Private control *with* Public money: How far can we go?

A Response to the SEBI Consultation Paper on Issuance and Listing of Shares with Differential Voting Rights

Response Paper

May 2019

V | D H | Centre for Legal Policy

This report is an independent, non-commissioned piece of work by the Vidhi Centre for Legal Policy, an independent think-tank doing legal research to make better laws and improve governance for public good.

About the Authors

Debanshu Mukherjee is Founding Member and Senior Resident Fellow at the Vidhi Centre for Legal Policy.

Astha Pandey is an Associate Fellow at the Vidhi Centre for Legal Policy.

The views expressed in the paper and errors, if any, are the authors' alone.

Acknowledgements

We would like to thank Mr. Vishnu Jerome, Founding Partner, Jerome Merchant + Partners, for his very helpful inputs and comments on earlier drafts of this paper.

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Chapter I: Introduction: Setting the Context

The desirability of capital structures enabling the issuance and listing of two or more classes of shares, thereby facilitating promoter/founder led companies to raise capital without losing control, either through retaining shares with superior voting rights or issuance of shares with lower or fractional voting rights to public investors, has been one of the most contentious and long-standing debates in corporate law scholarship.[1] Such shares are commonly known as shares with differential voting rights ("**DVRs**") in India, and dual-class shares or dual-class stock ("**DCS**") in the international context. They allocate superior voting rights to insiders and inferior voting rights to public shareholders (disproportionate to their economic ownership).[2] Conceptually, such structures militate against a well-recognised principle in corporate law that each share should carry one vote.

Internationally, the debate around DCS structures has gained rejuvenation owing to companies like Google, Facebook and Alibaba, which implemented versions of the DCS structure and made mega listings. In fact, it was Google's initial public offering ("**IPO**") in 2004 that paved the way for other major companies like Facebook and Zynga to adopt DCS structures. Google included the following disclosure in its prospectus from 2004: "*In the transition to public ownership we have set up a corporate structure that will make it harder for outside parties to take over or influence Google. We understand some investors do not favour dual class structures. Some may believe that our dual class structure will give us the ability to take actions that benefit us, but not Google's shareholders as a whole. We have considered this point of view carefully, and we and the board have not made our decision lightly…we believe the stability afforded by the dual class structure will enable us to retain our unique culture and continue to attract and retain talented people who are Google's lifeblood*".[3] While some have argued that Google's post-IPO capital structure is "*well suited for turbulent markets*", permitting management to "*place big, risky bets without the fear of losing their jobs or falling prey to a hostile takeover*", others have countered that it "*put outside investors at a severe disadvantage to insiders*".[4]

More recently, jurisdictions which were hitherto steadfast in their resistance to the use of such structures, have permitted listings of DCS on their stock exchanges.[5] However, rules or conventions of other important jurisdictions such as the United Kingdom ("**U.K.**"), Germany, Spain, China and Australia prohibit and discourage companies from going public with DCS structures, primarily on account of the underlying discomfort among institutional investors and market regulators with respect to the disparity between economic rights and control/voting rights of the shareholders.[6] Even in countries where DCS structures are permitted, for instance, the United States ("**U.S.**"), Canada, Singapore and Hong Kong, they are exceptions, rather than the norm. It is also important to highlight the implementation of sunset clauses in such jurisdictions which permit DCS structures: for instance, in the U.S., even though there is no mandatory requirement for companies to have a sunset clause, companies have adopted sunset clauses, post which the shares with higher voting rights get automatically converted into ordinary shares with one vote per share, and in countries such as Hong Kong and Canada, DCS

[1] SEBI Consultation Paper on Issuance of Shares with Differential Voting Rights, March 20, 2019, 2.
[2] Dov Solomon, "The Importance of Inferior Voting Rights in Dual-Class Firms" (2017), Brigham Young University Law Review, 3.
[3] David Berger, Wilson Sonsini Goodrich and Rosati, "Why Dual Class Stock: A Brief Response to Commissioners Jackson and Stein", February 22, 2018, Harvard Law School Forum on Corporate Governance and Financial Regulation, 8-9.
[4] Samuel L. Hayes, Lynn Sharp Paine and Christopher M. Bruner, "Dual Class Share Companies", Case Study 9-306-032 (2005), Harvard Business School , 1.
[5] Umakanth Varottil, "SEBI Consults on Shares with Differential Voting Rights", March 22, 2019, IndiaCorpLaw.
[6] Lucian A. Bebchuk and Kobi Kastiel, "The Untenable Case for Perpetual Dual-Class Stock", (2017), Virginia Law Review, 600.

structures are permitted subject to 'triggering event' sunset clauses, i.e., the shares with superior voting rights get automatically converted into ordinary shares upon the occurrence of a specified event. The rationale behind allowing DCS structures subject to these different versions of the sunset arrangement is to prevent founders or promoters from retaining control perpetually. Sunset clauses have been discussed in detail in Chapter IV of this paper.

In India, the concept of DVRs was first recognised by the Companies (Amendment) Act, 2000, which also imposed conditions upon their issuance, followed by similar provisions adopted by the Companies Act, 2013 ("**Companies Act**"). In July 2009, the Securities and Exchange Board of India ("**SEBI**") issued a pronouncement prohibiting companies from issuing shares with superior rights as to voting or dividend, which is also reflected in the provisions of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("**LODR Regulations**"). Therefore, in India, listed entities are prohibited from issuing equity shares with superior rights as to voting or dividend, but this restriction is not applicable to private limited companies and unlisted public companies. The reasoning behind this prohibition was "*to avoid the possible misuse by the persons in control to the detriment of public shareholders*".[7] On March 20, 2019, SEBI released a consultation paper on issuance of shares with DVRs ("**Consultation Paper**"), stating that the subject of DVRs was deliberated in the Primary Market Advisory Committee of SEBI and a group was constituted amongst the committee members ("**DVR Group**") to do an in-depth study of the proposal to introduce shares with DVRs in the Indian context. The proposal to relook at the scenario relating to the structuring and governance of DVRs in India, is possibly a result of the fervent and on-going debate on the issue in the Indian corporate sector as well as international developments regarding the employment of DCS structures. The DVR Group has submitted its report ("**DVR Group Report**") on the proposal to structure the regulation of DVR issuance in India to SEBI and SEBI, via the Consultation Paper, has invited public comments on the same.[8] Underlining the importance of raising funds through equity while retaining the founder's interest and control in the business of a company, the Consultation Paper provides that the mechanism through which this can be achieved is twofold: (i) issuance of shares with superior voting rights to founders/promoters ("**SR Shares**"); and/or (ii) issuance of shares with lower or fractional voting rights to raise funds from public/private investors ("**FR Shares**"). In other words, the Consultation Paper formulates the norms for issuance of shares with DVRs under two broad categories: (i) issuance by companies whose equity shares are already listed on stock exchanges; and (ii) issuance by companies with equity shares not listed but proposed to be offered to the public.[9]

The Consultation Paper underscores that India is experiencing a high growth phase which requires companies to raise capital in order to sustain this growth. This is especially relevant in the case of new technology firms, which continuously require growth through equity, which in turn results in dilution of the promoter's/founder's stake, thereby resulting in dilution of control. It also notes that in such firms, retaining the founder's/promoter's interest and control in the business is of great value to the shareholders. In this regard, the Consultation Paper states that one mechanism through which Indian entrepreneurs can have some autonomy in relation to managing and growing their businesses, without diluting control, is to allow companies to issue shares with differential voting rights to founders/promoters.

Against this background, the present paper takes the discussion in the Consultation Paper forward and evaluates the viability of DCS structures in India. This paper bases its findings on global precedents, best practices and empirical evidence in relation to DCS structures, rooted in other markets. It argues that while DVR struc-

[7] Umakanth Varottil (n. 5).
[8] SEBI Consultation Paper (n. 1).
[9] SEBI Consultation Paper (n. 1).

tures in general present issues concerning corporate governance, namely shareholder democracy and shareholder equity, and expose businesses to the perils of concentrated control, the potential advantages of even those DVR structures which are accompanied by appropriate sunset clauses, tend to fade with time, and are outweighed by the substantial risks involved with permitting such structures.

This paper is structured as follows:

Chapter II traces the evolution of DCS structures in countries like the U.S., and highlights the policy debates in relation to DCS structures across other jurisdictions. It also presents a brief overview of the legal and regulatory framework governing the issuance of DVRs in India.

Chapter III presents an overview of the recommendations of the DVR Group and the changes proposed by it, in relation to the current legal and regulatory framework governing DVRs in India.

Chapter IV evaluates the case against permitting the issuance of shares with DVRs in India. The position that allowing DVR structures in India is unfeasible is based on the conclusion derived from best practices across various jurisdictions that the potential advantages of DCS structures tend to recede (with or without optimal sunset clauses), and the potential costs tend to rise, over time. In other words, this paper highlights that while the rationale for permitting DCS structures is based on the belief that such structures are efficient at the time of the IPO, it is imperative, especially in the Indian context, to recognise that the risks that they entail are substantial and outweigh the advantages.

Chapter V recommends certain safeguards that must be taken into account while formulating the governance framework, in the event that the issuance of DVRs is permitted, in order to make the proposal more tenable in the Indian context.

Chapter VI reiterates key learnings, discussing empirical evidence pertaining to the long-term implications of permitting DCS structures, and underlining corporate governance issues and risks concerning such structures, while making the larger point that the case for enabling the issuance and listing of DVRs in India is untenable.

Chapter II: Overview of Dual Class Structures

A Brief overview of dual class structures across various jurisdictions

This section describes the heated policy debates between supporters and opponents of limitations on the use of DCS structures by companies going public, in the U.S. as well as other countries. It also presents a brief overview of the working of DCS structures in jurisdictions where they are permitted, and the regulatory framework and considerations in jurisdictions which prohibit their use.

As of the late nineteenth century, shares in U.S. companies generally had equal voting rights. However, by the early twentieth century, investment banks began to develop devices to centralise voting control in a small percentage of the outstanding equity shares, one such device being the DCS structure. By 1925, offerings of non-voting stock had become the subject of criticism and controversy.[10] In 1926, the New York Stock Exchange ("**NYSE**") decided to not list the stocks of companies which offered either no voting rights or unequal voting rights. The NYSE explained that its "one share - one vote" policy was grounded in its "*long-standing commitment to encourage high standards of corporate democracy and accountability to shareholders*". Thereafter, the NYSE insisted on preserving its one share - one vote rule for almost six decades. Over time, the NYSE came to be identified with mandatory listing conditions that protected '*shareholder democracy*' i.e., which sought to maintain the one-to-one connection between cash flow and voting rights, thereby ensuring all shareholders some measure of voice in company matters. Although DCS structures were not entirely eliminated, the policy against non-voting shares or shares with unequal voting rights grew into a normative principle that effectively barred dual class capitalisations from U.S. public markets.[11]

In 1985, pursuant to General Motors' threat to leave NASDAQ and increasing competition from other U.S. exchanges such as AMEX and NASDAQ that permitted the listing of companies with dual class structures, NYSE relaxed its long-held policy against dual class listings by not delisting General Motors and also proposed amendments to its listing requirements, permitting listed companies to use dual-class structures.[12] In 1988, the Securities and Exchange Commission ("**SEC**"), in response, promulgated Rule 19c-4 prohibiting dual class capitalisation of listed stock. Despite the District Court of Columbia Court of Appeals having invalidated Rule 19c-4 on ground that it exceed the SEC's rule-making authority, the SEC persuaded the main stock exchanges to prohibit dual-class recapitalisations under their listing standards.[13] As such, while U.S. companies still face constraints on introducing DCS structures, they have largely had the freedom to adopt such structures while going public, for almost three decades.[14]

In the U.S., the trend of multiple class shares gained traction in 2004 when Google decided to go public with a dual class capital structure, granting its co-founders, executive management team and directors 61.4 percent of the voting power.[15] The multi class structure has enabled founders of other companies that have gone public like Facebook, LinkedIn, Zynga and Groupon to hold the majority of voting rights and retain their control over

[10] Samuel L. Hayes, Lynn Sharp Paine and Christopher M. Bruner (n. 4), 2.
[11] Ibid.
[12] Lucian A. Bebchuk and Kobi Kastiel (n. 6), 596.
[13] Ibid 597.
[14] Ibid.
[15] Dov Solomon (n. 2), 8.

the company by issuing special classes of shares that give them more votes than the holders of other classes of shares.[16] Further, this trend of listing DCS shares on U.S. stock exchanges is not limited to U.S. companies. Since the U.K. and Hong Kong prohibited the use of dual class stock, some foreign companies have listed their dual class stock on U.S. exchanges, for instance, in 2012, Manchester United listed its shares on NYSE instead of the London Stock Exchange, and in 2014, Alibaba Group Holding Ltd. went public on the NYSE rather than the Hong Kong Stock Exchange.[17]

In Europe, DCS structures have been relatively common in many countries, though their prevalence has varied greatly from country to country. The diverse national business cultures and trends have substantially complicated efforts to harmonise the region's takeover laws.[18] While countries such as Denmark, Finland, Netherlands, Sweden and Switzerland permit DCS structures, other European countries like Germany, Belgium, Luxembourg, Poland and Spain, currently limit their use.[19]

In the U.K., the general rule is "one share - one vote". The investment community is particularly averse to structures that deliberately block takeover bids and therefore, the general hostility of institutional investors towards DCS structures has practically precluded their use in the U.K. Similarly, in Australia, listed companies are required to allocate one vote for each fully paid ordinary share in the capital on the company. The Australian Securities Exchange does not trade alternative voting rights shares such as non-voting shares, 'golden' shares or superior voting shares. Unlisted companies have more flexibility in their share class structure and may provide for shares with limited or disproportionate rights in the shareholders' agreements or in the constitutional documents of the company.

In April, 2018, Hong Kong Exchanges and Clearing Ltd. approved the biggest change to its initial public offering rules, thereby permitting the issue of DCS shares in certain circumstances. The introduction of DCS shares by the exchange is considered to be a result of the loss in 2014 when Alibaba decided to list its dual class stock on NYSE rather than in Hong Kong. While the exchange has deviated from its long-held prohibition, it placed significant emphasis on the fact that the "one share - one vote" rule continues to be the optimum method of empowering shareholders and aligning their interests in the company.[20]

Legal and regulatory framework governing the issuance of shares with differential voting rights in India

In order to understand the current framework governing DVRs in India, it is important to trace the trajectory of the regulatory and market considerations that led to its evolution.

A brief historical overview of the legal and regulatory considerations with respect to DVRs in India

The concept of DVRs was first introduced in India by an amendment to the Companies Act, 1956, in the year 2000, which is reflected in Section 86 of the Companies Act, 1956 and in Section 43 of the Companies Act. Until now, only five listed companies, namely, Tata Motors, Pantaloons, Gujarat NRE Coke Limited, Jain Irrigation

[16] Ibid.
[17] Ibid 9.
[18] Samuel L. Hayes, Lynn Sharp Paine and Christopher M. Bruner (n. 4), 4. The underlying basis of the efforts towards harmonising Europe's takeover laws, through the negotiation of a European Union (EU) directive, is the differential use of defensive structures such as the adoption of DCS across the region: while Germany wanted the EU's takeover directive to render defense mechanisms such as DCS inoperable in certain circumstances, this demand met strong opposition from Nordic countries wherein DCS structures are relatively common. In 2004, the EU adopted a directive aimed at harmonising the region's takeover laws which included a provision with respect to restrictions on voting rights, but countries reserve the right to not require companies to apply these provisions. Therefore, while the adoption of a directive is a step forward, the extent of diversity and consequently, discord, on such key issues suggests that actual harmonisation of takeover measures is a long time coming.
[19] Lucian A. Bebchuk and Kobi Kastiel (n. 6), 600.
[20] Benjamin Robertson, "Hong Kong Adds Dual-Class Shares, Paving Way for Tech Titans", April 24, 2018, Bloomberg.

Systems Limited and Stampede Capital have issued DVRs to the public in India. On July 21, 2009, following the Company Law Board's judgment in the matter of *Anand Pershad Jaiswal* v. *Jagatjit Industries Ltd. and Ors*. whereby the issuance of DVRs which resulted in an increase of voting rights to 62 percent for the promoters who only held 32 percent of the economic stake in the company, was held valid, SEBI issued a letter addressed to all stock exchanges, prohibiting the issuance of DVRs with superior rights as to voting or dividend. Similar provisions are reflected in Regulation 41(3) of the LODR Regulations.[21] The prohibition was enforced in order to prevent the possible misuse of such structures by persons in control, and to protect public shareholders.

It is important to note that very few Indian companies have issued DVRs, even a few years after they were introduced. Plausible reasons explaining this, as recognised by the Consultation Paper, include low additional dividends, discomfort with losing voting powers, lower interest among investors, owing to the fact that such shares are not understood and tracked by investors, which in turn, is attributable to lack of awareness about the features of such shares in the Indian market.[22]

The DVR Group Report is a product of deliberations of the DVR Group formed by the Primary Market Advisory Committee to work on the subject at its various meetings held in October, 2018 and January, 2019. As stated earlier, the DVR Group Report proposes to structure the regulation of DVR issuance by: (i) companies whose equity shares are already listed on stock exchanges; and (ii) companies whose equity shares are not listed but are proposed to be offered to the public.[23] The proposals made by the DVR Group Report, as reflected in the Consultation Paper, have been discussed in Chapter III of this paper.

Present legislative and regulatory framework governing DVRs in India

In India, listed entities are prohibited from issuing shares that may, in any manner, confer superior rights as to voting or dividend with regard to the rights on equity shares that are already listed, as per Regulation 41(3) of the LODR Regulations.[24] However, private limited companies and unlisted public companies are permitted to issue equity shares with disproportionate rights as to voting, dividend or otherwise, subject, *inter alia*, to this being authorised in their articles of association and by shareholders' approval.[25] The preconditions to be met by a company for such an issuance include: (i) having a consistent track record of distributable profits for the last three years; and (ii) the shares with differential rights shall not, at any point of time, exceed twenty six percent of the total paid-up equity share capital of the company (including shares with differential rights).

Though equity shares with non-voting rights are generally considered to be outside the ambit of the Companies Act, the restriction on zero voting rights has been made inapplicable to private companies, subject to appropriate authorisation in the articles of association of the company, through an amendment to the Companies Act in 2015. Therefore, private companies which are not subsidiaries of public companies, are permitted to issue equity shares with non-voting rights.

In light of this current regulatory regime, the Consultation Paper notes that permitting the issuance and listing of DVRs in India will enable entrepreneurs to pursue their unique visions in relation to managing and growing their businesses, without the fear of dilution of control. It also notes that this move will also act as a mechanism to prevent hostile takeovers which have become a growing concern among companies with low promoter-holdings.[26] The recommendations with respect to this proposal are discussed in the next Chapter of this paper.

[21] SEBI Consultation Paper (n. 1).
[22] Ibid.
[23] Ibid.
[24] Regulation 41, LODR Regulations.
[25] Section 43, Companies Act, read with Rule 4, Companies (Share Capital and Debentures) Rules, 2014.
[26] SEBI Consultation Paper (n. 1).

Chapter III: Overview of the Recommendations of the DVR Group Report

While Chapter II of this paper provided a broad overview of DCS structures across various jurisdictions and discussed the legislative and regulatory framework DVR structures in India, this Chapter discusses the recommendations of the DVR Group Report with respect to the structuring of DVRs in India and also underlines briefly, the changes proposed to the current legislative and regulatory regime governing the issuance of DVRs in India.

Recommendations of the DVR Group Report

Brief Synopsis

The Consultation Paper begins with a broad analysis of the evolution of DVRs and a consideration of the advantages and disadvantages of the structure, for both, issuers and investors. It then examines the legal and regulatory regime governing DVRs in India, including the Companies Act and various SEBI Regulations. The Consultation Paper then provides a comparative overview of the legal scenarios in jurisdictions such as the U.S., Canada, Hong Kong and Singapore and also notes that some countries like the U.K., Germany and Australia do not permit DCS structures.[27]

Having considered the various issues concerning DVRs, the Consultation Paper proposes to allow Indian companies to adopt DVR structures subject to certain conditions, namely: (i) the issuance of DVRs must be authorised by the articles of association of the company; and (ii) the issuance of DVRs must be authorised by a special resolution passed at a general meeting of the shareholders, with notice of specific matters such as size of issuance, ratio of the difference in voting rights, rights as to differential dividends, sunset clauses, coat-tail provisions etc. It permits this adoption via two routes: (i) for companies that are already listed on the stock exchanges and wish to list DVRs, the Consultation Paper permits issuance of FR Shares; and (ii) for companies that are unlisted but wish to list on the stock exchanges with DVR structures, the Consultation Paper permits issuance of SR Shares. [28]

Types of Listings: FR Shares and SR Shares

A company whose equity shares are already listed and traded on a recognised stock exchange for at least one year is permitted to issue FR Shares. These shares are typically issued to outside investors who are willing to receive lesser control rights in the company. The Consultation Paper has proposed that the voting rights on FR Shares cannot exceed the ratio of 1:10, i.e., one vote for every ten shares. The company may decide to pay higher dividend on FR Shares, which operates as an effective compensation for lower control rights given to investors holding FR Shares.[29]

[27] SEBI Consultation Paper (n. 1).
[28] Ibid.
[29] Ibid.

SR Shares, on the other hand, can be issued only by unlisted companies and to only their promoters. This is to ensure that promoters can maintain an additional level of control in excess of their economic rights before the company undertakes an IPO to list its shares. Post listing, a company cannot issue SR Shares. Certain conditions are attached to the issuance of SR Shares, for instance, promoters are prohibited from creating any form of encumbrance over them. Further, SR Shares shall be of a maximum ratio of 10:1, i.e., ten votes for every share. The Consultation Paper has also prescribed that SR Shares shall remain under a perpetual lock-in after the IPO.[30]

Other Key Proposals

Another key feature in the Consultation Paper with respect to SR Shares is that it prescribes certain "coat tail provisions" whereby SR Shares will be treated on par with other ordinary equity shares in terms of voting rights, i.e., one vote for one SR Share. The inclusion of "coat tail provisions" understandably takes into account the fact that it is not prudent to grant superior voting rights on SR Shares for every matter that is placed for decision-making before the shareholders. On certain matters of critical importance, all shareholders must be subject to the default rule of one vote per share. Such matters are fundamental to the existence of the company, for instance, change in control, appointment or removal of independent directors or auditor, material changes in the company's constitutional documents, voluntary winding up of the company etc.[31]

Further, SR Shares are also subject to a sunset clause whereby they would automatically convert into ordinary equity shares on the fifth anniversary of the listing of the ordinary shares of the company. In other words, the SR Shares will lose their superior voting rights and each SR Share will be at par with an ordinary equity share in that it will carry an entitlement to a single vote. However, the validity of SR Shares can be extended by another five years if the same is approved by way of a special resolution whereby all shareholders vote on a one-share one-vote basis. Promoters may accelerate conversion of their SR Shares into ordinary equity shares at their option.[32]

Changes proposed to the current legislative and regulatory framework governing issuance of DVRs in India

As stated earlier, the current legal and regulatory regime in India prohibits listed entities from issuing shares with superior voting rights to voting or dividend. The Consultation Paper, in furtherance of its proposal to permit DVR structures in India, suggests amendments to the Companies Act and various SEBI Regulations relating to capital issuances and continuous listing requirements, some of which are listed below.

Companies Act and SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 *("*ICDR Regulations*")*

As per the Companies Act and the rules thereunder,[33] a company which desires to issue DVR shares must have a consistent track record of distributable profits for the last three years. Regulation 6 of the ICDR Regulations permits IPOs of companies without a consistent track record of distributable profits for the last three years, subject to certain conditions such as the issuer must have net tangible assets of at least three crore rupees, an average operating profit of at least fifteen crore rupees, a net worth of at least one crore rupees etc. Given that new generation technology companies and innovative companies primarily focus on customer outreach and business expansion in the initial years, and subsequently concentrate on profits, thereby sacrificing short term financial gains to create long term value for shareholders, such companies will not be in a position to satisfy

[30] Ibid.
[31] Ibid.
[32] Ibid.
[33] Section 43, Companies Act read with Rule 4(1)(d), Companies (Share Capital and Debenture) Rules, 2014.

these conditions. In light of the discrepancy highlighted herein, the Consultation Paper has proposed that the extant provision should be amended in order to clarify that SEBI standards on to-be listed companies, as prescribed under Regulation 6 of the ICDR Regulations, would not be applicable to companies without a consistent track record of distributable profits.

Securities Contracts (Regulation) Rules, 1957 *("*SCRR*")*

The Consultation Paper has highlighted the fact that one of the probable reasons for no company having undertaken an IPO with multiple classes of equity shares in India is due to the challenges posed by the current regulatory framework, which are primarily twofold: (i) the minimum dilution and minimum subscription requirements prescribed under Rule 19(2)(b) of the SCRR have to be met for each class of equity shares, separately; and (ii) a company with multiple classes of equity shares is required to make an offer of each such class of equity shares to the public, while undertaking an IPO. In other words, a company with multiple classes of equity shares does not have the option of listing only one or some of the classes and has to mandatorily list all classes of its equity shares, including the equity shares with DVRs. This is not the case in jurisdictions like the U.S., Hong Kong and Singapore, which permit listing of ordinary shares while the shares with differential rights held by the founders remain unlisted. In light of this restriction, the Consultation Paper has proposed that should the issuance and listing of DVRs be permitted in India, Rule 19(2)(b) of the SCRR must be amended to permit companies with multiple classes of shares to list one or more classes of shares to the exclusion of other classes in order to facilitate the listing of ordinary shares, while the SR Shares held by promoters remain unlisted.

LODR Regulations

As stated earlier, Regulation 41(3) of the LODR Regulations prohibits listed companies from issuing shares which confer superior rights as to voting or dividend vis-a-vis the rights on equity shares that are already listed. The Consultation Paper has proposed that this regulation must be amended to allow SR Shares to be held by promoters post the IPO of its ordinary equity shares and to also allow for additional dividend on FR Shares.

In addition to the aforementioned changes, the Consultation Paper also suggests amendments to other SEBI Regulations, such as those governing buybacks and takeovers as well as delisting, which reflect the impact of DVRs on these regulatory provisions.

Chapter IV: The Case against Issuance of DVR Shares in India

This Chapter presents arguments against permitting the issuance of shares with DVRs in India, based on academic literature and empirical evidence. The position that allowing DVR structures is untenable in the Indian context is based on the conclusion derived from best practices across various jurisdictions that over time, the potential advantages of DCS structures tend to recede, and the potential costs tend to rise. The Chapter also discusses, briefly, the various types of sunset provisions employed by DCS companies in the U.S., and the problems associated with time-based sunsets in particular, in light of the sunset provision proposed in the Consultation Paper. In other words, this paper highlights that while the rationale for permitting DCS structures is based on the belief that such structures are efficient at the time of the IPO, it is imperative, especially in the Indian context, to recognise that the risks that they entail are substantial and outweigh the advantages.

The debate regarding DCS structures has been a long-standing one. The competing claims of founders and investors for control of public companies, especially in the U.S., have been the subject of serious contention and deliberation. Participants in the U.S. capital markets are at loggerheads: while advocates of founders argue that the present system in which founders have the discretion to choose their capital structure and invite investors to invest, is fair, efficient and must not be meddled with, advocates of investor groups argue that DCS structures should either be prohibited or strictly limited.[34] Therefore, on one side there are visionary founders who want to retain control while gaining access to public markets, and on the other, there is a structure that undermines accountability.[35]

In order to evaluate the efficacy of DCS structures, it is imperative to understand why they are sought by founders/promoters/entrepreneurs and resisted by investors. Founders seek control of their companies post IPOs as control enables them to retain the freedom to pursue their vision, which they believe will enhance corporate value and produce returns in the long run, without the apprehension that their decisions will be challenged by public shareholders.[36] Investors, on the other hand, have raised concerns with respect to DCS structures, contending that such arrangements undermine basic corporate governance norms such as shareholder democracy and accountability.[37] Further, they not only create an environment in which founders feel pressured to make decisions which reflect short term value enhancement, rather than pursuing long-term plans for value creation, but also create incentives for entrenched management owners to seek private benefits of control, misappropriating or destroying corporate value in the process.[38]

Before delving into the merits and demerits of DCS structures, it becomes important to briefly identify the underlying causes that have led companies in the U.S., including many of the most innovative and dynamic

[34] Andrew William Winden, "Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures", (2018), Colum. Bus. L. Rev., 897-898.
[35] Robert J. Jackson Jr., U.S. Securities and Exchange Commission, "Perpetual Dual-Class Stock: The Case Against Corporate Royalty", February 16, 2018, Harvard Law School Forum on Corporate Governance and Financial Regulation, 2.
[36] Andrew William Winden (n. 34), 890.
[37] Robert J. Jackson Jr. (n. 36), 2.
[38] Andrew William Winden (n. 34), 894.

public companies, to adopt DCS structures. The purpose of tracing the underlying reasons that have led to these structures becoming popular in the U.S. is to present the challenges posed by them holistically, rather than in isolation. Historical, philosophical and empirical evidence indicates that the three primary factors leading to some of the most successful technology companies opting for dual class stock are as follows: (i) the financialization of U.S. corporate governance markets, as a result of which it has become virtually impossible for a public company to use a metric other than shareholder value, and consequently, it has been increasingly acknowledged that the experiment of equating shareholder value with good corporate governance standards has largely failed;[39] (ii) the changing nature of equity capital and the limiting of the debate on corporate governance to just the voices of equity capital; and (iii) the exclusion of a large percentage of American households from any say in what constitutes good corporate governance, thereby excluding critical voices from the discussion on issues of corporate governance.[40] The overall implication of these aforementioned causes has been that it has become common practice to focus only on shareholder return, with less interest in issues such as linking higher corporate profits to long term growth and improvement, and even lesser interest in long-term corporate health.[41] Having broadly laid out the background against which deliberation on the desirability of DCS structures has largely ensued, and having presented underlying causes leading to the popularity of these structures, in the context of the U.S., set forth below are arguments in favour of DCS structures.

Three primary reasons most commonly cited in support of dual class stock or shares with disproportionate voting rights are as follows: (i) at least for a defined period of time early in a company's life, dual class shares can be beneficial as they allow entrepreneurs to build for long term, and in many cases, even transform entire industries, owing to the fact that DCS structures insulate corporate decision makers from short-term pressures, thereby enabling them to focus on long-term growth;[42] and (ii) such structures enable founders with expertise, proprietary information and business skills to utilise their proficiency and produce superior returns;[43] and (iii) DCS structures serve as an appropriate defence mechanism against hostile takeovers.[44] In the next segment, this paper sets forth and examines arguments against the use of DCS structures, by relying on academic scholarship and empirical evidence rooted in precedents and practices, especially the U.S., while making the larger point that permitting DVR structures is unfeasible and unwarranted in the Indian context.

Opponents of DCS structures argue that one share one vote should be the rule for all public corporations and that whatever the benefits of permitting dual stock maybe in a few well known cases, the costs for the investors who are left with no avenue to hold the management responsible while the DCS structure is in place, outweighs those benefits.[45] Two SEC commissioners, Robert Jackson and Kara Stein, have sharply criticised the practice of adopting dual class stock, and their objections can be broadly classified into three categories: (i) dual class corporate structures are inconsistent with America's foundational democratic norm of one share one vote; (ii) the stock price performance of dual class companies is lower than that of companies without such structures; and (iii) public shareholders of companies with dual class stock lack any effective ability to monitor and police the controlling group of shareholders.[46] Closely linked to these aforementioned arguments is the argument in relation to corporate governance issues and agency costs associated with DCS structures. Companies with DCS

[39] David Berger, Wilson Sonsini Goodrich and Rosati (n. 3), 4.
[40] Ibid 5-6.
[41] Ibid 6.
[42] Robert J. Jackson Jr. (n. 36), 2.
[43] Lucian A. Bebchuk and Kobi Kastiel (n. 6), 609.
[44] Vijay Govindarajan and Anup Srivastava, "Re-examining dual-class stock", August 21, 2017, SSRN, 7.
[45] Robert J. Jackson Jr. (n. 36), 2.
[46] David Berger, Wilson Sonsini Goodrich and Rosati (n. 3), 3.

structures pose severe corporate governance risks and agency costs because they present a problematic combination: on the one hand, because the controller is insulated from the disciplinary forces of the market, there is no real threat inducing such a controller to serve the interests of the public shareholders, and on the other hand, because the controller owns a relatively small equity stake, he/she does not have ownership incentives that come from owning a large equity stake.[47] Leading founders in control of companies post IPO presents risks of two kinds of agency costs: (i) management agency costs and control agency costs. Management agency costs arise from mismanagement, including reduced commitment, shirking, and pursuit of acquisitions to increase size or achieve diversification without generating value; and (ii) control agency costs arise from directly diverting private benefits to the controller through various mechanisms, such as excessive pay and related party transactions. Some scholars argue that the risk of management agency costs increases over time, i.e., even if the founder's vision produces high corporate value within the first few years of going public, either the business vision or his/her acumen to execute it, decline in later years, which ultimately results in inefficient business decisions that impose management agency costs on the shareholders.[48] Further, DCS structures increase the risk of management agency costs since controllers own less of the cash flow rights or have low economic skin in the game compared to the other shareholders while retaining control, and therefore, they internalise a smaller fraction of the negative implications of their decisions, without there being any effective impediments to their private benefits of control.[49] Economic analysis and empirical evidence demonstrate that this combination of entrenchment and low equity holdings reduces company value, distorts controller incentives and increases extraction of private benefits of control.[50] Studies indicate that the divergence between the founder's voting rights and equity capital leads to governance and agency problems becoming more severe across a wide array of decisions and contexts. In other words, the controller's equity stake is co-related to higher agency costs, higher governance risks and lower value.[51]

These aforementioned governance risks and agency costs are even more appurtenant in the context of India, because of the fact that promoter-owned businesses are a dominant feature of its organisational structure and economy.[52] A study conducted by Credit Suisse in 2017 found that India has the third highest number of family-owned companies, with a market capitalisation of six point five billion dollars.[53] Concentrated ownership and control is pretty much the norm rather than the exception, in India.[54] While promoter-owned companies have several advantages, which can be value maximizing for the public shareholders in the long run, they also expose them to the risks of lack of transparency, entrenchment and wealth expropriation. DVR structures can entrench concentrated ownership patterns perpetually and contribute to the risks and costs associated with the complicated conflict between the interests of controlling shareholders and non-controlling shareholders.[55] More specifically, such structures might encourage promoters to take risks more aggressively (with lesser accountability) as the economic consequences of their decisions will be disproportionately borne by the public shareholders.

The above analysis of governance issues and agency problems is supported by a majority of empirical findings. Studies around the world have shown that the combination of weak ownership and entrenchment decreases

[47] Lucian A. Bebchuk and Kobi Kastiel, "The Perils of Dell's Low-Voting Stock", (2018), Working Draft - part of the research work of the Research Project on Controlling Shareholders of the Harvard Law School Program on Corporate Governance, 9.
[48] Andrew William Winden (n. 34), 894.
[49] Ibid.
[50] Lucian A. Bebchuk and Kobi Kastiel (n. 6), 603-604.
[51] Lucian A. Bebchuk and Kobi Kastiel (n. 47), 9.
[52] CFA Institute, "Corporate Governance for Asian Publicly Listed Family-Controlled Firms", (2017), 8.
[53] Credit Suisse, "The CS Family 1000", (September 2017), 7.
[54] Jayati Sarkar, "Corporate Governance, Chapter 9: Ownership and Corporate Governance in Indian Firms", (2012), SAGE Publications.
[55] Manish Singhai, "Shareholder Rights and the Equitable Treatment of Shareholders", OECD, The Fourth Asian Roundtable on Corporate Governance, Mumbai, November 2002.

company value.[56] Some studies have compared the effect of DCS on company value to the effect of other mechanisms of separating cash flow rights and control rights, and found that company value increases with cash flow rights of the largest shareholder, and decreases when voting rights exceed cash flow rights, and that the value discount generally increases with the size of the gap between voting and cash flow rights.[57] A research published by the Investor Responsibility Research Centre and Institutional Shareholders Services found that compared to companies with a one share one vote structure, DCS companies have worse economic results in the long run.[58] These studies indicate that company value is positively associated with insiders' cash flow rights and negatively associated with insiders' control rights, and that unification of DCS structures into single share class increases company value.[59] This is further reinforced by the fact that one hundred and twenty one voluntary DCS unifications in Europe between 1996 to 2009 increased the value of companies' long term market value. These findings reflect that unifications per se are beneficial to public shareholders because of the corporate governance improvements accompanying them.[60] In assessing DCS structures, it is important to highlight an extremely important feature associated with these structures, which is that as time passes, the potential costs of a DCS structure tend to increase, while the potential benefits tend to crumble. Therefore, even those who are of the view that DCS structures are often efficient at the time of the IPO, must recognise that while at the time of IPOs, DCS companies tend to have a higher market valuation than single class share companies, the valuation premium declines and the associated agency costs increase, over time.[61]

In the U.S., the decision of regulators and stock exchanges to permit the use of DCS structures has not ended the debate on the desirability of the practice. After Google adopted its structure in 2004, public and academic discourse on DCS structures rekindled. Institutional investors and their advisors, and prominent governance leaders have expressed strong opposition to the employment of DCS structures.[62] The Council of Investors ("**CII**") which is an organisation of more than one hundred and forty public, union and corporate pension funds has denounced them as an "*autocratic model of governance*" and has petitioned the stock exchanges to adopt a one share one vote policy. Leading mutual funds, prominent pension funds and shareholder advisory groups, have all expressed their reservations regarding these structures.[63] In fact, the opposition to DCS structures has become so widely accepted that it was incorporated in documents attempting to identify minimum standards of acceptable corporate governance norms, and was also included in a set of corporate governance principles that were put forward by a group of leading executives that included chief executive officers of asset managers and major public companies. Such opposition was also incorporated in the set of governance principles adopted by a coalition of institutional investors managing more than seventeen trillion dollars in the aggregate.[64] Some legal scholars have also observed that DCS structures have purposes unrelated to preventing hostile takeovers. These scholars have argued that lawmakers should ensure that more purely defensive measures remain available to dilute management's incentive to adopt less regulable systems such as DCS structures.[65] Further, it is important to note that even in jurisdictions where DCS structures are permitted, for instance, Canada, institutional investors have advocated for strict limitations on such structures.[66] Even those who oppose the practice of adopting DCS structures altogether, are of the view that to the extent that companies are permitted to go

[56] Dov Solomon (n. 2), 18.
[57] Ibid.
[58] Ibid.
[59] Ibid 18-19.
[60] Ibid 19.
[61] Ibid 20 and Lucian A. Bebchuk and Kobi Kastiel (n. 6), 590.
[62] Lucian A. Bebchuk and Kobi Kastiel (n. 6), 597.
[63] Ibid 598.
[64] Ibid 599.
[65] Samuel L. Hayes, Lynn Sharp Paine and Christopher M. Bruner (n. 4), 4.
[66] Lucian A. Bebchuk and Kobi Kastiel (n. 6), 601.

public with dual class stock, such capital structures should be accompanied with appropriate sunset provisions. In the absence of a sunset provision, the lifecycle of a DCS structure is perpetual and this infinite duration is likely to increase risks and costs over time.[67] In the next segment, this paper briefly discusses the various types of sunset provisions, and argues that even when DCS structures are limited by sunset clauses, the complications and risks associated with them make DVR structures undesirable.

As stated above, leading intuitional investors have expressed their strong opposition to the use of DCS structures and have petitioned to end its use. Similarly, academic scholars have also shown their skepticism towards such structures and have written extensively in favour of reverting to single class structures. However, in jurisdictions where institutional investors conclude that putting an end to DCS structures is not feasible, they have advocated for the use of appropriate sunset clauses in DCS companies. This recommendation is based on the view that the adoption of optimal sunset provisions, particularly, time-based sunsets, addresses a major concern posed by DCS structures, which is, the problem of long-standing structures that become increasingly risky, costly and inefficient over time.[68] Companies with DCS structures have employed a variety of sunset provisions, including but not limited to: (i) fixed-time sunset; (ii) triggering event sunset; (iii) ownership percentage sunset;[69] (iv) founder separation from employment with the company or separation sunset; and (v) conversion upon transfers of the high vote shares to persons or entities other than permitted transferees or transfer sunsets.[70] The Consultation Paper has also proposed the inclusion of a sunset clause in the case of SR Shares whereby they would automatically get converted into ordinary shares at the end of five years from the date of listing, and their voting rights will be on par with other ordinary shares. Further, the validity of SR shares can be extended by another five years if the same is approved by way of a special resolution whereby all shareholders vote on a one share one vote basis.[71]

In light of the five-year sunset recommendation provided for in the Consultation Paper, and the discussion on sunset provisions above, this segment underlines the concerns and complexities affiliated with time-based sunsets. Firstly, the adoption of a time-based sunset provision can lead to a controlling shareholder to act opportunistically in the period just before the DCS structure is about to expire.[72] Further, because of the possibility of an extension, the controlling shareholder might be incentivised to perform better for the first term, say five years, and seek an extension, to pursue personal interests. In other words, a sunset provision merely prevents the controlling shareholders from unilaterally extending the DCS structure that public shareholders oppose as value reducing, and does not necessarily result in putting an end to such a structure after said period of time.[73] Secondly, a governance arrangement with respect to sunsets, which is optimal for some companies, might not be optimal for others.[74] Time-based sunsets currently in use do not appear to be, in any way, related to the achievement or failure of any aspect of a founder's vision, short term or long term performance, or value metrics. The estimation of how long it would take to realise the value of a founder's vision is ultimately an estimate, which may or may not be accurate. Consequently, time-based sunsets are heavily presumptuous in that the basis on which they are designed is arbitrary i.e., that the founder's control should end at some pre-determined date in the future.[75] This not only undermines entrepreneurial discretion, but also demonstrates that time-

[67] Ibid 618.
[68] Ibid 629.
[69] Ibid 619.
[70] Andrew William Winden (n. 34), 869-870.
[71] SEBI Consultation Paper (n. 1).
[72] Lucian A. Bebchuk and Kobi Kastiel (n. 6), 626.
[73] Ibid 624.
[74] Ibid.
[75] Andrew William Winden (n. 34), 917.

based sunsets are not appropriate instruments for resolving the tension between the founder's desire for control and non-interference from public shareholders and the public shareholders' desire for accountability and protection from bad management decisions.[76] Lastly, in relation to the argument in favour of time-based sunsets that controllers have incentives to retain control even when it would be economically more efficient to unify the capital structure or sell control, it is important to understand that while some inefficient DCS companies might be terminated through mandatory time-based sunsets, efficient companies will also be lost. Historical record indicates that it is not necessary to resort to time-based sunsets to eliminate DCS structures despite controller incentives to avoid unifications or sales. Therefore, since time-based sunset provisions do not protect the vision of founders and are not indispensable when it comes to protecting investors from economic inefficiencies, they do not function as adequate protective instruments in DCS structures.[77]

[76] Ibid.
[77] Ibid 920-922.

Chapter V: Safeguards for Permitting DVR Shares in India

The preceding Chapter discussed the risks associated with permitting the issuance and listing of DVR Shares in India, and demonstrated that such permissibility is undesirable and untenable in the Indian context. However, in the event that the proposals set forth in the Consultation Paper are taken forward by SEBI, this Chapter recommends certain additional safeguards to make the proposal relatively tenable.

Academic literature suggests that DCS structures can obtain legitimacy if the terms of such structures are designed in a manner that serve to ultimately achieve the goals of both, the founders and the investors, and at the same time, protect their interests effectively.[78] In structuring a regulatory framework for DVRs in India, it becomes particularly important to devise measures that increase transparency and accountability, and afford additional protection to public shareholders who can be, otherwise, at the receiving end of the disproportionate economic consequences of bad management decisions taken by promoters/founders with superior voting rights. Having taken into consideration the proposals laid out in the Consultation Paper, as well as the current legal and regulatory framework governing DVRs in India, set forth below are certain recommendations and accompanying safeguards that may be considered for adoption while formulating the framework for permitting DVRs in the Indian context.

It is submitted that in order to address the fundraising challenges of companies operating in sectors where the founders' vision and involvement is critical in the lead up to the IPO and immediately thereafter, SEBI could consider allowing the founders/promoters to have SR Shares, subject to a mandatory sunset provision of one year after the IPO with no possibility of extensions (i.e., the SR Shares will get converted into ordinary equity shares, lose their superior voting rights and each SR Share will carry an entitlement to a single vote, as if it were an ordinary equity share). Permitting listed companies operating in targeted sectors to have SR Shares in this manner will allow founders to retain control during this vulnerable period of transition while protecting the public shareholders from any long-term governance risks.

Notwithstanding the mandatory one year sunset provision (which should operate alongside safeguards proposed in the Consultation Paper), here are certain additional disclosure requirements that must be incorporated in the offer document for the IPO to make the founders holding SR shares more accountable: (i) the terms of offer should accurately reflect the quality of the promoter's vision for enhancing corporate value, including the nature of the business, the position of the company in the market and the capabilities of the company's management; (ii) the terms should be designed in a manner that they answer the following questions in the affirmative: (a) whether they support the founder's vision; (b) whether they contemplate mechanisms for public shareholders to influence management and hold them accountable; (c) whether they effectively guard the public shareholders from agency costs.[79] Further, the offer document should also incorporate consequences for

[78] Andrew William Winden (n. 34), 905.
[79] Ibid 909.

breach of fiduciary duties i.e., if the promoters are found to have breached their fiduciary duties to the public shareholders as officers, directors, or controlling shareholders of the company, then the consequences of such a breach should impact their control rights in the company.[80] Limiting DVRs through a mandatory one year sunset clause and subsuming the aforementioned considerations into offer documents will not only ensure increased transparency and accountability but will also provide investors with requisite protection from the risks and costs that typically accompany DVR structures.

In the case of unlisted companies, the Companies Act and the rules thereunder permit the issuance of DVRs on the condition that they must have a consistent track record of distributable profits for the last three years.[81] As highlighted earlier in Chapter III, new generation technology companies and innovative companies, in order to create long term value for their shareholders, primarily focus on customer outreach and business expansion in the initial years, and subsequently concentrate on profits. Therefore, in many cases, they are unable to satisfy these conditions. The elimination of the profitability conditions for unlisted companies will enable promoters/entrepreneurs who are skilled and have unique visions but have reservations with respect to going public, to pursue the growth and expansion of their companies without the fear of losing control and compromising on their visions.

[80] Ibid 930.

[81] Section 43, Companies Act read with Rule 4(1)(d), Companies (Share Capital and Debenture) Rules, 2014.

Chapter VI: Conclusion

At the core of the debate on DCS structures in the international context and DVR structures in the Indian context lies the fundamental tension or trade-off between a founder's freedom to pursue his/her vision for value creation and investors' need for protection from agency costs.[82] The preceding chapters were aimed at underlining the various policy deliberations, debates and practices across jurisdictions, in order to highlight the fact that the spectrum as regards the considerations to be taken into account in assessing the efficacy or desirability of capital structures with disproportionate voting rights, is rather wide. The limitations of time-based sunset provisions further manifest that given the diversity among founders and companies in terms of vision, execution, industry and competition, this is not a one size fits all exercise.[83] The questions that must be asked in order to assess such structures, such as: (i) whether the term supports the founder's vision; (ii) whether the term contemplates a means for investors to influence management; and (iii) whether the term is necessary to avoid agency costs; and (iv) whether there are less restrictive means to avoid agency costs, themselves verify the assertion that the issue is gravely complicated and that its assessment must take into account the various risks and costs that come with such structures.

The discourse on DCS structures has and continues to reveal the complexities and challenges involved with adopting such structures. It is important to highlight that in the U.S., CII's tracking of the IPO market in 2017 shows that more than four in five companies went public with the one share one vote structure: of the one hundred and twenty four IPOs, eighty nine percent comprised of companies with single class structures, which demonstrates the infrequent employment of DCS structures.[84]

The analysis in this paper shows that the potential benefits of DCS structures tend to decline and the potential costs tend to increase, over time. Moreover, time-based sunset clauses pose significant problems and are not calibrated for resolving the tension between a founder's desire for protection from interference or termination and the shareholders' need for protection from agency costs resulting from poor management decisions. It is therefore submitted that permitting the issuance and listing of shares with DVRs, especially in the context of India, is not only untenable but also unwarranted because of the fact that the governance risks and agency costs that flow from capital structures with DVRs, coupled with the inadequacy of optimal sunset provisions in serving as protective mechanisms, outweigh the advantages that the efficiency of such structures are believed to yield at the time of the IPO. However, in the event that DVRs are permitted, it is submitted that the safeguards set forth in the preceding Chapter be considered and taken into account, while devising the governing framework for the issuance and listing of DVRs in India.

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[82] Ibid 937.
[83] Ibid 938.
[84] Council of Institutional Investors, Dual-Class IPO Snapshot: 2017-2018 Statistics, available at https://www.cii.org/files/2018Y%20IPO%20Stats%20for%20Website.pdf.

Vidhi Centre for Legal Policy

D-359, Defence Colony

New Delhi – 110024

Phone: 011-43102767/43831699

Website: www.vidhilegalpolicy.in