunset clauses are effective in the US because controlling investors have a fiduciary duty to all shareholders and a well-worn class action suite mechanism – and the huge price discount for DVR's in the Indian market reflects this reality.

Another safeguard is in terms of specifying resolutions on which the founders have super-majority a vote and those where the vote is equalized (compensation) or even done away with (related party transactions). But this collapsible voting power, complicates decision taking for investors.

Four, the fear that a number of the technology firms will list overseas without listing in India may have merit, but the examples - Rediff.com and Sify.com hold a lesson, fashions are fickle.

Finally, the Indian equity markets have steadily moved up the ranks in protecting minority investor interest. The Ease of Doing Business ranks India at #7 in this category. The journey has been hard-fought with regulations – the Companies Act and SEBI LODR, and stock-exchanges steadily raising the governance standards and disclosure norms. This has resulted in a steady flow of domestic and international money comforted in the improved transparency and rights that shareholders have gained. The recent roll-out of stewardship codes further empowers shareholders, forcing managements to change behaviour. The DVR's risk jeopardising India's rank and alienating investors.

Just four issues over ten `years and none in the last eight, steep price discount to ordinary shares, sallow trading volumes. Such shares are clearly unloved. There are many products where markets need to be cranked to get them going: DVR's is clearly not one of them.

A modified version of above the comment was published in Business Standard under the title 'Do we really need dual class shares?' on 26 December 2018. You can read the column by clicking this link or typing/cutting-pasting the following to your url: https://www.business-standard.com/article/opinion/do-we-really-need-dual-class-shares-118122500627_1.html

Annex A: India - Current DVR Regulations

The Companies Act, 2013 under Section 43 permits companies having two types of share capital:

a. Equity share capital – with voting rights or with differential rights (as to dividend, voting)
b. Preference share capital

Conditions for issue of shares with differential rights:

- Authorisation in the articles of association
- Ordinary resolution passed by members (through postal ballot in case of a listed company)
- Issue size should not exceed 26% of the post-issue paid-up capital of the company
- Consistent track record of distributable profit for the preceding three years
- No default in filing financial statements and annual returns for the immediately preceding 3 financial years
- No subsisting default in the repayment of deposits, redemption of any class of shares or payment of dividend (company may issue equity shares with differential rights upon expiry of 5 years from the end of the financial year in which such default was made good)
- the company has not been penalised by any regulatory body in the last three years

A company cannot convert its existing equity share capital with voting rights into equity share capital carrying differential voting rights and vice–versa (effectively a fresh issue needs to be made by the company).

The holders of the equity shares with differential rights will enjoy all other rights such as bonus shares, rights-shares etc., which the holders of equity shares are entitled to, subject to the differential rights with which such shares have been issued.

The Board's report for the financial year in which the such issue was completed shall contain detailed disclosures regarding the issue of shares with differential voting rights:

- number of shares allotted
- details of the differential rights relating to voting rights and dividends
- percentage of DVR shares to the percentage of the post-issue capital and percentage of voting rights respectively
- issue price
- particulars of promoters, directors or key managerial personnel to whom such shares are issued
- change in control, if any, in the company consequent to the issue
- diluted Earnings Per Share pursuant to the issue of each class of shares
- pre and post issue shareholding pattern along with voting rights

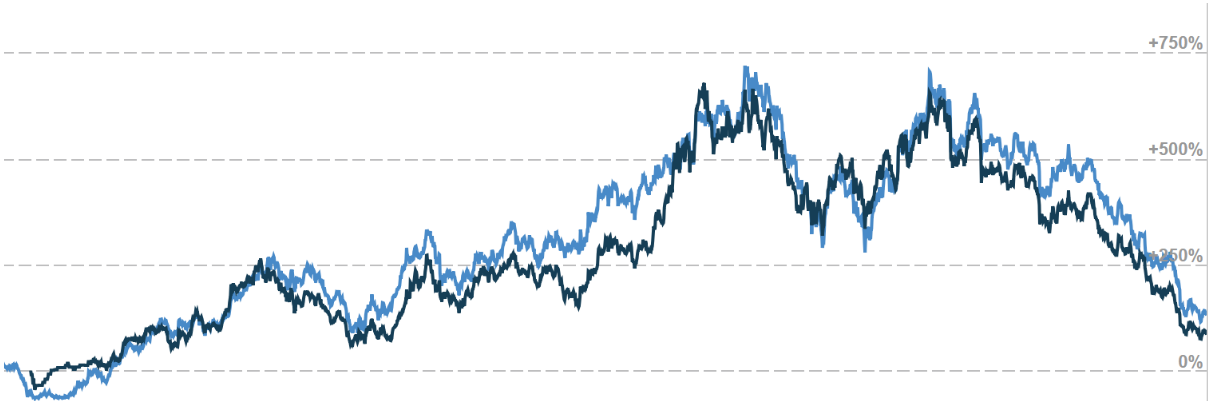
Annex B: India DVR Issuance terms and price movements

Exhibit 2: DVR share issuance in India terms

Company	Differential Voting Rights	Differential Dividend
Tata Motors	One vote for every 10 DVR equity shares	5% higher than the rate on ordinary shares
Jain Irrigation	One vote for every 10 DVR equity shares	Same as ordinary shares
Future Enterprises	Three votes for every four DVR equity shares	2% higher than the rate on ordinary shares

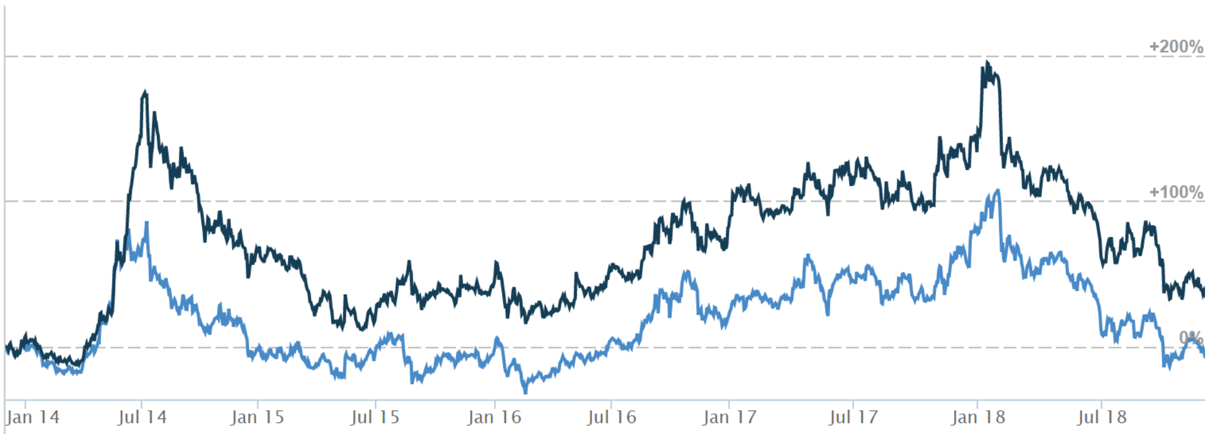
In addition to the above companies Gujarat NRE Coke has issued DVR shares

Exhibit 3: Tata Motors Ordinary Vs Tata Motors DVR (Since Issuance)



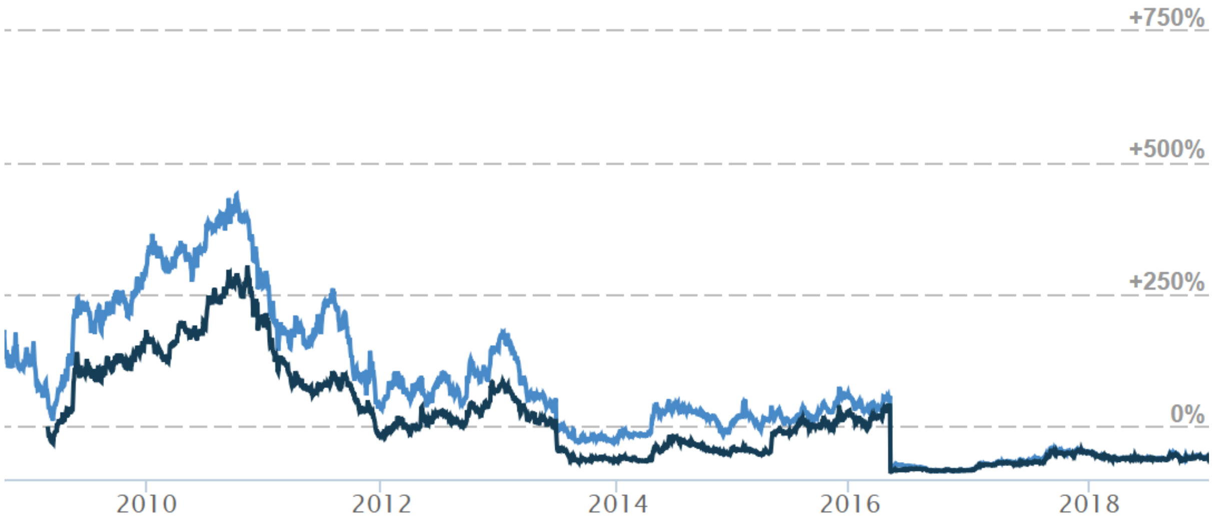
Ordinary DVR

Exhibit 4: Jain Irrigation Ordinary Vs Jain Irrigation DVR (Five years)



Ordinary DVR

Exhibit 5: Future Enterprises Ordinary Vs Future Enterprises DVR



Note: Gujarat NRE Coke, the fourth India company to issue DVR’s quotes at around Rs 1.50 per share.

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