ECGI Workshop
New Listing Rules for SPACs and Dual Class?

Dual Class Shares - Theory

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Dual-class shares have been controversial for quite some time.

The (policy) debates seem to come and go.

In Europe, question was last in the spotlight in the early 2000 when the EU consider a one-share one-vote rule.

- In late 2007 EU Commission decided against it

What has changed since?

Do recent experiences suggest a re-appraisal of dual-class shares?
What has changed?

- Drop in number of publicly listed firms (US, UK)
- Dual class shares popular, notably among US IPOs of high-tech firms (e.g., Google, LinkedIn, Snap, Facebook, Alibaba, Peloton)
- Sunset provisions are advocated as means to balance cost and benefits of dual class shares
  - Dual class shares no longer a “zero-one” decision
- Loyalty shares (increased voting power) for long-term shareholders are advocated as means to combat short-termism of investors/markets

**Unchanged:** Opposition of institutional investors & proxy advisors.
Why (more) publicly listed firms?

- Are non public firms financially (more) constrained?
  - Are dual-class shares an attractive funding source?
  - If yes, one share one vote rule may lead to suboptimal financing choices, foregone firm growth, or use of alternative CEMs (e.g., pyramids)

- Should general public be able to invest (directly or indirectly) in high-tech growth firms?

- Stock exchanges (e.g., LSE) competing to attract high-tech firms?
  - Since some exchanges allow dual-class shares, others must as well to attract these firms.
Recent US experience shows that quite a few firms opt to go public with dual-class share structures
- In 2016-2018 35% of tech IPOs & 15% of non-tech IPOs in the US used dual class shares (Ritter, 2018)

It must be correct that permitting dual class shares does not deter firms from listing, but the one-share one-vote rule may deter some
- This is not to say that dual-class shares are an effective means to increase listing

(Possible loss of) control is only one dimension of listing decision
A Primer on Dual-Class Shares

- Allocation of votes across shares shapes governance mechanisms based on ownership & control
  - Active owners and shareholder interference
  - Control transfers (takeovers)

- Common view is that both mechanisms perform best under one share - one vote
  - Alignment of (voting) power and financial interest strengthens incentives to maximize firm value
  - It ensures efficient control allocation

- (Recent) caveat: Dual class shares protect “visionary” founders from short-termism of capital markets, enabling them to realize long-term vision
Wedge between (voting) power and financial stake increases insiders’ ability to extract control benefits

- Still, dominant shareholders have way more skin in the game than professional managers (in widely held firms)

Disproportionate voting power makes it more attractive to be large active owners

- Without private benefits, who wants to incur cost of owning large block (e.g., under-diversification)?

Disproportionate voting power increases effectiveness of monitoring by large shareholders
Disproportionate voting power reduces or undermines control contestability

- But control contestability also comes with costs:
  - Takeovers can be motivated by other reasons than value improvement, e.g. empire-building
  - Manager may resort to defensive actions or abstain from firm-specific investment
  - Prospect of remaining in control can enhance incentives (to create value)

Compared to full acquisition, trading the controlling block makes both value-increasing and reducing transfers more likely/cheaper
(Contended) finding that dual class shares are associated with lower firm value does not establish that

- Dual class shares are inefficient/destroy value
- Public investors are exploited

Minority shareholder protection is not a compelling argument against dual class shares

- Nobody has to invest in dual-class shares
- Other (legal) safeguards against “excessive” diversion of corporate resources by insiders
- If downsides are large(r) rational investors buy dual-class shares at “fair” discount, or dual class shares become unattractive funding source
Sunset provisions remove unequal voting rights
- Time-based (after e.g., 7 or 10 years)
- Event-based (e.g., stake falls below some cut-off)
- Transfer-based (e.g., stake is sold)

UK Listing Review proposes to limit superior voting rights to ensure board seats of insiders and to block takeovers.

Given control retention is purpose of dual class shares and heterogeneity among dual class firms, imposing uniform sunset provisions makes little sense.

Voluntary sunset provision or unification remain options.
Summing Up

- Economic theory does not support claim that one vote one share is unambiguously superior or let alone optimal.

- Ultimately, it is question whether large owners or professional managers perform better.
  - Owners are more aligned
  - Managers are more easily replaced.

- Firms & circumstances are too diverse to impose uniform sunset provisions or outright ban of dual class shares.

- If too many investors dislike dual class shares, inferior voting shares stop being attractive funding source.