Theory, Evidence, and Policy on Dual-Class Shares: A Country-Specific Response to a Global Debate

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Abstract

Dual-class shares have become one of the most controversial issues in today's capital markets and corporate governance debates. In the past years, academics, regulators, policymakers and stock exchanges from all over the world have been discussing whether companies should be allowed to go public with dual-class shares and, if so, which restrictions should be imposed. After analysing the regulatory approach to dual-class shares existing in several jurisdictions around the world, this article shows that countries seem to have adopted three primary models to deal with dual-class share structures: (i) the imposition of bans traditionally existing in the United Kingdom, Australia and several jurisdictions in Asia, Europe and Latin America; (ii) the permissive model allowing dual-class structures without any significant restrictions, as it happens in the United States, Sweden, and the Netherlands; and (iii) the restrictive approach implemented in Singapore, Hong Kong, Canada, India and Mainland China. It will be argued that, despite the global nature of the debate on dual-class shares, regulators should be careful when analysing foreign studies and approaches since the optimal regulatory model to deal with dual-class shares depends on a variety of local factors. Namely, this article argues that, in countries with sophisticated markets and regulators, strong legal protection for minority investors, and low private benefits of control, regulators should allow companies to go public with dual-class shares with no restrictions or minor regulatory intervention. By contrast, in countries without sophisticated markets and regulators, high private benefits of control, and weak legal protection for minority investors, dual-class shares should be prohibited or subject to higher restrictions. Finally, intermediate solutions should be adopted for countries with mixed features. Therefore, the key question to be addressed from a policy perspective is not whether companies should be allowed to go public with dual-class shares, as many authors and regulators have been discussing in the past years, but whether dual-class class shares should be allowed and, if so, under which conditions, taking into account the particular features of a country.

Keywords Dual-class shares · Controlling shareholders · Corporate governance · Capital markets · Regulatory competition

Extended author information available on the last page of the article

1 Introduction

Dual-class shares have become one of the most controversial issues in today's capital markets and corporate governance debates around the world.¹ On the one hand, a tough regulatory competition to attract initial public offerings (IPOs) has led many stock exchanges, including the Singapore Exchange (SGX), the Stock Exchange of Hong Kong (HKEX), the Shanghai's Science Technology and Innovation Board (STAR Market), and the Shenzhen Stock Exchange (SZSE), to revise their regulatory framework to allow companies to go public with dual-class shares. On the other hand, Nasdaq and the New York Stock Exchange (NYSE) in the United States have been asked by the Council of Institutional Investors to impose time-based sunset clauses on firms going public with dual-class share structures.² In the meantime, the United Kingdom is reconsidering the traditional ban on dual-class shares existing in the London Stock Exchange (LSE) Main Market's Premium Segment.³

This article argues that, despite the global nature of this debate, the desirability of dual-class share structures differs across jurisdictions. Therefore, regulators and policymakers should be careful when assessing foreign studies and regulatory models on dual-class shares. The question is not whether companies should be allowed to go public with dual-class share structures, as many authors and regulators have been discussing in the past years, but whether dual-class class shares should be allowed and, if so, under which conditions, taking into account the particular features of a country.

Section 2 discusses the features and rationale of dual-class share structures and the misconceptions surrounding the one-share-one-vote principle traditionally existing in corporate law. While this article will be focused on the use of dual-class shares by companies going public, it should be kept in mind that companies might decide to create dual-class share structures at different stages: (i) when a company is still private (stage 1); (ii) when a company is seeking to go public (stage 2); and (iii) when a company is already public (stage 3). This article will focus on the second stage—that is, companies seeking to go public with dual-class shares. In general, most countries around the world allow private companies to have shares with multiple voting rights due to the reduced contracting failures existing in these companies.⁴ In listed companies, however, that is not usually the case: due to the greater separation of ownership and control, insiders can use their power and superior information

¹ Coffee (2018); Committee on Capital Markets Regulation (2020).

² The Council of Institutional Investors submitted a proposal to Nasdaq and the New York Stock Exchange suggesting the imposition of a 7-year mandatory sunset clause. After this period, the dual-class shares will disappear unless a majority of minority investors decides otherwise. See Council of Institutional Investors (2018a).

³ HM Treasury (2020). Commenting the consultation process assessing the possibility of adopting dual-class share structures in the United Kingdom, see Hinks (2020).

⁴ In privately held corporations, the shareholders do not face the asymmetries of information and the lack of bargaining power existing in a large listed company. Therefore, it makes more sense to provide greater flexibility and contractual freedom to privately held companies. See Bebchuk (1989); Ventrone (2016); Armour et al. (2017), p 18.

to take advantage of public investors.⁵ Moreover, while founders of private companies seeking to go public have incentives to choose an optimal governance structure at the IPO stage, these incentives will be notably reduced if a company is already public. Therefore, as a result of this factor, as well as the existence of greater asymmetries of information, insiders of listed companies may want to opportunistically adopt dual-class shares after the IPO. For this reason, most countries around the world prohibit dual-class recapitalizations.⁶

Section 3 explains the rise of the debate on dual-class shares in recent years. Section 4 discusses the arguments in favour and against dual-class share structures. Section 5 reviews the empirical literature on dual-class shares. Section 6 analyses the different regulatory approaches to deal with dual-class share structures. Section 7 explains the variety of legal, economic and institutional factors affecting the desirability of dual-class shares. Section 8 advocates for a country-specific approach to dual-class share structures, suggesting different regulatory models depending on the particular features of a country. Section 9 concludes.

2 Features and Rationale of Dual-Class Shares and the Misconception Surrounding the One-Share-One-Vote Principle in Corporate Law

In a company with dual-class shares, the firm's common equity is divided into different classes of shares. In a typical dual-class share structure, there are at least two classes of shares: (i) one class of shares ('Class B' shares), usually kept by the founders and the company's executives, entitle their holders to multiple voting rights per share; (ii) another class of shares ('Class A' shares), usually sold to public investors, embracing the one-share-one-vote principle.⁷ Thus, the use of dual-class shares allows insiders to keep control with a minority of the company's share capital.⁸

Even though the debate on dual-class shares became very popular in the past years, dual-class share structures are not a new phenomenon. In fact, it has been argued that deviations from the one-share-one-vote rule are as old as the corporate form.⁹ Moreover, while the common perception is that the one-share-one-vote rule

⁵ Gordon (1988); Gilson (1987); Fishel (1987); Ferrarini (2006).

⁶ This prohibition even exists in countries that are generally friendly towards the use of dual-class shares such as the United States. However, this prohibition has not always existed. For an analysis of the prohibition of dual-class recapitalizations in the United States and the rationale behind it, see Gordon (1988) and Bainbridge (1994).

⁷ For the concept of dual-class shares, see Bebchuk et al. (2000), pp 445–460; Bebchuk and Kastiel (2017). For a comparative analysis of the concept and treatment of dual-class shares, see Hong Kong Stock Exchange and Clearing Limited (2014); CFA Institute (2018); Securities and Exchange Board of India (2019).

⁸ Bebchuk and Kastiel (2019d).

⁹ Bainbridge (2017).

has been an essential principle of corporate law,¹⁰ this is a misconception.¹¹ Indeed, while this principle has been formally adopted by most jurisdictions around the world, a more careful examination of the reality existing in many countries shows that the one-share-one-vote principle is actually the *exception* rather than the general rule.

First, many companies deviate from the one-share-one-vote rule by issuing *preference shares*—that is, shares with no voting rights in exchange for additional economic advantages attached to those shares.¹² Through the issuance of preference shares, controllers can raise capital without losing control. Therefore, as it happens with dual-class share structures, preference shares can serve as a mechanism to separate cash-flow rights from voting rights,¹³ potentially creating controlling minority shareholders.¹⁴

Second, other companies or legislations impose caps on voting rights, as well as majority of minority approvals for certain transactions.¹⁵ Therefore, while the cash-flow rights of controlling shareholders remain unaffected, these minority approvals or limitations of voting rights sometimes make the company deviate from the one-share-one-vote principle.

Third, in many countries, the use of stock pyramids and cross-ownership also creates deviations from the one-share-one-vote principle.¹⁶ In a typical stock pyramid, founders obtain control through complex group structures with several layers.¹⁷ In situations of cross-ownership, companies are linked by horizontal cross-holdings of shares that reinforce and entrench the power of central controllers by reducing the amount of equity that a shareholder has to invest to acquire, maintain or defend the

¹⁰ The one-share-one-vote principle has been seen as a cornerstone of corporate law. According to this principle, shareholders' voting rights will be based on the number of shares owned by the shareholder. For an analysis of this principle, see Grossman and Hart (1987); Ferrarini (2006); Enriques et al. (2017), pp 80–83.

¹¹ According to Bainbridge: '[...] Prior to the adoption of general incorporation statutes in the mid-1800s, the best evidence as to corporate voting rights is found in individual corporate charters granted by legislatures. Three distinct systems were used. A few charters adopted a one-share-one-vote rule. Many charters went to the opposite extreme, providing for one vote per shareholder without regard to the number of shares owned. Most followed a middle path, limiting the voting rights of large shareholders. Some charters in the latter category simply imposed a maximum number of votes to which any individual shareholder was entitled. Others specified a complicated formula decreasing per share voting rights as the size of the investor's holdings increased. These charters also often imposed a cap on the number of votes any one shareholder could cast [...]'. See Bainbridge (2017).

¹² For an analysis of these shares, see Ferran and Ho (2014), pp 132–136.

¹³ Unlike other mechanisms to separate cash-flow rights from voting rights, holders of preference shares are compensated for giving up their voting rights. This is accomplished through several mechanisms, including a mandatory dividend, a higher dividend, or a higher priority in the event of insolvency. See Ferran and Ho (2014), pp 132–136.

¹⁴ For the concept of controlling minority shareholder, see Bebchuk et al. (2000), pp 445–460.

¹⁵ Fried et al. (2018).

¹⁶ Bebchuk et al. (2000), pp 445–460; La Porta et al. (1999); Claessens et al. (2000); Masulis et al. (2011).

¹⁷ Bebchuk et al. (2000), pp 445–460; Bebchuk and Kastiel (2019d).

control of a corporation.¹⁸ In both cases, a minority stake can lead to a majority of the company's voting rights.

As a result of these situations, while many countries embrace the one-share-one-vote principle 'on the books', the reality is quite different. Therefore, regardless of being in favour or against deviations from the one-share-one-vote rule, there seems to be a misconception surrounding this rule. Even though this rule has been *formally* adopted in many jurisdictions, the truth is that there are many deviations from the one-share-one-vote principle.

3 The Renaissance of Dual-Class Share Structures

While firms with dual-class share structures are not new, various factors have made the discussion on dual-class shares particularly popular in the past years.¹⁹ First, there has been a significant increase in the number of companies going public with dual-class shares in the United States: from 46 dual-class firms going public between 2006 and 2010 to a total of 104 companies between 2011 and 2015.²⁰ In 2018, public companies in the United States with dual-class shares were worth more than \$5 trillion.²¹

Second, tough regulatory competition to attract IPOs has led many jurisdictions to revise their regulatory approaches to dual-class shares.²² This has been the case for various Asian financial centres, including Hong Kong and Singapore,²³ and more recently Shanghai²⁴ and Shenzhen.²⁵ In all of these jurisdictions, the use of dual-class share structure has been traditionally prohibited, and it is currently allowed if certain requirements are met.²⁶ In 2019, India also revised its approach to dual-class share structures,²⁷ and the United Kingdom is currently discussing whether dual-class share structures should be allowed for companies seeking to list on the LSE Main Market's Premium Listing.²⁸

Third, many tech companies that went public in the past two decades—including Google, Alibaba, Facebook, LinkedIn and, more recently, Snapchat, Pinterest,

¹⁸ Ferrarini (2000), p 11.

¹⁹ Committee on Capital Markets Regulation (2020).

²⁰ Ritter (2018).

²¹ Jackson (2018).

²² For a comparison of the regulatory framework of dual-class shares in Hong Kong and Singapore, see CFA Institute (2018), pp 50–52. See also Huang (2018).

²³ The discussions leading to the implementation of dual-class shares in these jurisdictions seemed to start with the unsuccessful attempt of Alibaba to go public in Hong Kong. See CFA Institute (2018), p 2.

²⁴ In Shanghai, see Egan et al. (2020).

²⁵ In Shenzhen, the regulations allowing companies going public with dual-class shares were passed on 26 August 2020. See <https://kr-asia.com/new-rules-registered-technology-companies-in-shenzhen-can-implement-dual-class-shares>.

²⁶ For an analysis of these requirements, see CFA Institute (2018) and Egan et al. (2020).

²⁷ See Securities and Exchange Board of India (2019).

²⁸ Analysing the desirability of dual-class share structures in the United Kingdom, see Reddy (2020).

and Lyft—did so with dual-class share structures.²⁹ Therefore, in addition to being a powerful tool to promote IPOs, allowing companies to go public with dual-class share structures can also become an attractive option for countries seeking to attract tech companies and lead the Fourth Industrial Revolution.

4 The Promises and Perils of Dual-Class Shares

4.1 The Benefits Associated with the Use of Dual-Class Shares

Several arguments seem to support the use of dual-class shares. First, by allowing companies to go public with dual-class shares, entrepreneurs will not face the fear of losing control.³⁰ Therefore, they will have more incentives to take their companies public. As a result, several benefits can be created. On the one hand, founders will have the opportunity to raise more funds—not only due to the money raised at the IPO stage but also afterwards.³¹ Thus, they will be in a better position to expand their businesses, ultimately contributing to create jobs and wealth. On the other hand, investors will enjoy the opportunity to easily invest in many innovative companies that may outperform the market.³² Therefore, the profits of a successful business will be shared with a larger number of investors. Finally, by promoting IPOs, securities regulators can also contribute to the development of their local capital markets, and this latter aspect can be desirable not only for investors and the market itself—since it may bring more trading, liquidity and informational efficiency—but also for a variety of stakeholders, including stock exchanges, lawyers, bankers, and accountants. Therefore, the attraction of IPOs can be a desirable goal for a country.³³

Second, the use of dual-class shares is a way to allow founders to create value by pursuing their—sometimes unique—‘idiosyncratic vision’.³⁴ Besides, as history has shown in cases like Steve Jobs or Mark Zuckerberg, allowing founders to pursue their vision can also be a profitable business for investors.³⁵

²⁹ See Krishna et al. (2016); Bebchuk and Kastiel (2019b, c).

³⁰ According to a survey conducted to a sample of Chief Financial Officers (CFOs), losing control is one of the most important reasons for companies to stay private. See Brau and Fawcett (2006).

³¹ Since the company is already public, it will be in a position to raise funds not only as a result of having access to more investors but also because the imposition of more stringent disclosure and corporate governance rules will reduce asymmetries of information between the company and investors. Therefore, these lower asymmetries of information may lead to a reduction in the company’s cost of capital.

³² See CFA Institute (2018), p 1.

³³ Nonetheless, it should be kept in mind that regulators should not become obsessed with the development of capital markets. As some authors have suggested, it is more important to focus on developing the financial system, regardless of whether this financial development is associated with a bank-based or market-based financial system. See Demirguc-Kunt and Levine (1999). However, it will be difficult to promote financial development and the goals of the financial system in the absence of competition among providers of capital. Therefore, the development of capital market still seems to be a desirable policy. For the goals of the financial system, see Levine (1997). See also Armour et al. (2016), pp 22–50.

³⁴ Goshen and Hamdani (2016).

³⁵ When Google went public in 2004, the company’s shares were priced at \$85 per share. The price increased to about \$600 in 2007, and about \$1,103 in 2019. Similarly, a \$1,000 investment in Facebook at the time of its IPO in 2012 would have increased to about \$4,600 in 2018. See Yahoo Finance,

Third, the use of dual-class shares may protect companies from shareholder activists.³⁶ Therefore, founders and directors can focus on their long-term projects, which can be desirable to promote innovation, research, and sustainable growth.³⁷

Fourth, while dual-class recapitalizations may lead to an outcome potentially undesired by investors, companies going public with dual-class shares provide a fair and transparent deal: investors have the opportunity to invest or not in a company going public with dual-class shares. If investors do not trust the founders of companies going public with dual-class share structures, or they think their faith can be lost after a period of time, they will not buy shares in the company or they will do so at a discount. Therefore, nobody is forcing investors to be part of a company with dual-class share structures. If they decide to invest, it is probably because they think it will be a profitable investment. Hence, in the absence of fraud or any type of opportunistic behaviour, there should be no reasons to complain if the investment does not turn out as expected. It is part of the game in the securities markets. Besides, while investors can be protected *ex ante* by deciding not to invest in a dual-class company they can also be protected *ex post* through exit rights: if they are not satisfied with the performance of the company, they can always sell their shares.

Fifth, market forces incentivize founders to choose efficient corporate governance structures at the IPO stage.³⁸ As has been mentioned, investors will discount (or they might not even buy) shares in a company whose insiders keep control with a minority position unless they have something ‘special’. Therefore, in the absence of any special vision or skills, the founders themselves will not have incentives to go public with dual-class shares. Otherwise, the IPO may be a failure. Therefore, they will only take the company public with dual-class structures if they think (and investors believe) that the gains associated with their particular vision and expertise can exceed the potential costs of having dual-class share structures. In those situations, investors will be interested in purchasing shares in the company even if, *ceteris paribus*, they would have probably preferred to invest in a company where the one-share-one-vote principle is respected.

Finally, if many countries—even those prohibiting the use of dual-class shares for listed companies—allow the separation of cash-flow rights and control rights through other legal devices (e.g., preference shares, stock pyramids, and cross-ownership structures³⁹), why should dual-class shares be prohibited when they fulfil a similar goal and this separation of ownership and control can actually take place in

Footnote 35 (continued)

‘Google Nasdaq Real Time Price’ (<https://finance.yahoo.com/quote/GOOG/history/>); Yahoo Finance, ‘Facebook Inc Nasdaq Real Time Price’ (<https://finance.yahoo.com/quote/FB/history/>). See Edmonston (2009). See also Carter (2018).

³⁶ Jordan et al. (2016).

³⁷ Lipton (2007).

³⁸ Hart (1995), p 208.

³⁹ For the concepts of stock pyramids and cross-ownerships and their importance around the world, see La Porta et al. (1999); Claessens et al. (2000); Bebchuk et al. (2000), pp 445–460; Masulis et al. (2011). For an analysis of preference shares, see Conac (2005). See also Ferran and Ho (2014), pp 132–138.

a more transparent way?⁴⁰ Therefore, several reasons seem to suggest that dual-class share structures should be allowed.

4.2 The Risks and Costs of Dual-Class Share Structures

Despite this optimistic view of dual-class shares, there are reasons to be sceptical about the use of dual-class share structures. First, the existence of dual-class shares may increase agency costs between insiders (i.e., directors, managers and controlling shareholders) and outsiders (mainly minority investors).⁴¹ On the one hand, dual-class shares allow managers and controllers to be entrenched and therefore isolated from the market for corporate control.⁴² As a result, managers may be more relaxed when running the company, and potential acquirers may be prevented from taking over the company and implementing a potentially superior business plan. Therefore, entrenchment may also lead to an opportunity cost for public investors and society as a whole.⁴³ On the other hand, the existence of dual-class shares may allow insiders to extract private benefits of control regardless of the value added to the corporation.⁴⁴ Hence, the combination of entrenchment and the expropriation of corporate resources from public investors would significantly increase the agency costs existing in firms with dual-class shares.⁴⁵

Second, while allowing companies to go public with dual-class share structures may sound appealing for the attraction of IPOs and the development of capital markets, this regulatory strategy may end up harming the development of the market if minority investors are not properly protected or if the adoption of dual-class shares just obeys the request of a particular company/founder.⁴⁶ Indeed, if minority investors are not adequately protected, they may abandon the market. Therefore, in addition to reducing the size and depth of a market, this decision will also reduce the ability of companies to raise capital, making the market less attractive for founders seeking to take their companies public.⁴⁷ Likewise, if a regulatory framework is amended just to attract a particular company (as the United Kingdom was considering with Saudi Aramco,⁴⁸ or Alibaba probably expected from the Hong Kong securities regulator), the reputation, credibility and independence of the regulator can be questioned by investors. And if so, they may also decide to abandon the market. Under this scenario, the adoption of dual-class shares could decrease the depth

⁴⁰ Gurrea-Martínez (2018a).

⁴¹ Pointing out that deviations from the one-share-one-vote principle increase agency costs, see Bebchuk (1999).

⁴² Gurrea-Martínez (2018a).

⁴³ This situation can change if a type of 'breakthrough rule', such as the one existing in Europe, is implemented. Under this rule, the company's insiders would not be able to use their weighted voting rights to fight a hostile acquisition. See Coates (2004); Ferrarini (2006); Geens and Hopt (2010).

⁴⁴ Gurrea-Martínez (2018a).

⁴⁵ Bebchuk et al. (2000), pp 445–460; Bebchuk and Kastiel (2017, 2018, 2019d).

⁴⁶ Gurrea-Martínez (2018a).

⁴⁷ Gurrea-Martínez (2018a).

⁴⁸ Bingham et al. (2017).

of a capital market, discouraging companies from going public in those markets. Therefore, allowing dual-class shares may decrease rather than increase IPOs and the development of capital markets.⁴⁹

Third, the use of dual-class share structures may create moral hazard due to the fact that, while founders will enjoy the private benefits of control, they will not fully internalize the costs associated with value-destroying decisions.⁵⁰ In other words, since the founders only own a small percentage of the company's share capital, they will only bear a small percentage of the company's potential losses. Therefore, they will not have the right incentives to make the most value-maximizing decisions.

Fourth, according to the efficient market hypothesis, prices reflect all publicly available information as well as the intrinsic value of companies based on their future cash-flows.⁵¹ However, several concerns have been raised about the validity of this hypothesis.⁵² On the one hand, behavioural economists have shown that, due to the problems of bounded rationality and certain biases, people can make mistakes.⁵³ Therefore, investors might not be able to accurately price a company at the IPO stage. On the other hand, even if investors are able to accurately price the company going public, they do not have enough information about how the company and its founders may perform or behave in the future. As a result of these asymmetries of information, their decisions might not be as optimal as they may seem at first. Finally, it should be kept in mind that if the efficient market hypothesis is controversial in countries with sophisticated capital markets such as the United States, there will be more reasons to be sceptical about the validity of this hypothesis in countries with less sophisticated markets and actors.⁵⁴

Fifth, while the use of dual-class shares can indeed isolate firms from activist investors, this can actually destroy rather than increase value. On the one hand, shareholder activists perform a valuable monitoring function in the market.⁵⁵ Therefore, they can reduce agency problems and increase the value of firms.⁵⁶ On the other hand, shareholder activists can also implement value-enhancing strategies. Finally, it is not clear whether shareholder activism leads to short-termism,⁵⁷ and, if so, whether that is a problem.⁵⁸ Therefore, isolating companies from shareholder activists may end up destroying value.⁵⁹

Sixth, it should be taken into account that, even if, at an early stage, founders have a unique vision that can create value for everyone, this vision can become obsolete,

⁴⁹ Gurrea-Martínez (2018a).

⁵⁰ Bebchuk et al. (2000), pp 445–460; Bebchuk and Kastiel (2017, 2019d).

⁵¹ See Fama (1970); Gilson and Kraakman (1984).

⁵² See Shiller (2000); De Bondt and Thaler (1985); Shleifer (2000).

⁵³ Jolls (2007).

⁵⁴ Gurrea-Martínez (2018a).

⁵⁵ Gurrea-Martínez (2016a).

⁵⁶ Brav et al. (2008).

⁵⁷ Showing that shareholder activism by hedge funds does not destroy value in the long-term, see Bebchuk et al. (2015).

⁵⁸ Roe (2013); Gurrea-Martínez (2016a).

⁵⁹ Gurrea-Martínez (2016a).

or the founders can become incompetent or less enthusiastic at some point in the future.⁶⁰ Therefore, the fact that founders might be entitled to keep running the firm *forever* might not be the most value-maximizing option for society.

5 The Evidence

5.1 The Impact of Dual-Class Shares at a Firm Level

5.1.1 Evidence Undermining the Desirability of Dual-Class Shares

In a pioneer empirical investigation of firms with single and dual-class share structures in the United States, Gompers, Ishii, and Metrick found that the value of a firm decreases as insider voting rights increase relative to cash-flow rights.⁶¹ Therefore, dual-class shares are associated with lower firm value.⁶² In another interesting study, Smart, Thirumalai, and Zutter also concluded that dual-class firms trade at lower values than their peers following IPO, and this valuation discount persists for the subsequent 5 years.⁶³ They also found that shareholders react positively to share-class unifications. Therefore, the combination of both findings seems to suggest that dual-class shares destroy value.⁶⁴

Masulis, Wang, and Xie examined how the divergences between insider voting rights and cash-flow rights affect the managerial extraction of private benefits of control.⁶⁵ They found that as the divergence widens at dual-class companies, corporate cash holdings are worth less to outside shareholders, CEOs receive higher levels of compensation, managers are more likely to make shareholder-value destroying acquisitions, and capital expenditures contribute less to shareholder value.⁶⁶ Therefore, this study supports the hypothesis that managers with greater control rights in excess of cash-flow rights are prone to waste corporate resources to pursue private benefits at the expense of shareholders.⁶⁷

Lauterbach and Pajuste studied the impact of share-class unification on firm value.⁶⁸ They found that voluntary share-class unifications are associated with economically significant increases in firm value (Tobin's Q).⁶⁹ Therefore, removing

⁶⁰ One example of this situation occurred with the media company Viacom. While the dual-class share structure allowed its founder to maintain full control of the company and helped him transform the company into a \$40 billion 'entertainment empire', he has allegedly suffered from a 'profound physical and mental illness' raising concerns that he may not be the best leader for the company. See Bebchuk and Kastiel (2017).

⁶¹ Gompers et al. (2010).

⁶² Gompers et al. (2010).

⁶³ Smart et al. (2008).

⁶⁴ Smart et al. (2008).

⁶⁵ Masulis et al. (2009).

⁶⁶ Masulis et al. (2009).

⁶⁷ Masulis et al. (2009).

⁶⁸ Lauterbach and Pajuste (2015).

⁶⁹ Lauterbach and Pajuste (2015).

dual-class shares is beneficial to firm value, suggesting that dual-class shares can be a sign of poor governance.⁷⁰

In a study of 675 European public companies from 11 countries, Barontini and Caprio analysed the relation between firm value and the wedge between the voting and the cash-flow rights of the largest shareholder.⁷¹ The authors found a negative association between corporate valuation and the control-enhancing devices used by the largest shareholder.⁷² Therefore, this study also supports the hypothesis that dual-class share structures destroy value for investors.

Using a dataset of corporate voting rights from 1971 to 2015, Kim and Michaely found that as dual-class firms mature, their valuation declines, and they become less efficient in their margins, innovation, and labour productivity compared to their single-class counterparts.⁷³ Voting premiums increase with the firm's age, suggesting that private benefits increase over time. On the basis of these findings, the authors suggest that effective, time-consistent sunset provisions should be based on age or on inferior shareholders' periodic right to eliminate dual-class voting.⁷⁴

Cremers, Lauterbach, and Pajuste studied the long-term performance of companies with dual-class shares.⁷⁵ They found that, while companies with dual-class shares have higher valuation at the IPO stage (Tobin's Q), the premium disappears 6–9 years later.⁷⁶ Therefore, the desirability of dual-class shares decreases over time. This leads the authors to speak about a 'life cycle' of dual-class shares.⁷⁷ This study is consistent with Baran, Forst and Via,⁷⁸ who show that, even though insider control at multi-class firms exhibits a positive association with innovation output that exceeds the costs of the voting misalignment, this effect changes over time. Therefore, they conclude that the decreasing positive effects of disproportionate insider control post-IPO support the call for 'sunset provisions' to convert dual-class shares to single-class shares within a certain period of time after the IPO.⁷⁹

The underperformance of firms with perpetual dual-class shares has also been shown in an empirical study conducted by the former Commissioner of SEC, Professor Robert J. Jackson, Jr.⁸⁰ Namely, this study shows that firms with perpetual dual-class shares underperform their peers after a certain period of time. Therefore, the author concludes that a mandatory time-based sunset clause may seem desirable.⁸¹

⁷⁰ Lauterbach and Pajuste (2015).

⁷¹ Barontini and Caprio (2005).

⁷² Barontini and Caprio (2005).

⁷³ Kim and Michaely (2019).

⁷⁴ Kim and Michaely (2019).

⁷⁵ Cremers et al. (2018).

⁷⁶ Cremers et al. (2018).

⁷⁷ Cremers et al. (2018).

⁷⁸ Baran et al. (2018).

⁷⁹ Baran et al. (2018).

⁸⁰ Jackson (2018).

⁸¹ Jackson (2018).

5.1.2 Evidence Supporting the Use of Dual-Class Shares

Other studies, however, have shown positive effects associated with the use of dual-class shares. In an empirical study conducted by Jordan, Kim, and Liu, the authors showed that firms with dual-class shares face lower short-term market pressures, have more growth opportunities and obtain higher market valuations than single-class firms.⁸² Likewise, Anderson, Ottolenghi and Reeb found that firms with dual-class shares were larger, older and better operating performers than their single-class peers.⁸³

Other studies have suggested that giving more voting power to shareholders who are better informed while reducing the voting power of those less informed, including passive index funds, can be efficient.⁸⁴ Therefore, it will make sense to allow founders with knowledge and expertise to run the company even if investors pay a discounted price in exchange for waiving their voting rights.⁸⁵

In another interesting study, Kim and Michaely showed that the value of mature firms with dual-class shares declines over time. However, they found that young dual-class firms trade at a premium and operate at least as efficiently as young single-class firms.⁸⁶ Therefore, the use of dual-class share structures can be desirable, at least for young firms.⁸⁷

Finally, in an empirical investigation of Canadian firms, other authors have shown that firms with dual-class shares outperform their peers over 5, 10, and 15-year periods.⁸⁸ Moreover, the use of dual-class share structures may create other benefits for a local economy—especially in terms of attraction of IPOs and the development of the financial industry.⁸⁹ Therefore, allowing dual-class share structures is economically desirable.

5.1.3 Conclusion

Most empirical studies seem to show that the value of companies with dual-class share structures decreases over time. Therefore, the evidence seems to favour the position of those advocating for the imposition of mandatory *time-based sunset clauses*.⁹⁰

⁸² Jordan et al. (2016).

⁸³ Anderson et al. (2017).

⁸⁴ Lund (2019). In favour of empowering shareholders, see Bebchuk (2005). Against this empowerment, however, see Bainbridge (2006).

⁸⁵ Lund (2019).

⁸⁶ Kim and Michaely (2019).

⁸⁷ Kim and Michaely (2019).

⁸⁸ Allaire (2016), p 3.

⁸⁹ Allaire (2016), p 3.

⁹⁰ See Jackson (2018); Bebchuk and Kastiel (2017); Council of Institutional Investors (2018c); Coffee (2018).

In my opinion, however, there are reasons to be sceptical about this proposal.⁹¹

First, the empirical evidence on dual-class shares is not conclusive.⁹² While most studies have indeed found that the value of dual-class firms declined after a certain period of time, they also show that the same firms may enjoy higher valuations at the IPO stage and they can also generate other benefits, including higher levels of innovation, more protection against short-term market pressure, and the promotion of local industry.⁹³

Second, as some authors have pointed out,⁹⁴ it should be taken into account that until Google went public in 2004, most companies going public with dual-class shares were family-owned, media companies.⁹⁵ In fact, the percentage of *non-tech* companies, compared to those with a technology-based business, going public with dual-class shares has been traditionally higher in the United States at least until 2014. Since then, the percentage of tech companies going public with dual-class share structures has exceeded the number of their non-tech peers.⁹⁶ Therefore, many empirical studies analysing the desirability of dual-class shares may not have captured the higher idiosyncratic value probably created by founders of tech firms. As a result, more research is needed *across industries* before coming up with such an interventionist solution like the imposition of time-based sunset clauses. On average, it is true that dual-class firms seem to underperform their peers in the long term. But perhaps this result differs across industries,⁹⁷ and innovative, technology-based companies may end up outperforming their peers with single-class share structures.⁹⁸

⁹¹ Expressing their scepticism about the adoption of mandatory time-based sunset clauses, see also Goshen (2018) and Moore (2020).

⁹² For a summary of the empirical literature and the number of studies in favour and against the use of dual-class shares, see Allaire (2018), p 8. Some studies have also found that a multi-class common equity structure with unequal voting rights neither increases nor decreases a company's annualized return on invested capital. Therefore, the use of dual-class shares does not affect firm performance. See Morey (2017).

⁹³ Allaire (2016), p 4; Baran et al. (2018).

⁹⁴ Berger and Hodrick (2018).

⁹⁵ Berger and Hodrick (2018).

⁹⁶ In 2014, 11.8% of non-tech companies went public with dual-class shares, while 11.3% of tech companies went public with dual-class shares. In 2015, 10.1% of non-tech companies went public with dual-class shares while 38.9% of tech companies went public with dual-class shares. More recently, in 2017, 21.8% of non-tech companies went public with dual-class shares while 43.3% of tech companies went public with dual-class shares. CFA Institute (2018). See also Ritter (2018).

⁹⁷ In my opinion, the desirability of dual-class shares differs across firms and founders. However, from a policy perspective, regulators should clarify whether they allow, restrict or prohibit dual-class shares. Exploring this policy question is the primary purpose of this article.

⁹⁸ This is probably the rationale behind the reform of dual-class shares in Hong Kong. According to the new regulatory framework for dual-class shares in Hong Kong, only 'innovative' firms can go public with dual-class shares. This provision seems to be explained by the belief that the founders of these firms can create more value. See Hong Kong Exchange (2018a), p 8. In my view, however, while the rationale of this approach can be easily understood, it would have been more appropriate if, before implementing such a significant reform, the Hong Kong securities regulator had conducted an empirical study analysing whether innovative firms actually outperform their peers, and what they mean by 'innovative firm'. In the 2014 Concept Paper, the Hong Kong Exchange considered that 'innovative', according to the Oxford English Dictionary, means 'adjective (of a product, idea, etc.) featuring new methods, advanced and orig-

Third, as this article will show, the desirability of dual-class shares may differ not only across firms and industries but also across jurisdictions. Therefore, when assessing whether dual-class shares firms outperform or underperform their peers with single-class share structures, regulators should ideally observe the empirical evidence existing in their *own* markets and jurisdictions even if studies from other jurisdictions can be relevant for the discussion.

Finally, and perhaps more importantly, it should be taken into account that, in the absence of dual-class shares, some firms included in these empirical studies would never have gone public.⁹⁹ Therefore, *even if* it were unequivocally shown that firms with dual-class share structures underperform their peers, there would still be reasons to be sceptical about prohibiting dual-class shares or imposing significant restrictions such as mandatory time-based sunset clauses. If regulators adopt a solution potentially undesired by founders, entrepreneurs may have incentives to keep their companies private, not only hampering firms' access to finance and the development of a local capital market, but also preventing public shareholders from enjoying the benefits associated with investing in many successful businesses.¹⁰⁰

5.2 The Implementation of Dual-Class Shares: A Powerful Tool to Attract IPOs? Early Evidence from Singapore, Hong Kong and Shanghai

In April 2018, Hong Kong decided to allow companies to go public with dual-class share structures. As of 31 December 2019, however, only 3 out of 401 newly listed companies went public with dual-class shares.¹⁰¹ In Singapore, even though companies listing on the SGX Mainboard are allowed to go public with dual-class shares since June 2018, none of the companies going public in 2018 and 2019 adopted these share structures.¹⁰² Only AMTD International, a NYSE-listed company with headquarters in Hong Kong, had a secondary listing on the SGX with dual-class share structures.¹⁰³ Finally, in Shanghai, while companies are only allowed to go

Footnote 98 (continued)

inal'. Although it also noted that determining whether a company is 'innovative' would be subjective and the definition can change over time. The intention behind including this definition was to 'foster the listing of exceptional companies that may have transformative effect on their industry or society in general and that could, in time, produce significant benefits for the market as a whole and to the public'. See Hong Kong Exchange and Clearing Limited (2014). Still, the existence of that requirement may create uncertainty, and it can also prevent value-creating founders from taking their companies public with dual-class share structures.

⁹⁹ Keeping control is one of the most important factors to remain private. See Brau and Fawcett (2006); Meluzín et al. (2018).

¹⁰⁰ Arguing, however, that the existence of sunset clauses or even the prohibition of dual-class shares would not discourage companies from going public, see Bebchuk and Kastiel (2017).

¹⁰¹ In 2018, only Xiami Corporation and Meituan Dianping went public with dual-class shares. See Hong Kong Exchange (2018b). In 2019, only one out of 183 companies decided to go public with dual-class share structures. See Hong Kong Exchange (2019).

¹⁰² Singapore Exchange (2020a).

¹⁰³ Singapore Exchange (2020b).

public with dual-class shares since 2019, the success of dual-class share structures has also been very limited so far.¹⁰⁴

While it is too early to judge the effectiveness of the implementation of dual-class shares for the attraction of IPOs in Singapore, Hong Kong, and Shanghai, there are reasons to be optimistic. On the one hand, all of these jurisdictions have adopted a middle-ground approach to deal with dual-class shares.¹⁰⁵ Therefore, as this paper will argue, even though some further reforms can still be implemented to enhance the protection of minority investors, especially in China,¹⁰⁶ the approach followed in these jurisdictions seems to be the most desirable one to regulate dual-class shares in Singapore, Hong Kong and Mainland China. Additionally, the capital markets and venture capital industry have grown very rapidly in Hong Kong, Singapore and Mainland China in the past years. Therefore, the increasing attention of companies and investors in Asian capital markets will probably lead to more IPOs in the near future.¹⁰⁷ Thus, even though it is unclear whether Singapore, Hong Kong and Mainland China will be able to compete with New York for the attraction of IPOs (especially in the context of large non-US firms, since US companies usually go public in their local exchanges), companies seeking to go public in Asia will no longer be forced to end up in New York *just* because of the inability of the founders to go public with dual-class share structures.¹⁰⁸

6 Regulatory Approaches to Deal with Dual-class Shares

6.1 Bans

Many countries around the world, including the United Kingdom (LSE Main Market's Premium Listing Segment),¹⁰⁹ Australia, Belgium, Brazil (Novo Mercado), Colombia, Ecuador, Germany, Malaysia, Poland and Spain prohibit the use of dual-class shares for companies seeking to go public. In my opinion, the strict adherence

¹⁰⁴ By January 2020, only one company (Ucloud) went public with dual-class shares in Shanghai. See <https://www.chinadaily.com.cn/a/202001/21/WS5e2695fda310128217272898.html>.

¹⁰⁵ See Tay (2018); Ballard (2018); Egan et al. (2020).

¹⁰⁶ Even though the existence of controlling shareholders justifies additional protections to minority shareholders in all of these jurisdictions, the efficient and sophisticated judicial systems existing in Hong Kong and Singapore provide a greater level of protection to minority shareholders. Therefore, in all of these jurisdictions, but specially in China, more protections may be needed for minority shareholders. Among others, the greater use of majority of minority approvals and the imposition of independent directors appointed by minority shareholders can be a useful tool to protect minority investors. See Gurrea-Martínez (2020).

¹⁰⁷ Thus, the IPO would provide an exit to venture capitalists. Analyzing the relationship between capital markets and the venture capital industry, see Black and Gilson (1998).

¹⁰⁸ This is actually what happened with Alibaba and Manchester United.

¹⁰⁹ The use of dual-class shares has been traditionally prohibited for companies listed on the LSE Main Market's Premium Segment. See Financial Conduct Authority (2019a). However, the United Kingdom is currently considering the possibility of allowing companies to go public with dual-class shares. For that purpose, it has published a consultation process. Commenting the reform on dual-class shares potentially adopted in the United Kingdom, see Hinks (2020).

to the one-share-one-vote principle can probably be explained by three primary factors: (i) economic reasons associated with moral hazard, entrenchment and agency problems; (ii) legal reasons mainly related to fairness and the equal treatment of shareholders; and (iii) the influence of certain lobbies.

From an economic perspective, dual-class shares have been criticized on two primary grounds. First, as it has been mentioned, the use of dual-class shares can create a moral hazard problem as a result of the existence of small-minority controllers.¹¹⁰ Indeed, even if these shareholders have their reputation and part of their wealth at risk, they do not internalize all the costs of their decisions.¹¹¹ Therefore, they might not have the right incentives to make the most reasonable and value-maximizing decisions. Second, the existence of dual-class shares may entrench current insiders from the market for corporate control.¹¹² Therefore, since it will be more difficult to remove the existing controllers, not only will the shareholders be prevented from having other directors with a potentially superior business plan but they can also be exposed to managerial opportunism and laziness.¹¹³

A second argument potentially provided to explain the prohibition of dual-class shares in certain countries can be based on the concept of equality among shareholders.¹¹⁴ According to this argument, dual-class shares should be prohibited on the basis of the one-share-one-vote principle that should prevail in corporate law. In my opinion, however, this justification does not seem to be very convincing. As has been mentioned, there are many ways to circumvent this principle, including the use of stock pyramids and cross-ownership.¹¹⁵ Moreover, even if all deviations of the one-share-one-vote rule were prohibited, it is not clear whether this is the most efficient solution for firms.¹¹⁶ Therefore, this argument seems very vague.

Finally, another aspect sometimes omitted in the study of corporate law is the role played by lobbies. Some authors have argued that the director-friendly and shareholder-friendly takeover law existing in the United States and the United Kingdom, respectively, is partially explained by the corporate ownership structures existing in these countries.¹¹⁷ Namely, due to the dispersed ownership structures with small and rationally apathetic shareholders existing in the United States, the directors of US public companies became very powerful.¹¹⁸ Therefore, they were able to influence the design of takeover law in the United States.¹¹⁹ In the United Kingdom, however, institutional investors have traditionally played a more significant role in

¹¹⁰ Bebchuk and Kastiel (2019d).

¹¹¹ Bebchuk et al. (2000), pp 445–460; Bebchuk and Kastiel (2017, 2018, 2019a); Winden (2019).

¹¹² For an analysis and importance of the market for corporate control, see Manne (1965); Easterbrook and Fischel (1981).

¹¹³ Bebchuk and Kastiel (2019d).

¹¹⁴ Ferrarini (2006).

¹¹⁵ Bebchuk et al. (2000).

¹¹⁶ See Hart and Grossman (1987); Ferrarini (2006).

¹¹⁷ Armour and Skeel (2007).

¹¹⁸ Roe (1994).

¹¹⁹ Armour and Skeel (2007).

capital markets.¹²⁰ Therefore, their power and influence may have led to the shareholder-friendly takeover regulation existing in the United Kingdom.¹²¹ This factor may explain other corporate law developments in the United Kingdom favouring the position of minority shareholders, such as the enactment of the first Corporate Governance code and the reluctance to dual-class share structures.

While the prohibition of dual-class shares in the United Kingdom can be explained—at least in part—by the power and influence of institutional investors,¹²² other lobbies may have also contributed to preserve the one-share-one-vote principle in other jurisdictions. For example, the doctrinal legal scholarship mainly existing in Continental Europe and Latin America,¹²³ along with a problem of path dependence, may have incentivized many countries in these regions to retain the one-share-one-vote rule. Finally, the maintenance of this rule may have also been due to the fact that many regulators and policymakers around the world often replicate practices existing in other jurisdictions. Therefore, as UK law has been very influential internationally, at least when it comes to corporate governance and takeover regulation,¹²⁴ the existence of the one-share-one-vote principle in the United Kingdom may have encouraged other jurisdictions to keep this rule.

6.2 Permissive Model

Several countries around the world, including the United States, Sweden, and the Netherlands, allow companies to go public with dual-class shares in a very permissible way—that is, without imposing significant restrictions. This regulatory model can be explained on the basis of three primary reasons: (i) legal reasons mainly associated with the existence of a more flexible corporate law; (ii) the influence of certain lobbies; and (iii) several economic factors, including the benefits potentially created by keeping founders running the firm, the ability of the market to incentivize optimal governance structures at the IPO stage, and the desire to attract IPOs in such a competitive regulatory environment.

First, while corporate law generally provides more contractual freedom to private companies, many jurisdictions still provide the shareholders of public companies with a significant degree of contractual freedom especially when it comes to

¹²⁰ La Porta et al. (1998, 1999); Cheffins (2010); Mayer and Franks (2017).

¹²¹ Armour and Skeel (2007).

¹²² For the role and importance of institutional shareholders in the adoption of dual-class shares, see Kim et al. (2018).

¹²³ Emphasizing the doctrinal approach generally existing in many civil law countries, see Grechenig and Gelter (2008); Garoupa and Pargendler (2014); Gurrea-Martínez (2018b).

¹²⁴ This influence of the United Kingdom in other jurisdictions has been particularly relevant in the field of corporate governance and takeover regulation. The proof is that, despite the existence of significant divergences in the corporate ownership structure and agency problems of UK public companies compared to those existing in large listed companies in Continental Europe, Asia and Latin America, these latter jurisdictions have adopted many provisions from the United Kingdom, including adaptations from both the UK Corporate Governance Code and the UK Code on Takeovers. Criticising some of these provisions in countries with controlling shareholders, see Gurrea-Martínez (2016b) and Wan (2017).

corporate governance matters adopted prior to the IPO.¹²⁵ Even though this greater level of contractual freedom can be observed in many countries, it has been one of the essential features of certain jurisdictions adopting the permissive approach to dual-class shares such as the United States.¹²⁶

Second, as has been mentioned, directors seem to have played a major role in the design of corporate law in certain jurisdictions such as the United States.¹²⁷ Therefore, taking into account that many directors of start-ups are also founders, the power and influence of the actors may have the United States become a ‘pro-founder’ jurisdiction. Moreover, the United States—and particularly Silicon Valley—has positioned itself as a leading entrepreneurial hub. Therefore, it would be more consistent with this vision to allow founders to keep pursuing their ventures. In other countries adopting this permissive approach, such as Sweden, the explanation can even be more straightforward: since Sweden is a country with many family-owned firms,¹²⁸ the controlling families may have pushed for this reform. In fact, this argument has been made by some authors in the context of takeover law in Continental Europe.¹²⁹

Finally, from an economic perspective, several factors justify the adoption of a permissive approach to dual-class shares. First, allowing founders to keep running the firm once the company is already public may be economically desirable. Sometimes, they have a unique set of skills or a vision that nobody else can replicate.¹³⁰ Therefore, prohibiting founders from pursuing their vision can be harmful for the shareholders as a whole.¹³¹ Second, market forces discourage value-destroying founders from going public with dual-class shares. Indeed, since the market would price the company and its founders, insiders should not have incentives to go public with dual-class shares unless they think (and investors believe) that they can create value. This factor would explain why not all founders take their companies public with dual-class shares,¹³² and why many founders voluntarily restrict their powers through the use of contractual provisions usually referred to as ‘sunset clauses’.¹³³ Third, another economic explanation justifying this regulatory approach to dual-class shares can be found in the desire to attract IPOs and become (or remain) a competitive stock exchange. As has been mentioned, the fear of losing control is one

¹²⁵ Bebchuk (1989); Ventrone (2016).

¹²⁶ Bebchuk (1989); Ventrone (2016).

¹²⁷ In the context of takeovers, see Armour and Skeel (2007).

¹²⁸ Bjuggren et al. (2011).

¹²⁹ Ventrone (2008). See also Armour and Skeel (2007).

¹³⁰ Goshen and Hamdani (2016).

¹³¹ Goshen and Hamdani (2016).

¹³² After all, losing control seems to be one of the major fears to take a company public. See Brau and Fawcett (2006).

¹³³ For the concept and types of sunset clauses, see Bebchuk and Kastiel (2017). Showing some data about the evolution of (voluntary) sunset clauses in companies with dual-class share structures in the United States, see Allaire (2018), p 14. See also Winden (2019). The increasing use of more restricted sunset clauses can be due to the existence of more sophisticated investors demanding more accountability from founders.

of the most important reasons for founders to keep their companies private.¹³⁴ Thus, the use of dual-class shares may incentivize founders to go public, which can be potentially desirable not only for both founders and investors but also for the market, the financial industry, and the economy as a whole. Therefore, allowing dual-class shares can be a way to face the tough regulatory competition that exists nowadays for the attraction of IPOs. In fact, this seems to explain why Hong Kong, Singapore and Mainland China have allowed companies to go public with dual-class shares, and why the United Kingdom is currently revising its existing regulatory model.

6.3 Restrictive Approach

Finally, other countries have opted for an intermediate approach. Under this model, companies can go public with dual-class shares provided that several requirements are met. This approach was adopted by Hong Kong and Singapore in an attempt to compete with other leading financial centres for the attraction of IPOs, after seeing how companies like Alibaba—the biggest IPO in history¹³⁵—decided to go public in New York just because they were unable to go public with dual-class shares in Hong Kong.¹³⁶ More recently, this restrictive approach has also been adopted in India,¹³⁷ Shanghai,¹³⁸ and Shenzhen.¹³⁹

Under this model, the requirements generally imposed on companies seeking to go public with dual-class shares can be classified into five primary groups: (i) more stringent corporate governance rules; (ii) sunset clauses; (iii) maximum differential voting rights; (iv) types of companies allowed to go public with dual-class shares; and (v) approval by stock exchanges.

First, countries adopting this restrictive model may implement, or require companies to adopt, more stringent corporate governance rules. Namely, as public investors will become less powerful in a company with dual-class shares, it would make sense to enhance the protection of minority shareholders. This can be achieved, for example, by requiring minority-appointed directors,¹⁴⁰ empowering minority investors for the election of independent directors,¹⁴¹ or subjecting related party transactions and

¹³⁴ Brau and Fawcett (2006).

¹³⁵ Alibaba raised \$25 billion from its IPO. See Mac et al. (2014). See also New York Stock Exchange (2014).

¹³⁶ Betts (2014).

¹³⁷ See Securities and Exchange Board of India (2019).

¹³⁸ Egan et al. (2020).

¹³⁹ See <https://kr-asia.com/new-rules-registered-technology-companies-in-shenzhen-can-implement-dual-class-shares>.

¹⁴⁰ The imposition of minority-appointed directors has been adopted in Italy. See Passador (2018); Gurrea-Martínez (2020).

¹⁴¹ In the UK, independent directors in controlled firms are elected by two majorities: (i) a majority of the shareholders' meeting, and (ii) a majority of independent shareholders. See Financial Conduct Authority (2019b). See also Gurrea-Martínez (2020).

other decisions potentially conflicted for the controllers to more stringent approvals, including qualified majorities or a majority of the minority.¹⁴²

Second, the imposition of sunset clauses can also serve a reasonable middle ground for the regulation of dual-class shares. These clauses consist of contractual provisions that would make the dual-class shares disappear once a specified situation occurs (e.g., a specific period of time, the founder's death, a transfer of years, etc.) unless a majority of the minority decides otherwise.¹⁴³ There are two main types of subset clauses: time-based sunset clauses and event-based sunset clauses.¹⁴⁴

In a time-based sunset clause,¹⁴⁵ the triggering event is the expiration of a defined period of time. These clauses seek to respond to the so-called 'life cycle' of dual-class shares, that is, the fact that the value of firms with dual-class share structures usually declines after a certain number of years.¹⁴⁶ As of 31 December 2020, none of the leading financial centres allowing companies to go public with dual-class shares, including the United States, Hong Kong, Singapore and Shanghai, have required companies to adopt these provisions.¹⁴⁷ However, Nasdaq and NYSE have been asked by the Council of Institutional Investors to impose a 7 year time-based sunset clause to companies going public with dual-class share structures.¹⁴⁸ Among the countries recently amending their regulatory frameworks to allow dual-class shares, only India has imposed a time-based sunset clause of 5 years.¹⁴⁹

In event-based sunset clauses, however, the triggering event is a defined fact, such as the founder's death or incapacity, the transfer of shares to third parties, or the failure to meet certain requirements in terms of ownership of the company's share capital. These latter clauses, more common in practice, and required in various stock exchanges, including the SGX, the HKEX, and the Shanghai's STAR Market,¹⁵⁰ may have different policy justifications depending on the type of event-based sunset clause. For example, if the use of a dual-class share structure is justified on the basis of the unique vision of the founders, it would not make sense to keep the dual-class share structure if the founders die, transfer their shares, or are incapacitated. However, when the triggering event is the failure to keep a minimum percentage of the

¹⁴² This majority of the minority approval is used for certain transactions in several jurisdictions, including Hong Kong and Israel. See Fried et al. (2018).

¹⁴³ For an in-depth analysis of the concept and features of sunset clauses, see Bebchuk and Kastiel (2017).

¹⁴⁴ Bebchuk and Kastiel (2017).

¹⁴⁵ The adoption of time-based sunset clauses has been suggested by several authors and institutions. See Council of Institutional Investors (2018d); Bebchuk and Kastiel (2017); Jackson (2018).

¹⁴⁶ See Cremers et al. (2018); Jackson (2018).

¹⁴⁷ In any case, it should be noted that many companies have voluntarily adopted time-based sunset clauses. For an overview of the types of sunset provisions adopted in the United States, see Winden (2019).

¹⁴⁸ Council of Institutional Investors (2018a).

¹⁴⁹ This provision can be extended for five additional years with the approval of the shareholders by way of a special resolution in a general meeting where all members vote on one-share-one vote basis irrespective of the nature of their shareholding. See Securities and Exchange Board of India (2019), p 19.

¹⁵⁰ For an analysis and comparison of the event-based sunset clauses adopted in Hong Kong, Singapore and Shanghai, see Egan et al. (2020).

shares, the rationale behind this provision is showing public investors that founders have enough skin in the game. Therefore, since the interests of the founders will be more aligned with the interests of public investors, and the founders will internalize a higher portion of the costs associated with their decisions, the moral hazard problem potentially created by the use of dual-class shares will be reduced.¹⁵¹

Third, another type of restriction for the use of dual-class shares may consist of imposing caps on the number of votes associated with those shares with superior voting rights. For example, a jurisdiction may decide, as Hong Kong, Singapore and Shanghai have actually done, to limit the number of voting rights to 10 votes per share.¹⁵² Thus, public investors can be more protected by making sure that, in order to have full control, the founders should keep a minimum percentage of the company's share capital. Therefore, as happens with sunset clauses triggered once the founders are unable to keep a minimum percentage of the company's shares, this system will help align the interest of the founders with the interest of public investors.

Fourth, regulators can also impose restrictions on the use of dual-class shares depending on the type of firm interested in going public. For example, it could be stated that the use of dual-class shares is just available to 'tech' or 'innovative' companies, as Mainland China and Hong Kong actually require.¹⁵³ The rationale behind this approach is allowing dual-class shares only in the context of companies with more disruptive business models, in which the particular vision and skills of the founders can justify the existence of dual-class shares.

Finally, another type of restriction may consist of requiring the approval of the stock exchange after conducting a thorough assessment of the 'suitability' of the company interested in going public with dual-class shares. This approach has been adopted in Singapore,¹⁵⁴ and it requires issuers to demonstrate the 'suitability' of the company to list with a dual-class share structure, for example, by showing the particular features of the business model, the skills and competence of the controlling shareholders, and the corporate governance of the firm, among other aspects.¹⁵⁵ This approach may provide public investors with an additional layer of protection, since the stock exchange would be fulfilling the filtering function that, in countries with highly sophisticated capital markets such as the United States, is performed by the market itself. However, in order for this system to work, the stock exchange assessing the suitability of the company should meet several features, including sophistication, credibility, and independence of the people involved in this assessment. Moreover, it would only work in countries with low levels of corruption such as

¹⁵¹ Bebchuk and Kastiel (2017).

¹⁵² For a comparison of the requirements to go public with dual-class shares in Hong Kong and Singapore, see CFA Institute (2018), p 51. For another comparative approach, including the requirements in Shanghai, see Egan et al. (2020).

¹⁵³ Egan et al. (2020).

¹⁵⁴ For a complete analysis of the factors suggested to determine the 'suitability' of a company to be allowed to go public with dual-class shares, see Singapore Exchange (2018).

¹⁵⁵ Singapore Exchange (2018), pp 3–4.

Singapore.¹⁵⁶ In the absence of sophisticated and reliable institutions, this approach can end up doing more harm than good. Besides, it should be kept in mind that this suitability requirement only makes sense in markets unable to accurately price the governance structure of a company seeking to go public. Therefore, I do not think this requirement is actually needed for a relatively sophisticated trading venue such as the SGX Mainboard. In fact, it can even create uncertainty,¹⁵⁷ as it may happen also with the provision of the HKEX restricting the use of dual-class shares only to ‘innovative companies’.¹⁵⁸ In my opinion, this suitability requirement would have made sense in the SGX Calatist—that is, Singapore’s listing venue for smaller, growing companies.¹⁵⁹ Unfortunately, the use of dual-class shares is not allowed for companies seeking to list on the SGX Catalist.¹⁶⁰ While several factors, including the lower sophistication and liquidity of this trading venue, may justify this prohibition, there are still reasons to support the use of dual-class shares on the Catalist. First, this market is primarily designed to serve as a listing venue for growing companies. Therefore, due to the major role played by the founders in the early stages of a business, it might make more sense to favour the use of dual-class shares in these companies. Second, the Catalist imposes similar corporate governance rules as those that exist for the Mainboard. Therefore, in terms of corporate governance mechanisms imposed to protect public investors, there are no significant differences between both listing venues. Third, as the Catalist is a sponsor-based regime (similar to the UK’s Alternative Investment Market), there is a gatekeeper appointed to work closely with the issuer. Therefore, the existence of these gatekeepers may compensate investors for the reduced informational efficiency potentially existing in these markets.¹⁶¹ For these reasons, I think that Singapore should reconsider its position regarding the prohibition of companies going public with dual-class shares on the Catalist. Namely, I believe that the use of dual-class shares should be allowed on the Catalist subject to the restrictions currently existing on the Mainboard, including the ‘suitability requirement’. By contrast, I do not think the suitability requirement is needed for a sophisticated trading venue such as the SGX Mainboard.

¹⁵⁶ Examining the level of corruption existing in countries around the world, see World Economic Forum (2019).

¹⁵⁷ This objection was made by many respondents to the consultation paper in Singapore. See Singapore Exchange (2018), p 4.

¹⁵⁸ A similar requirement has also been imposed in India and Shanghai. For India, see Securities and Exchange Board of India (2019). In Shanghai, see Egan et al. (2020).

¹⁵⁹ The Catalist is a platform targeting young and rapidly-growing companies. It is the equivalent of the UK’s Alternative Investment Markets. Companies looking to list on the Catalist are subject to less stringent requirements as compared to listing on the Mainboard. See Teen and Lai (2019). For Catalist Listing Rules, see Singapore Exchange (2019). For the UK’s Alternative Investment Markets, see Hornok (2015).

¹⁶⁰ Suggesting that the use of dual-class shares should also be allowed for companies listed on the Catalist, see Lin (2018).

¹⁶¹ Gurrea-Martínez (2015).

6.4 Summary

A global view to the treatment of dual-class share structures seems to suggest that countries have adopted three primary models to deal with dual-class shares. The first approach consists of the imposition of bans traditionally existing in many countries, including the United Kingdom, Australia, Brazil (Novo Mercado), Colombia, Ecuador, Malaysia and Spain. A second regulatory model consists of the permissive approach allowing dual-class share structures without any significant restrictions. This approach has been adopted in several jurisdictions, including the United States, Sweden, and the Netherlands. Finally, a third regulatory approach to dual-class share structures, found in various jurisdictions, including Singapore, Hong Kong, Canada, India and Mainland China, consists of imposing certain restrictions for the use of dual-class share structures (see Table 1).

From a policy perspective, the key question to be addressed is not whether companies should be allowed to go public with dual-class shares but whether dual-class class shares should be allowed and, if so, under which conditions, *given* the particular features of a country. As it will be mentioned in Sect. 7, the desirability of each regulatory approach will depend on a variety of country-specific factors.

7 Local Factors Affecting the Desirability of Dual-Class Shares

Many countries and scholars around the world have been discussing whether companies should be allowed to go public with dual-class shares. In my opinion, however, the discussion has not been properly framed. The question is not whether securities regulators should allow companies to go public with dual-class shares but whether they should do so, and if so how, taking into account the particular features of a country.

It will be argued that, when deciding the optimal regulatory response to deal with dual-class shares, regulators should consider a variety of local factors, including: (i) the level of sophistication of capital markets; (ii) the level of investor protection provided by corporate and securities laws; (iii) the level of private benefits of control potentially enjoyed by corporate insiders; (iv) procedural laws; (v) accounting and audit regulation; and (vi) the quality and credibility of enforcement. These factors will help regulators to determine the *overall* level of protection provided to public investors, which should be the leading factor determining whether or not dual-class shares should be allowed, and if so how, in a particular country.

7.1 Sophistication of Capital Markets

One of the most important aspects in considering whether and, if so, under which conditions companies should be allowed to go public with dual-class shares is the level of sophistication of a capital market. In countries with more sophisticated markets—usually due to the existence of more issuers, trading volumes, liquidity, sophisticated investors, investment banks, analysts, broker-dealers, proxy advisors,

Table 1. Regulatory approaches to dual-class shares around the world

Regulatory approach	Jurisdictions (sample)
Bans	United Kingdom (LSE Premium Listing), Australia, Belgium, Brazil (Novo Mercado), Colombia, Ecuador, Germany, Malaysia, Poland, Spain
Permissive approach	United States, Sweden, The Netherlands
Restrictive model	Singapore, Hong Kong, India, Canada, Mainland China

securities lawyers, and financial advisors, among other aspects—, the implementation of dual-class share structures is less risky. In these countries, markets will be able to price—at least much better than in non-sophisticated markets—the value potentially added by the founders.¹⁶² In order words, markets will become more informationally efficient.¹⁶³ As a result, the market will be able to price if the founders are as ‘special’ as they think they are. Therefore, founders will only choose to go public with dual-class shares if they think (and investors believe) that they can add value to the company. Similarly, once a company has become public, the existence of a sophisticated capital market will incentivize corporate directors to behave in a more efficient, diligent and honest manner. Otherwise, the market will react by pushing down the stock price. And taking into account that, if the stock price goes down, the directors can lose their jobs if they are subject to a hostile takeover, and they can also lose the value of their shares and stock options (if any), they will have incentives *ex ante* to maximize the interest of the shareholders. Therefore, the sophistication of the market will protect public investors.

As a result, in countries with more sophisticated markets, such as the United States, the risk of allowing dual-class shares will be lower. By contrast, in countries with less sophisticated markets, unable to effectively and efficiently price the information associated with a company or their insiders, investors will enjoy a lower level of protection provided by the market. In these markets, investors will face a type of adverse selection problem, since they will not be able to distinguish between good and bad firms/managers. Besides, due to the inability of the market to reflect the value of corporate decisions through the stock price, managers and controlling shareholders may have incentives to opportunistically enrich themselves at the expense of public investors. After all, the market will not be punishing them for any misbehaviour. Therefore, the risk of allowing dual-class shares will be higher in countries with less sophisticated capital markets. In contrast, when the capital market is sophisticated enough, the market itself may act as one of the most powerful mechanisms to protect public investors.

¹⁶² Therefore, these markets will closely follow the ideas expressed by the efficient market hypothesis according to which prices reflect all publicly available information and the intrinsic value of the future cash-flows of a firm. See Fama (1970); Gilson and Kraakman (1984).

¹⁶³ Gilson and Kraakman (1984).

7.2 Corporate and Securities Laws

Most of the legal protections provided to public investors are derived from a country's corporate and securities laws. Hence, in order to decide how risky the use of dual-class shares can be in a country, it might be useful to analyse how protected minority investors are in a particular jurisdiction. For that purpose, it would be useful to analyse a variety of provisions mainly seeking to protect minority shareholders such as the availability of derivative actions,¹⁶⁴ mandatory disclosure,¹⁶⁵ oppression remedies,¹⁶⁶ approval of transactions by a majority of the minority,¹⁶⁷ or the existence of directors appointed by minority investors.¹⁶⁸

The way in which securities law is designed can also affect the protection of investors.¹⁶⁹ For example, in order to reduce regulatory costs for firms, many countries may decide to reduce the level of disclosure imposed to issuers. If so, a lower level of information may reduce the level of protection for public investors.¹⁷⁰

After conducting a comprehensive assessment of corporate and securities laws, if it is concluded that minority investors are not properly protected in a particular country, the use of dual-class shares will be riskier. By contrast, if a country's corporate and securities laws provide strong protection for public investors, the use of dual-class shares will be less risky from the perspective of minority shareholders.

7.3 Private Benefits of Control

Closely related to the level of investor protection provided under corporate and securities laws, another important feature affecting the level of risk associated with allowing companies to go public with dual-class shares is the existence and significance of private benefits of control. In other words, it will be relevant to analyse the level of influence, power and appropriation of corporate resources by insiders.¹⁷¹

¹⁶⁴ In some countries, derivative actions exist 'on the books' but they are not so common in practice due to a variety of factors, including procedural rules (e.g., allocation of legal fees) and the level of share concentration existing in the country. For an analysis of derivative actions around the world and why they are not common in some countries, see Koh (2001); Li (2007); Reisberg (2007); Siems (2012), pp 93–116; Gelter (2012); Puchniak et al. (2012); Erickson (2018).

¹⁶⁵ In fact, in the discussion on the desirability of dual-class share structures, some authors have argued that, instead of relying on mandatory sunset clauses and other provisions that may create unintended consequences, the best way to protect investors while still encouraging companies to go public is promoting a system of enhanced disclosure for companies with dual-class share structures. See Committee on Capital Markets Regulation (2020), pp 27–31.

¹⁶⁶ Nenova (2003).

¹⁶⁷ Fried et al. (2018); Enriques (2015).

¹⁶⁸ Malberti and Sironi (2007); Belcredi and Enriques (2015); Passador (2018); Gurrea-Martínez (2020).

¹⁶⁹ La Porta et al. (2006).

¹⁷⁰ Emphasizing the importance of disclosure in securities markets and how it can be a valuable mechanism to protect investors, see La Porta et al. (2006). In the context of dual-class shares, see Committee on Capital Markets Regulation (2020), pp 29–31.

¹⁷¹ Dyck and Zingales (2004).

In countries where controllers enjoy large private benefits of control,¹⁷² making the controllers more powerful will become riskier for public investors. Therefore, regulators should become more sceptical about the possibility of allowing companies to go public with dual-class shares.¹⁷³ By contrast, in countries with low levels of private benefits of control, there will be a lower risk associated with permitting dual-class share structures.¹⁷⁴

7.4 Procedural Laws

Other legal remedies potentially provided to protect investors can be found in the laws governing civil procedures and class actions. For example, if a country imposes a high burden of proof to sue corporate insiders, there will be a higher risk of opportunism by insiders vis-à-vis public investors. Therefore, it will be riskier to allow the use of dual-class shares. By contrast, if litigation is facilitated by not imposing a high burden of proof to the plaintiff, or by facilitating the use of class actions, public investors will enjoy a greater level of protection due to the fact that corporate insiders will be more exposed to the risk of being sued. Therefore, they will have more incentives to avoid any violation of the law and any type of opportunistic behaviour. Therefore, in countries with more friendly litigation rules, especially if these rules include the existence of class actions, there will be a lower risk associated with allowing the use of dual-class shares. By contrast, if a country does not allow the use of class actions and makes litigation against corporate directors more difficult, there will be a higher risk of opportunism by insiders vis-à-vis public investors. Therefore, regulators should be more sceptical about the possibility of allowing companies to go public with dual-class shares.¹⁷⁵

¹⁷² These countries include, for example, South Korea, Mexico, Italy and Brazil. See Dyck and Zingales (2004).

¹⁷³ Interestingly, however, even though countries like France and Italy are dominated by controlled firms, and particularly Italy has generally exhibited high levels of private benefits of control, various empirical studies have shown that the market in Italy and France has reacted positively to the implementation of shares conferring superior voting rights to certain shareholders. See Ecchia and Visconti (2016); Belot et al. (2019); Bourveau et al. (2019); Bajo et al. (2019). It should be noted, however, that the shares with superior voting rights recently adopted in France and Italy are not the typical dual-class share structures mainly covered in this paper, but the ‘loyalty shares’ adopted in some European countries. For the concept and features of loyalty shares, see Bolton and Samama (2013).

¹⁷⁴ These countries include, for example, Sweden, Norway, Singapore, the United Kingdom, and the United States. In Sweden, 80% of public companies have dual-class shares. See Shearman & Sterling and ECGI (2007). See also Ventoruzzo (2015). While this percentage can be worrying for other countries, it does not seem to be risky in a country like Sweden, not only characterized by the existence of low private benefits of control but also—and very related—for their good laws. See Gilson (2006).

¹⁷⁵ In fact, the lack of class actions seemed to be one of the factors influencing the decision to prohibit the use of dual-class shares in Hong Kong. Analysing the desirability of allowing dual-class share structures in Hong Kong, see Hong Kong Exchanges and Clearing Limited (2014).

7.5 Accounting and Audit Regulation

Financial reporting and audit regulation also play an essential role in the protection of public investors. Namely, by providing information about the company's performance and financial position, the existence of accounting and financial reporting obligations help to reduce asymmetries of information between issuers and investors while facilitating investment decisions.

However, since issuers may have perverse incentives to lie about their financial situation in order to attract more investors, the appointment of a reliable, qualified third party to verify this information seems to be needed. This is essentially the role and function played by auditors. By acting as reliable third parties in charge of verifying the company's financial statements, auditors have two primary functions. Ex post, they protect public investors by making sure that corporate insiders do not lie about the company's financial position.¹⁷⁶ Ex ante, they create confidence among public investors, facilitating firms' access to finance and the development of capital markets.¹⁷⁷

However, since auditors are appointed, paid and removed by the audited company, and they often provide other professional services to the audited company, they face a clear conflict of interest. For this reason, when assessing how protected public investors are, it is important to analyse the credibility of the system of auditors, and the independence of auditors from corporate insiders.¹⁷⁸

In countries with more stringent regulations for the independence and qualifications of auditors, and more comprehensive rules of financial reporting, public investors will enjoy a higher level of protection. In those cases, the risk of allowing dual-class shares will be lower. By contrast, in countries with less stringent accounting and audit rules, the risk of expropriation by corporate insiders vis-à-vis public investors will be higher. In these latter jurisdictions, allowing the use of dual-class shares will be riskier.

7.6 Quality and Credibility of Enforcement

The quality of the 'law on the books' in a country is useless unless it is accompanied by a proper enforcement. Therefore, the way in which the laws are enforced is an essential component of investor protection.¹⁷⁹ For that purpose, there are many types of enforcement mechanisms, as well as many factors potentially affecting the quality and credibility of enforcement.¹⁸⁰ In any case, regardless of whether the enforcement

¹⁷⁶ Gelter and Gurrea-Martínez (2020).

¹⁷⁷ Gelter and Gurrea-Martínez (2020).

¹⁷⁸ Suggesting various policy recommendations to enhance the independence of auditors, see Gelter and Gurrea-Martínez (2020).

¹⁷⁹ See La Porta et al. (2000). Some authors have even argued that 'enforcement of the rule of law is the central functional difference between developed market economies and developing economies'. See Bergelöf and Claessens (2016).

¹⁸⁰ Jackson and Roe (2009); Armour et al. (2017).

is private or public, or how the enforcement has been achieved, the quality and credibility of the enforcement will depend on the sophistication and reliability of various actors and institutions.

First, the judicial system plays an essential part in the enforcement institutions in a country. Indeed, the existence of a reliable, independent, sophisticated, and efficient judiciary makes public investors be more confident about the protection of their rights, since they know that any opportunistic conduct by corporate insiders will be quickly challenged and, if so, punished. As a result, directors and controlling shareholders will have less incentives to expropriate minority investors. Therefore, in countries with more efficient, independent and sophisticated judicial systems, the use of dual-class shares will be less risky. By contrast, if a judicial system is slow, unsophisticated, or corrupt, the rights of public investors might not be properly or quickly protected. As a result, allowing companies to go public with dual-class shares would be riskier in these jurisdictions.

Second, securities regulators also play a major role in the enforcement of the law—particularly securities laws and, in some countries, also corporate laws. Indeed, since a sophisticated, independent and well-equipped regulator will have the opportunity to provide a more effective supervision of securities markets, corporate insiders will be more deterred from violating the law or engaging in any type of opportunistic behaviour. As a result, public investors will enjoy a greater level of protection. Therefore, the risk of allowing dual-class shares will be lower in these countries. By contrast, if a securities regulator is not very sophisticated, or it is ‘captured’ by the regulated entities, the regulator will unlikely perform its monitoring and enforcement functions in an effective manner. Thus, since public investors might not be properly protected, the use of dual-class shares will be riskier in these countries.

Third, the existence and sophistication of a market of securities and litigation lawyers can also play an important role in the enforcement of corporate and securities laws. As it has been mentioned, the likelihood of being sued for breaking the law or for a breach of fiduciary duties may affect the behaviour of corporate directors. Therefore, the more developed a market of litigation lawyers is, the more protected public investors can be from the opportunism of corporate insiders.¹⁸¹ Therefore, in countries with an active market of securities and litigation lawyers, the risk of allowing dual-class shares will be lower. By contrast, in countries without a developed market of securities and litigation lawyers, there will be a higher risk associated with the use of dual-class shares.

Finally, the existence of activist investors may not only affect the sophistication and informational efficiency of a market but also the effectiveness and credibility of the enforcement. Indeed, due to the higher interest of activist investors in the governance and performance of companies, these shareholders have incentives to spend resources in gathering and analysing information, as well as monitoring corporate insiders. Likewise, in case of identifying a breach of directors’ duties, or any

¹⁸¹ Sometimes, the size of the market of litigation lawyers will depend on a variety of factors including the availability of class actions and the possibility of using contingency fees.

type of oppressive conduct by corporate insiders, they also have the incentives and resources to initiate a lawsuit. In fact, even if the directors properly perform their duties but, in the view of the shareholder activist, the directors are not maximizing the value of the firm, they can still do something: shareholder activists can consider the possibility of starting a campaign against corporate insiders with the purpose of influencing some managerial, corporate or financial decisions.

As a result, public investors will be more protected in countries with activist shareholders willing and able to closely monitor corporate insiders. Thus, the risk of allowing dual-class shares will be lower in these markets. By contrast, the use of dual-class shares will be higher in markets mainly formed by passive shareholders. For that purpose, however, it should be noted that, depending on the type of passive investor prevailing in the market, the risks associated with the use of dual-class shares may also differ. For example, if most passive shareholders are institutional investors, there will be a lower risk of allowing dual-class shares, since these investors have more resources and bargaining power. However, if most passive shareholders in a market are retail investors, the risk of allowing dual-class shares will be much higher, not only because these shareholders will have a lower bargaining power but also because they will face larger asymmetries of information.

8 Choosing the Optimal Response to the Dual-Class Share Puzzle

The use of dual-class shares may create several benefits, mainly associated with allowing founders to pursue their idiosyncratic vision and encouraging firms to go public. However, the existence of shares with multiple voting rights also entails some risks. Even though the costs and benefits of a dual-class share structure are *firm-specific*, and therefore will depend on the particular company and founders, from a policy perspective, regulators should decide how to deal with dual-class shares.

In my view, the optimal way to deal with dual-class shares depends on the particular features of a country. For that purpose, this article divides countries into three main groups. Group 1 is formed by countries with sophisticated capital markets, strong legal protections for minority investors in corporate and securities laws, low private benefits of control, effective audit, accounting and litigation rules, and independent and sophisticated regulators and courts. Therefore, this group includes jurisdictions such as the United States, the United Kingdom, Singapore and Hong Kong. Due to the existence of class actions and a more sophisticated capital market, the United States would probably be the most suitable country for this group even if, in certain aspects such as audit regulation and independent directors, the regulatory framework in the United States can still be improved in order to provide more protection to minority shareholders.¹⁸² Still, the particular features of US markets

¹⁸² These additional protections to minority shareholders may include greater powers in the appointment and removal of auditors and independent directors, as well as a more significant role in the context of hostile takeovers. See Gurrea-Martínez (2016b); Bebchuk and Hamdani (2017); Gelter and Gurrea-Martínez (2020).

Table 2. Choosing an optimal approach to dual-class share structures

Group	Country-specific features	Jurisdictions	Desirable approach
Group 1	Countries with sophisticated capital markets Strong legal protections for minority investors in corporate and securities laws Low private benefits of control Effective audit, accounting and litigation rules Independent, efficient and sophisticated judiciary and regulators	United States and, to a lesser extent, the United Kingdom, and then Hong Kong and Singapore	No restrictions or a minimum level of regulatory interventions (US), minor restrictions (UK), or additional restrictions but still a flexible approach (Hong Kong, Singapore)
Group 2	Countries without sophisticated capital markets High private benefits of control Lack of effective audit, accounting and litigation rules Weak legal protections for minority investors in corporate and securities laws Lack of independent, efficient and sophisticated judiciary and regulators	Most emerging economies	Bans or significant restrictions
Group 3	Countries with mixed features (e.g., sophisticated markets and poor institutions; good institutions but underdeveloped capital markets)	China, India, Australia and most European countries	Restrictions (more/less stringent)

provide a greater level of protection to minority investors, justifying a more flexible approach to dual-class shares, as compared to the minor regulatory interventions that might be needed in the United Kingdom, and especially in Hong Kong and Singapore.

Group 2 is formed by countries without sophisticated capital markets, high private benefits of control, lack of effective audit, accounting and litigation rules, weak legal protections for minority investors in corporate and securities laws, and lack of independent and sophisticated regulators and courts. As a result, it would generally include emerging economies, and therefore most countries in Latin America, Eastern Europe, Africa, Middle East and Asia. Finally, Group 3 is formed by countries with mixed features. Therefore, it would include certain emerging economies with large capital markets, such as China and India, as well as countries that, even though they do not have developed capital markets, have sophisticated and reliable institutions, as it happens in Australia and most European countries. See Table 2.

This article argues that the use of dual-class shares is not very risky in countries included in Group 1. Therefore, if a country meets all the features generally existing in Group 1, as it happens with the United States, there does not seem to be any need to prohibit or significantly restrict the use of dual-class shares.¹⁸³ Instead, the most desirable approach to dual-class shares will consist of enhanced disclosure¹⁸⁴ and, if so, certain event-based sunset clauses. However, in countries with less sophisticated markets and/or no class actions included in Group 1, such as the United Kingdom, and especially Hong Kong and Singapore, more restrictions might be needed. For this reason, it is argued that the imposition of event-based sunset clauses and more stringent corporate governance rules would be desirable in these latter jurisdictions included in Group 1. Therefore, the middle-ground approach to dual-class shares adopted in Hong Kong and Singapore seems to be economically desirable. A similar approach, even with fewer restrictions due to the higher level of sophistication of the market and the existence of enhanced rules for the appointment of independent directors in the context of controlled firms,¹⁸⁵ would also be desirable for the United Kingdom. In none of these jurisdictions, however, the imposition of very stringent measures such as mandatory time-based sunset clauses seems to be justified.¹⁸⁶

In countries included in Group 2, the use of dual-class shares should be prohibited or subject to stringent restrictions such as the imposition of time-based sunset clauses, caps on the number of votes per share, and enhanced corporate governance mechanisms and legal and institutional reforms seeking to improve the protection of

¹⁸³ In a speech delivered by Professor Robert J. Jackson Jr., the former Commissioner of the US Securities and Exchange Commission argued that the restrictive approach existing in Singapore and Hong Kong should inspire countries with sophisticated markets such as the United States. See Tay (2018). In a similar way, see also Moore (2020).

¹⁸⁴ Committee on Capital Markets Regulation (2020), pp 29–31.

¹⁸⁵ Bebchuk and Hamdani (2017); Gurreea-Martínez (2020).

¹⁸⁶ Expressing their scepticism against the imposition of time-based sunset clauses, see also Goshen (2018) and Moore (2020).

minority shareholders.¹⁸⁷ In the absence of these additional safeguards, the adoption of dual-class shares could actually hamper, rather than develop, the local capital markets, since many public investors may feel unprotected. Therefore, they would not have incentives to invest in the market.

Finally, in jurisdictions included in Group 3, the optimal way to deal with dual-class share structures may differ depending on the particular features of a country. For example, if the country is closer to those included in Group 1, as it may happen with Australia and some European countries, the use of dual-class shares can be allowed subject to several restrictions, including the imposition of event-based sunset clauses, limitations on the number of votes per share and, especially in countries with controlling shareholders and a higher risk of tunnelling,¹⁸⁸ stringent corporate governance rules to protect minority shareholders.¹⁸⁹ Moreover, the implementation of class actions can also be a desirable policy to enhance the protection of minority investors. By contrast, if a particular country is closer to those included in Group 2, as it may happen with China or in India,¹⁹⁰ a more restrictive approach should be adopted. For example, in addition to the restrictions suggested for countries closer to those included in Group 1, the adoption of time-based sunset clauses may also be justified in these cases. For this reason, the adoption of a mandatory time-based sunset clause of 5 years in India seems to be a desirable policy for a country that, despite its relatively developed capital markets, and the significant improvements

¹⁸⁷ These reforms should ideally include also the improvement of the judicial system. In the absence of institutional reforms, however, the imposition of approvals by a majority of the minority, or the existence of minority-appointed directors, could probably serve as powerful mechanisms to protect minority shareholders. See Gurrea-Martínez (2020).

¹⁸⁸ For the concept of ‘tunnelling’, see Johnson et al. (2000). The authors use the term tunnelling to refer to ‘the transfer of resources out of a company to its controlling shareholder (who is typically also a top manager)’. Therefore, ‘it does not cover other agency problems, such as incompetent management, placement of relatives in executive positions, excessive or insufficient investment, or resistance to value-increasing takeovers’. According to the authors ‘[...] tunnelling comes in two forms. First, a controlling shareholder can simply transfer resources from the firm for his own benefit through self-dealing transactions. Such transactions include outright theft or fraud, which are illegal everywhere though often go undetected or unpunished, but also asset sales, contracts such as transfer pricing advantageous to the controlling shareholder, excessive executive compensation, loan guarantees, expropriation of corporate opportunities, and so on. Second, the controlling shareholder can increase his share of the firm without transferring any assets through dilutive share issues, minority freeze-outs, insider trading, creeping acquisitions, or other financial transactions that discriminate against minorities [...]’. For other definitions of tunnelling, distinguishing between asset tunnelling, equity tunnelling, and cash-flow tunnelling, see Atanasov et al. (2014). For an empirical investigation of tunnelling through related party transactions in Hong Kong and Singapore, see Chen et al. (2018).

¹⁸⁹ Some of these mechanisms may include those mentioned *supra* n. 187.

¹⁹⁰ While these countries have more developed capital markets than many European countries, and particularly India has adopted many good corporate governance policies in the past decades, both jurisdictions have poor enforcement institutions. Therefore, the lack of sophisticated, efficient and reliable courts undermine the protection of minority shareholders. Emphasizing the lack of an efficient enforcement in India, see Varotil (2018). Showing the severe problems of tunnelling existing in Chinese companies, and therefore the need to provide more protection to minority shareholders in China, see Li (2010) and Jiang et al. (2010).

made in the past decades to enhance the protection of minority investors, still has many corporate governance challenges, especially in terms of enforcement.¹⁹¹

Regardless of the classification of a particular jurisdiction, countries with low levels of corruption and good institutions may also consider the possibility of allowing the stock exchange to decide whether a company is ‘suitable’ to go public with dual-class shares.¹⁹² For that purpose, companies seeking to go public with dual-class shares may show the robustness of their corporate governance system, especially from the perspective of minority investors.¹⁹³ These measures may include the empowerment of minority shareholders (even including some independent directors directly appointed by minority shareholders),¹⁹⁴ and the use of majority of minority approvals for certain transactions.¹⁹⁵ In my view, subjective factors—such as the uniqueness of the business model or the particular expertise of the founder—should not be assessed by the stock exchange, since only the marketplace will judge the attractiveness of the company’s strategy and business model. The effectiveness of the corporate governance mechanisms potentially used to protect minority shareholders, however, can be more easily assessed by qualified actors from a stock exchange. After conducting this assessment, even if the judgment of the stock exchange may sometimes fail—for instance, allowing companies to go public with dual-class shares when they should not and the other way around—, this system may still work more effectively than a non-sophisticated market. Namely, in countries with underdeveloped capital markets, the stock exchange would be performing the filtering function that, in countries like the United States, would be performed by the market. In the absence of good institutions and stock exchanges, however, the implementation of this system would do more harm than good. Therefore, the assessment of the suitability of a company to go public with dual-class shares, examined from the perspective of the corporate governance mechanisms adopted to protect minority investors, would only be desirable in countries with underdeveloped capital markets *and* reliable institutions.

9 Conclusion

Dual-class shares have become one of the most controversial issues in today’s capital markets and corporate governance debates around the world. This article has argued that, despite the global nature of the debate, regulators and policymakers should be careful when analysing foreign studies and approaches because the optimal regulatory model to deal with dual-class shares depends on a variety of local factors. It has been argued that in countries with sophisticated markets and regulators, strong

¹⁹¹ See Varottil (2018). For an analysis of the enhanced regulatory framework of dual-class shares approved in India, see the Securities and Exchange Board of India (2019).

¹⁹² This is the approach followed in Singapore. See Singapore Exchange (2018).

¹⁹³ For a variety of corporate governance mechanisms potentially considered to show the suitability of a company to go public with dual-class shares in Singapore, see Singapore Exchange (2018), pp 3–4.

¹⁹⁴ Gurrea-Martínez (2020).

¹⁹⁵ Fried et al. (2018).

legal protection for minority investors, and low private benefits of control, regulators should allow companies to go public with dual-class shares with no restrictions or minor regulatory intervention. By contrast, in countries without sophisticated markets and regulators, high private benefits of control, and weak legal protection for minority investors, dual-class shares should be prohibited or subject to greater restrictions. Intermediate solutions should be adopted for countries with mixed features. Therefore, the key question to be addressed from a policy perspective is not whether companies should be allowed to go public with dual-class shares, as many authors and regulators have been discussing in the past years, but whether dual-class shares should be allowed and, if so, under which conditions, taking into account the particular features of a country.

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