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Dual-Class Shares will weaken the corporate governance ecosystem in India

SEBI's decision to allow companies to issue shares with differential voting rights attempts to facilitate promoters of new-age companies while protecting shareholders. While the intent may be right, we have often seen a difference between regulatory intent and the reality of its implementation. Given the weak enforcement environment in India and the strength of the corporate lobby, it is the corporate governance agenda that will be compromised the most.

The debate on dual class shares (DCS) or shares with differential voting rights (DVR)[1] – in India and globally – is largely centred around new-age technology companies that are currently unlisted, of reasonable size, and with a set of external investors (typically, private equity). While these companies grow quickly – at a much faster pace and with greater intensity – the vision of their entrepreneurs remain critical to the on-going success of the venture. Therefore, DCS supporters see a need to create structures that allow such companies to raise equity, yet keep the entrepreneur in charge. Detractors of DCS believe that their issuance compromises the overall corporate governance agenda.

Exchanges see their role as facilitators to trading – that is, ensuring that scrip prices are market determined, and that trades are properly executed and that they are fair. Exchanges do not necessarily see themselves as gatekeepers of market standards. Therefore, most of them are playing the revenue card in this debate, under the guise of increasing the choice of instruments for investments leading to better market development. In July 2018, the Singapore stock exchange (SGX) announced separate rules for initial public offerings (IPO) of companies with dual class shares – in the backdrop of losing the listing of Manchester United plc's IPO[2]. Similarly, in November 2018 the Hong Kong stock exchange (HKEX) decided to reconsider its stance on DCS IPOs after Alibaba decided to list on the New York Stock Exchange (NYSE). SEBI too is afraid that large unlisted companies will be compelled to list elsewhere, if Indian exchanges do not allow their listing for having DVRs.

DCS reduces the stewardship incentives of asset managers, leading to a weakening of the corporate governance ecosystem. In an environment where investors find it difficult to assert their rights as it is, issuing shares with fractional voting rights[3] (or allowing promoters to hold shares with superior voting rights) further weakens investors and favours management

[1] *DVRs and DCS are being used interchangeably in this report.*
[2] *Source: CFA Institute's August 2018 publication entitled, "Dual-Class Shares: The Good, The Bad, And The Ugly"*
[3] *One share will have less than one vote*

entrenchment. Global investments are steadily moving towards index funds. MorningStar estimates that in 2018 a little less than USD 4 trillion has moved to passive investing in USA and Bloomberg estimates that if the trend of growing passive funds increases, then 2019 will see US-passive funds aggregate over 50% of total investments. Being long-term investors with a compulsion to invest index stocks, these asset managers have an increased responsibility to avoid a corporate governance blowout. Even so, passive fund managers are less inclined to engage with companies; holding shares with fractional voting rights will dampen their enthusiasm to engage even more. The other concern global investors raise is that the issuance of DCS reduces overall market valuations – since these shares will trade at a discount to ordinary shares[4]. How the market will value the discount attributable to the voting rights is yet to be determined. The Council of institutional Investors (whose members manage assets of over USD 40 trillion), and the Asian Corporate Governance Association (whose members manage assets upwards of USD 30 trillion) have both decried the issuance of DCS[5].

Market indices, which are created for asset managers to benchmark their performance against, are hearing the voice of institutional investors. In 2017, S&P Dow Jones Indices announced that its S&P Composite 1500 and its components (includes S&P 500) will no longer allow additions of companies that had DCS – it would, however, grandfather the current inclusions. FTSE Russell too announced in 2017 that it would include only those companies that had at least 5% of their voting rights with public shareholders (free float). This restriction would apply to all index inclusions – companies currently included in the main indices will be grandfathered only for a five-year period (till September 2022). Companies like Snap Inc, whose public shares have no voting rights, cannot be part of these indices. This stance taken by the global indices will reduce the compulsion of index funds to invest in shares with fractional voting rights. Indian indices are yet to take a forthright stance on DVRs – although Tata Motors Limited's DVRs did form part of the NIFTY 50 until recently.

SEBI has been instrumental in pushing regulation towards better corporate governance practices in India. To that extent, even while drafting the consultation paper for issuance of DVRs, SEBI has been careful in differentiating between already-listed companies and companies that are going to be listed. It has created a sunset clause for superior voting rights[6] (which cannot be issued by already listed companies) and created coat-tail provisions[7] that equate all shares when voting on resolutions that materially

[4] *Ordinary shares: one share, one vote*

[5] *Source: https://www.cii.org/dualclass_stock; http://www.acga-asia.org/pdf/20190507-acga-letter-to-sebi-on-dvr*

[6] *One share can have a maximum of 10 votes, under SEBI's consultation paper on DVRs*

[7] *Circumstances under which shares with superior voting rights will be considered as ordinary shares in terms of their voting rights*

impact non-controlling shareholders. Above all, SEBI has enforced its minimum public voting rights of 25% for companies issuing DVRs.

In its theoretical construct and in its intent, SEBI has attempted to facilitate the listing of new-age technology companies (though, the issuance of DVRs is not restricted – it is applicable to all companies), with safeguards to protect the interest of shareholders. Yet, we have often seen a vast difference between the intent of regulation and the reality of its implementation. Listed public sector enterprises (state-owned enterprises including banks) often violate regulation (example: board composition norms, minimum public shareholding norms) and there are little repercussions for such violations. Companies too are not far behind in walking the fine path – several the follow the letter of the law rather than the spirit of the regulation. In doing so, it is impossible to take legal action for violations and investors are compelled to use their engagement (and influence) to effect change, else live with compromised corporate governance practices. Class action suits were supposed to provide a suitable remedy to investor grievances, but the implementation of these provisions has proved difficult – resulting in no class action suit being filed against a listed company almost four years after the regulation was notified. There are several reasons why India ranks 163 of 190 in Enforcement of Contracts in the World Bank's Doing Business Report 2019.

The strength of the corporate lobby must not be underestimated. Under the garb of 'ease of doing business', the corporate lobby has attempted to thwart several measures that improve corporate governance practices. It has managed to get SEBI to delay the implementation of the resolution seeking shareholder approval for royalty payments over 2% of revenues. It has also managed to get SEBI to rescind regulation that required companies to disclose and file with stock exchanges any default on bank loans (not just capital market instruments). Recent media reports suggest that the corporate lobby wants to extend the sunset clause period from the recommended five years to fifteen-to-twenty years. Let's leave aside the argument that even the Government of India is elected only a five-year term.

The weak enforcement environment, the strength of the corporate lobby, and the regulation-compelled voting participation of institutional shareholders all argue against the issuance of DVRs. Yet, SEBI will likely allow companies to issue DCS. If it must, it should put a hard stop to the sunset clause at five years, rather than allow roll-overs through a shareholder vote. SEBI must allow only those companies with a sizable institutional shareholding (over 26%) to issue DVRs: for companies with a sizable retail shareholding, the voting power is already diffused, and issuing DVRs will diffuse the voting power even more.

The overall corporate governance ecosystem in India is improving. Asset managers are accepting their stewardship role and recognizing the value of

their engagement with investee companies. But with 2/3rd of companies being promoter owned, and the average promoter ownership at 49%, the corporate governance levels are still driven by controlling shareholders rather than an institutional mechanism. In this context, the issuance of DVRs is likely to challenge investors' ability to effectively influence corporate actions.

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