Shares with Differential Voting Rights

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The Securities and Exchange Board of India (SEBI) has recently issued a consultation paper on 'Issuance of shares with Differential Voting Rights (DVRs)'[1] by companies registered in India. SEBI has invited public comments on this issue. Should India follow the international practice by allowing firms to issue shares with disproportionate voting rights? Once allowed, firms will be entitled to issue shares with ownership rights different from cash flow (economic) rights. To put it simply, an investor holding a DVR may have higher control (voting) rights and lower cash flow (dividend) rights. For example, Mark Zuckerberg (with a small group of insiders) owns 18 percent of shares of Facebook (cash flow rights), but these are special types of shares (class B) which entitle the owners 10 votes per share (control rights). Such granting of disproportionate control rights to a section of the shareholders is made possible through a dual class structure. So, Facebook has issued two types (class) of common shares- one for the founders (class B) and the other (class A) for all other shareholders where each share has one vote. Google goes a step further. It has three different classes of common (equity) shares- class A (*normal class* with one vote per share), class B (*the gold class* with 10 votes per share), and class C (*the cattle class* with no voting rights). Facebook and Google are not alone in this game. A report[2] mentions that a year ago, 355 of the companies in the Russell 3000(an index which tracks the performance of the 3000 largest U.S-traded stocks) had a dual voting-class structure.

SEBI has in the past permitted listing of shares with 'inferior voting rights' but prohibited shares with 'superior voting rights'. Later in 2009, SEBI had prohibited issue of any form of DVRs. SEBI, through this consultation paper, proposes that stock exchanges should now allow issue of shares with differential voting rights. This is to bring the SEBI regulations at par with the provisions of the Companies Act, 2013 which allows every company registered in India to issue shares with DVRs. The Companies Act, 2013 provides a cap on the number of shares with DVRs that can be issued by any company to 26% of the total post-issue capital. This is not a small size- refer to the Facebook example. Incidentally, shares with DVRs cover both inferior and superior voting rights issuances. Though the amendments in the earlier Companies Act in 2000 and later the new Companies Act (2013) allowed companies to issue DVRs, only a handful of companies has actually issued DVRs. Major reason for such a poor show could be the heavy discount at which DVRs trade compared to the ordinary shares. For example, Tata Motors ordinary shares closed at Rs. 180.20 on March 20, 2019 when the DVR of the same company closed at Rs. 89.20- a whopping discount of 50 percent. It was not just a bad day for the DVR shares. Six months ago, the discount of Tata Motors DVRs was 52 percent.

Notwithstanding the reluctance of listed and stable companies in DVRs, the new generation high-growth early stage companies are craving for such options in raising new capital. In fact, one argues that in the absence of such an enabling provision in the capital market regulations, startups still depend to a large degree on private equity market for much-needed funds. SEBI and the stock exchanges in India have been trying since the past few years to attract startups and young companies to list in main or SME platform of the exchanges to raise risk capital. But, among many other factors, one of the major bottlenecks was dilution of ownership of the founders. Any founder of a startup does not want to significantly dilute control rights at the early stage when the firm is growing at breakneck speed. Since SEBI presently prohibits issue of shares with DVRs, the public stock market is therefore not a lucrative option for the startups. Flipkart, for example, had in the past thought of listing in Indian stock exchanges and yet decided against domestic listing. Rather it preferred strategic investment as a better alternative for the exit of existing investors.

SEBI, through this proposal, seems to address the dilution worries of the technology companies. Is it a right call, given the experience of other markets? Let us explore.

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[1] SEBI Consultation Paper issued on March 20, 2019. Accessed from www.sebi.gov.in on March 21, 2019

[2] Www.cnbc.com/2018/03/20/shareholders-wont-force-zuckerbergs-hand-in-Facebook-management.html

SEBI's Recommendations

Let us quickly list down the broad suggestions of the regulator in this regard. The consultation paper is quite comprehensive and the DVR group of the SEBI which was entrusted with the responsibility of preparing the note has done a thorough job. The paper covers experience and regulatory actions of other countries, academic findings, stock market performance of Indian firms which have issued DVRs, and extant provisions of various applicable laws in India.

A company can have three class of equity shares- ordinary equity shares, equity shares with fractional voting rights (FR), and equity shares with superior voting rights (SR). There can be only one type of FR and SR. SEBI, in the consultation paper, has made separate recommendations for listed and unlisted companies.

Listed firms (more than one year old since listing) can issue only FR shares and these shares cannot ordinarily be converted into ordinary equity shares. The fractional voting rights for any holder of FR shares cannot exceed 1:10 (I.e., any one holding 10FR shares will have one vote). As a compensation for inferior voting rights, FR shares may get additional dividend. The face value of FR shares is same as ordinary equity shares. FR shares can be extinguished only though buyback by the company or reduction of capital. FR shares can be converted to ordinary equity shares only under a scheme of arrangement (i.e. M&A).

SR shares can only be issued to the promoters of a company by an unlisted company. Such an unlisted company can only issue ordinary equity shares at the time of IPO. In other words, once listed, a company is not allowed to issue SR shares. It can subsequently issue FR shares. The SR shares, after listing, can have a maximum voting ratio of 10:1 (ten votes for every SR share held). Promoters with SR shares cannot have more than 75% voting rights under any circumstances. Unlike FR shares, SR shares shall be eligible for the same dividend as ordinary equity shares.Clearly, SR shares are structured to provide promoters of a company absolute control over the company once it gets listed.

In order to ensure that owners of SR shares do not enjoy the superior voting rights perpetually and hence indulge in managerial entrenchment, the consultation paper recommends two restraining provisions:

Coat-tail Provisions: In case of certain important decisions that require shareholders approval, the SR shares (post-IPO) shall be treated as ordinary equity shares in terms of voting rights (i.e., 1:1). Such decisions include appointment/removal of an independent director and or auditor, change in the control of the company, extension of validity of SR shares beyond the initial period of five years.

Sunset Clause: SR shares will get converted into ordinary equity shares after five years of listing of the company. This privilege can be extended by a maximum of another five year term. When SR shares are finally converted, each SR share will be converted into one ordinary equity share.

SEBI has also highlighted the required changes that need to be made in several other laws in order to consider SR shares as valid financial securities. For example, the SEBI ICDR (Issue of Capital and Disclosure Requirements) regulations should be amended to allow any listed company to issue dual class shares. Similarly, the SEBI Takeover Code needs to be amended to ensure that any conversion of SR shares into ordinary equity shares do not necessitate open offer, provided there is no change in control. A challenge for SEBI would be to get the Ministry of Corporate Affairs (MCA) agree to amend the Companies (Share Capital and Debenture) Rules, 2014 in order to allow unlisted companies without profitability track record to issue DVRs.

A Critique

A basic criticism of dual class shares is it violates central principle of 'one share one vote' norms of corporate governance. Holding SR shares allows some group of shareholders to control boardroom decisions. Other criticisms of dual class shares include higher management entrenchment (a matter also recognised by SEBI), large executive compensation, and value-destroying acquisitions[3].

Was there any need for SEBI to enable listing of dual class shares? Stock markets do not favour complex or non-transparent securities. In the past, companies in the West issued tracking stocks to fund acquisitions. Instead of a legal separation, tracking stock allowed issuing companies to create accounting separation of the merged/acquired entity. Stock market did not like it. Stock market reactions to dual class shares (particularly FR shares) have most of the times been negative or at best muted in many countries. Since SEBI's recommendation prohibits issue of SR shares, investors in FR shares will only be penalised with huge discount (see, the Tata Motors example). A supposedly higher amount of dividend for FR shares (compared to ordinary equity shares) would not be able to offset the market price discount. In a way even the existence of ordinary equity shares and FR shares in the market provides ordinary equity shares superior voting rights. So, consider a promoter-run listed company which issues FR shares to raise money and thus relatively ensures higher voting rights for the promoters at the cost of the FR shareholders. Therefore, even with the proposed prohibition on issue of SR shares, ordinary equity shareholders would enjoy superior voting rights.

There are several arguments in favour of dual-class structure. SR shares offer protection against proxy contests initiated by institutional or other short-term investors. Look at the recent episode in HDFC where proxy voters had almost ousted Deepak Parekh from the Board of the company. Thus, SR shares would help promoters of early-stage Company's concentrate on growth without bothering much about stock market reactions. Innovative entrepreneurs, mostly in the technology-driven startups, do not favour myopic actions only to satisfy financial investors whose sole objective is to earn superior returns in the short-run. Dual-class shares provide much required immunity to the entrepreneurs in the initial years.

When a hitherto unlisted firm decides to enter stock market with IPO, the promoters' cash flow (dividend) rights would anyway be lower at that stage with venture capital and private equity firms holding majority of ordinary equity shares. Promoters would protect themselves with SR shares.

The proposed DVR regulations do not allow a listed company to issue non-voting shares (FR shares have voting rights), though the Companies Act, 2013 allows issue of non-voting shares. The consultation paper is silent on what happens to those non-voting shares when a company goes for an IPO.

A Possible Alternative?

Do not advocate different status for equity shareholders. Instead of DVR shares, SEBI should promote issuance of preference shares. Startups regularly issue compulsorily convertible preference shares (CCPS) while raising money from venture capital firms. Hence, SEBI should urge MCA to prohibit issue of SR equity shares to promoters by unlisted firms. They should rather issue CCPS to non-promoter investors. The CCPS can have a conversion period of five or more years. CCPS will generally be converted into ordinary equity shares.

Similarly, instead of FR shares, SEBI should prescribe issue of non-convertible cumulative preference shares by listed firms. The advantages with preference shares are many: (a) there will be no comparison with ordinary equity shares when one looks at stock market performance of preference shares as these are two different types of shares; (b) preference shares are generally considered as

[3] Vijay Govindarajan, Shivram Rajagopal, Anup Srivastava, and Luminita Enache, *Should Dual-class Shares be Banned?* Harvard Business Review. December 03, 2018

bond surrogates as most of its return comes from dividend yield and hence investors in these shares would be happy with a generous and definitive dividend; (c) unlike FR shares, non-convertible preference shares will be redeemed; (d) unlike dual class shares, there will be no need for issuing additional preference shares whenever a company decides to issue bonus or rights shares; (e) issue of preference shares would protect the promoters of unlisted companies with same immunity as they would get with SR shares; (f) this enabling provision may create a market for preference shares which hardly exists in India; (g) the face value of preference shares may be delinked from that of ordinary equity shares; (h) there will be no need of restrictive provisions like coat-tail provision and sunset clause; (i) the MCA need not be persuaded to amend provisions in the Companies Rules as proposed by SEBI; and (j) the burden of dividend distribution tax will be same as with SR and FR.

The regulations for issue of preference shares already exist in the SEBI (Issue and Listing of Non-Convertible Redeemable Preference Shares) Regulations, 2013. The preference shareholders would not enjoy any voting rights and hence such instrument will protect the interests of promoters of a company from dilution of control rights till such time the CCPS get converted into equity shares. Only drawback with non-convertible preference shares (NCPS), compared to the FR shares, is the requirement of creation of Capital Redemption Reserve in accordance with the provisions of the Companies Act, 2013. NCPS are better than FR shares in three ways: (i) the issuing company will be required to set aside a part of profit (before declaring dividend) as capital redemption reserve and thus would be restrained on the amount of dividend that can be paid to ordinary equity shareholders; (ii) the finite life of NCPS would discipline the incumbent management as redemption of the paid up capital would be a contractual obligation; and (iii) the expectations of investors in preference shares are quite different from equity shareholders. Thus, there is no need for dual-class structure and there should be only one class of listed equity shares. Investors as well as the founders may be happier with this alternative.