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Exploring China's Dual-Class Equity Structure: Investor Protection Measures and Policy Implications

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September 2023

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Abstract

Mainland China traditionally maintained the one-share-one-vote (OSOV) principle. Since 2019, however, Chinese authorities have introduced rules supporting the dual-class equity structure (DCES) for "innovative enterprises." Due to concerns about investor-protection issues, China's DCES currently operates as a "stringent permit system," and as of the end of June 2023, only eight corporations have achieved listings with DCES adopted. This article provides a broad and profound policy analysis of the Chinese DCES system, including empirical analyses on the eight existing DCES cases. Also, this article explores the legal and economic aspects of investor-protection issues with respect to the China's DCES. Regarding DCES rules in the context of investor protection, this article examines "three sets of investor safeguard measures": (1) "three numerically specified rules" (this article calls the three rules the "10% equity rule," the "10-time voting-right rule," and the "2/3 voting-right rule"); (2) "sunset provisions" (such as event-driven sunset and time-based sunset); and (3) "rules converting special-voting shares (shares with higher voting rights) into shares with one vote" (such as conversion in mergers and a conversion in an amendment of the charter). Due to the concerns about the prevailing practice of tunneling in China, this article argues in favor of the "DCES with enhanced investor protection." To foment founders' entrepreneurship and allow more corporations with the DCES, however, this article recommends that the Chinese authorities gradually relax the implementation of the current DCES system of de facto stringent permit system. The future relaxation of the stringent permit system will also be beneficial for China because, as a result of the escalated tension with the U.S., China has already lost a substantial portion of its reliable DCES-IPO markets in the U.S. Also, DCES-IPO markets in Hong Kong is still inactive. Thus, the establishment of viable DCES-IPO markets will soon be necessary in Mainland China.

Keywords: dual-class shares, China, investor protection, equity structure, one-share-one-vote, STAR Market, voting rights

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EXPLORING CHINA'S DUAL-CLASS EQUITY STRUCTURE:

INVESTOR PROTECTION MEASURES AND POLICY IMPLICATIONS

Sang Yop Kang & Tong Ling***

This is a revised version as of September 24, 2023.

ABSTRACT

Mainland China traditionally maintained the one-share-one-vote (OSOV) principle. Since 2019, however, Chinese authorities have introduced rules supporting the dual-class equity structure (DCES) for "innovative enterprises." Due to concerns about investor-protection issues, China's DCES currently operates as a "stringent permit system," and as of the end of June 2023, only eight corporations have achieved listings with DCES adopted. This article provides a broad and profound policy analysis of the Chinese DCES system, including empirical analyses on the eight existing DCES cases. Also, this article explores the legal and economic aspects of investor-protection issues with respect to the China's DCES. Regarding DCES rules in the context of investor protection, this article examines "three sets of investor safeguard measures": (1) "three numerically specified rules" (this article calls the three rules the "10% equity rule," the "10-time voting-right rule," and the "2/3 voting-right rule"); (2) "sunset provisions" (such as event-driven sunset and time-based sunset); and (3) "rules converting special-voting shares (shares with higher voting rights) into shares with one vote" (such as conversion in mergers and a conversion in an amendment of the charter). Due to the concerns about the prevailing practice of tunneling in China, this article argues in favor of the "DCES with enhanced investor protection." To foment founders' entrepreneurship and allow more corporations with the DCES, however, this article recommends that the Chinese authorities gradually relax the implementation of the current DCES system of *de facto* stringent permit system. The future relaxation of the stringent permit system will also be beneficial for China because, as a result of the escalated tension with the U.S., China has already lost a substantial portion of its reliable DCES-IPO markets in the U.S. Also, DCES-IPO markets

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KEYWORDS

Dual-Class Equity Structure (DCES), DCES with enhanced investor protection, Stringent Permit System, Investor Safeguard Measures, Numerically Specified Rules, Sunset Provisions, Converting Special-Voting Shares into Shares with One Vote

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I. INTRODUCTION

In the dual-class equity structures (DCES), founders, based on shares with multiple votes, can maintain their decision-making power in a company. In this light, the DCES enhances founders' entrepreneurial spirit and contributes to innovation in an economy. For this reason, many major jurisdictions have considered adopting the DCES.[1] The U.S. has allowed the DCES for a long time. Japan implemented a system functionally similar to the DCES. Singapore and Hong Kong also accepted the DCES. Recently, in April 2023, Korea adopted the DCES.[2] Nonetheless, the DCES is still controversial.[3] Proponents highlight the advantages of the DCES in ensuring control by the founders who have outstanding "human capital" (such as technology, expertise, and vision) that would be beneficial to all shareholders.[4] By contrast, critics argue that the DCES

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[1] To make London a more attractive market for high-growth companies to list, changes have been proposed to the London Stock Exchange to introduce the dual-class share system on the standard segment. Lucy Frost, *FCA's New Listing Rules Cement Positive Outlook for London*. International Financial Law Review, https://www.iflr.com/article/2a647e1ubbp4gemxzs1z4/fcas-new-listing-rules-cement-positive-outlook-for-london (last visited Jul. 31, 2023).

[2] *See* MINISTRY OF SMEs AND STARTUPS, *Legislation Allowing DCES for the Founders of Unlisted Venture Companies Passed by the National Assembly* (2023.4.28) (explaining that on April 27, 2023, the National Assembly passed the law allowing the DCES in unlisted venture companies). In the past, however, Commercial Law in Korea already allowed "common shares with limits of voting rights" (such as zero votes or partial votes) in the limited situations. *See* Korea Commercial Code, art 344-3; Sang Yop Kang, *Taking Voting Leverage and Anti-Director Rights More Seriously: A Critical Analysis of the Law and Finance Theory*, 28 COLUM. J. ASIAN L. 1, 30 n. 107 (2014) [hereinafter Kang, *Taking Voting Leverage and Anti-Director Rights More Seriously*]. Thus, theoretically speaking, even before the adoption of DCES, a system functionally similar to DCES existed although it was not.

[3] *See* Daniel Wells, *Shareholder Inequity in the Age of Big Tech: Public Policy Dangers of Dual-Class Share Structures and the Case for Congressional Action*, 13 NE. U.L. REV. 41, 42 (2021). Some empirical studies show that dual-class firms perform as well as, and even outperform, OSOV firms from the perspective of operating performance and stock returns. *See* Bobby V. Reddy, *More than Meets the Eye: Reassessing the Empirical Evidence on U.S. Dual-Class Stock*, 23 U. PA. J. BUS. L. 955, 994 (2021); *Research Report: Listing Regime Reforms for Dual-Class Share Structure and Biotech Industry*, HONG KONG STOCK EXCH. (Nov. 2018), https://www.hkex.com.hk/-/media/HKEX-Market/News/Research-Reports/HKEx-Research-Papers/2018/CCEO_DualClass_201811_e.pdf?la=en (hereinafter HKEx Research Report).

[4] *See* generally Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L. J. 560 (2016) (arguing that the dual-class structure provides the entrepreneurs with maximum ability to realize their idiosyncratic vision, which can ultimately benefit both the entrepreneurs and investors by increasing the pie's size);

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presents investor-protection problems such as founder-controllers' immunity from accountability, management entrenchment, and curtailment of legitimate shareholder activism (e.g., takeover)[5] as well as tunneling (i.e., controlling shareholders' expropriation of corporate value).[6]

Although China traditionally adhered to the one-share-one-vote (OSOV) as a firm corporate-law principle,[7] in 2019 the China Securities Regulatory Commission (CSRC) introduced rules to support the DCES (in Chinese, 特别表决权 which means "special-voting rights"), so that "innovative enterprises" can issue shares with multiple voting rights to their founders. In China, however, the DCES system operates as a *de facto* "stringent permit system," as Chinese authorities are cautious about the potential abuse of the system and its negative impacts on investors. As a result, so far, Chinese authorities do not approve the DCES in many cases although issuers pass the requirements in relation to the DCES: as of the end of June 2023, only eight companies have successfully used special voting rights.[8]

Regarding China's DCES, several articles have been published. Some articles provide introductory and descriptive explanations of the DCES system,[9] while other articles analyze it

see also Adi Grinapell, *Dual-Class Stock Structure and Firm Innovation*, 25 STAN. J. L. BUS. & FIN. 40, 46 (2020) (arguing that founder's idiosyncratic vision is of greater importance in choosing dual-class structure, which is likely to be an efficient capital structure for companies with significant innovative activity).

[5] The Investor Advisory Committee of SEC summarized the unique risks created by dual class and other entrenching governance structures. *See Discussion Draft: Dual Class And Other Entrenching Governance Structures in Public Companies*, INVESTOR ADVISORY COMMITTEE OF SEC, Nov. 9, 2017, https://www.sec.gov/spotlight/investor-advisory-committee-2012/discussion-draft-dual-class-recommendation-iac-120717.pdf. For the explanation of how informed investors may be deterred from shareholder activism, *see* Dorothy Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STANFORD L. REV. 687, 720 (2019).

[6] Regarding tunneling, *see* Johnson Simon & Rafael La Porta & Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22-27 (2000); Simeon Djankov et al., *Debt Enforcement Around the World*, 116 J. POL. ECON. 1105 (2008).

[7] Regarding non-listed companies, shareholders have the flexibility to determine the voting weight assigned to each share, although the default rule is often OSOV. *See* Gongsi Fa (2018 Xiuzheng) (公司法（2018 修正）) [Company Law (2018 Amendment)] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 26, 2018, effective Oct. 26, 2018) MOFCOM, Oct. 17, 2019, http://mg.mofcom.gov.cn/article/policy/201910/20191002905610.shtml, art 42 [hereinafter PRC Company Law].

[8] *See* Part II.B. and Table 2.

[9] *See, e.g.*, Bai Yun, *Chayihua Biaojuequan Jiegou Xia De "Chuangshiren-Touzizhe Tianping"—Jianping Kechuangban Zhong De Chayihua Biaojuequan Jiegou* (差异化表决权结构下的"创始人—投资者天平"——兼评科创板中的差异化表决权结构) [*"Founder-Investor Balance" under Differential Voting Rights Structure — A Review of Differential Voting Rights Structure in the Science and Technology Innovation Board*], 102 FINANCIAL LAW FORUM] 111(2020).

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from a comparative perspective.[10] Also, some articles propose classifying investor protection risk-preventive measures in DCES based on various forms of controlling interests.[11] For instance, Min Yan examined underlying reasons for the discrepancy between the expectation and the reality of China's implementation of DCES.[12] His study was conducted when there was only one DCES case in China. After more than three years of DCES's implementation, however, in this article we conduct a broader and more comprehensive policy analysis of the China's DCES.

For instance, this article presents empirical case analysis based on all eight DCES examples in China.[13] In addition, this article provides an in-depth legal and economic analysis focusing on the investor-protection measures of China's DCES. More specifically, we refer to investor-protection related DCES rules as the "three sets of investor safeguard measures": (1) "three numerically specified rules,"[14] (2) sunset-provision rules,[15] (3) rules converting special-voting shares (i.e., shares with higher voting rights) into shares with one vote.[16] Table 1 summarizes the three sets of investor safeguard measures. To the best of our knowledge, our approach is the first *systematic, thorough* analysis of China's DCES in terms of investor protection across multiple facets. Based on our analysis, this article also proposes suggestions aiming to improve China's DCES system.

Table 1: Three Sets of Investor Safeguard Rules

[10] *See, e.g.*, Lu Longjie, *The Regulation of the Dual-class Share Structure in China: A Comparative Perspective*, 15 CAPITAL MKT. L. J. 224 (2020).

[11] *See, e.g.*, Li Li, *Shuangceng Guquan Jiegou Bentuhua De Qianzaifengxian Yu Fangfanzhidu Yanjiu— Jianping Kechuangban Tebiebiaojuequan Guize* (双层股权结构本土化的潜在风险与防范制度研究——兼评科创板特别表决权规则) [*Research on the Localization Potential Risks and Prevention System of Dual-class Share Structure—a Review of the Special Voting Rules of the Science and Technology Innovation Board*], 12 FIN. REGUL. RSCH. 23 (2019).

[12] *See* Min Yan, *Differentiated Voting Rights Arrangement under Dual-class Share Structures in China: Expectation, Reality, and Future*, 28 ASIA PAC. L. REV. 337 (2020).

[13] *See infra* Part II.B.

[14] We coined this terminology. For the further explanation, *see* Part III.

[15] Regarding sunset provisions in general, *see* Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 617-25 (2017).

[16] In addition, (4) rules on founder-directors are an important set of investor safeguard measures. Due to the space limit and (4)'s importance as an independent research topic, this article does not cover (4).

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(1) Three Numerically Specified Rules	i) 10% Equity Rule ii) 10-Time Voting-Right Rule iii) 2/3 Voting-Right Rule
(2) Sunset Provision Rules	i) Event-driven Sunset ii) Time-based Sunset
(3) Rules on Converting Special-Voting Shares into Shares with One Vote	i) Conversion in a hostile takeover ii) Conversion in an amendment of the charter

Based on the new perspective, this article examines various policy implications of "three sets of investor protection measures" in the DCES. Also, this article examines how "three sets of investor measures" establishes China's unique approach of a *more stringent* DCES, which we call "DCES with enhanced investor protection."[17] We argue that in China, *for the time being*, China's DCES system needs to *prioritize* investor protection, while also offering new alternatives to founders' control because the Chinese capital markets are not sophisticatedly developed and there is still a high chance of controllers' tunneling. In essence, it is crucial to restore market stability and investor confidence in the Chinese capital markets by placing a strong emphasis on investor protection.

As of the end of June 2023, the presence of only eight DCES cases also reflects the *substantial* caution exercised by Chinese regulatory authorities, such as the CSRC and stock exchanges, regarding investor protection. We explain that the limited adoption of DCES in China primarily results from the stringent permit system: the Chinese authorities permit system is *far stricter* than the written regulation about DCES, and thus, even if a corporation literally passes the DCES' statutory requirements, it does not guarantee the corporation to adopt DCES. Considering the existence of enhanced investor protection measures, we argue that the Chinese authorities should *gradually relax* the implementation of the *de facto* stringent permit system. Otherwise, DCES in China will be merely a legislative ornament.

When analyzing the Chinese DCES system, it is also worth noting that for a while, numerous Chinese companies have been listing on the U.S. capital markets and embracing DCES.

[17] *See supra* Part II.E.

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However, due to escalating tensions with the U.S., China is facing challenges in actively leveraging the U.S. capital markets and is strategically striving to reduce its reliance on them. From this perspective, China's DCES not only seeks to foster entrepreneurship but also aims to substitute the DCES in the US capital markets. Hence, if China continues to uphold an overly conservative and cautious stance on DCES, exemplified by the prevailing stringent permit system, it suggests that the Chinese companies' DCES opportunities missed in the U.S. capital markets cannot be recaptured in the Chinese capital markets. Furthermore, the current stringent permit system for DCES could pose substantial limitations as China develops its economic policies.

The remainder of this article is structured as follows. Part II sketches the DCES system in China. Parts III to V explain the investor safeguard measures of China's DCES. Part III analyzes Table 1's (1) three numerically specified rules. Part IV examines Table 1's (2) sunset provisions. Part V explores Table 1's (3) rules on converting special-voting shares into shares with one vote. Finally, Part VI summarizes and concludes this article's explanations, analyses, suggestions, and arguments.

II. The Chinese DCES

A. China's Current Legal System on the DCES

In recent years, Chinese regulators have initiated a series of market-oriented regulatory reforms. As a part of these reforms, the DCES was adopted as a crucial part of its pilot registration-based IPO regime for the purpose of competing for listings with overseas stock exchanges such as the New York Stock Exchange (NYSE), the National Association of Securities Dealers Automated Quotations (NASDAQ), and the Hong Kong Stock Exchange (HKEx).

OSOV has been embodied in the People's Republic of China (PRC) Company Law since its first draft promulgated in 1993.[18] However, article 131 of the PRC Company Law may provide an exception to OSOV, awarding a virtually "blanket power" to the State Council (i.e., central government) to stipulate separate regulation on the issuance of classes of shares to accommodate

[18] PRC Company Law, *supra* note 7, art 106.

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the ever-changing capital market.[19] In other words, the current Company Law has *no specific* statute allowing the DCES. Since a few years ago, under the authorization of the State Council,[20] the CRSC and three major stock exchanges in Mainland China have promulgated rules and regulations to allow newly listed issuers to adopt the DCES. In March 2019, the Shanghai Stock Exchange (SSE) issued the "Listing Rule for the Listing of Stocks on the Science and Technology Innovation Board of Shanghai Stock Exchange (SSE STAR Market Listing Rules)," which provides implementation measures for "innovative enterprises" to issue shares with special-voting rights.[21] The SSE STAR Market Listing Rules set forth requirements for adopting the DCES, including admission criteria, restrictions on special-voting shares, disclosure requirements, and other safeguarding measures.

As China further expanded its trial of the registration-based IPO regime, the STAR Market-style DCES was transplanted to other stock markets in China, including the ChiNext Board of the Shenzhen Stock Exchange (SZSE) in 2020, and the Beijing Stock Exchange (BSE) in 2021, and finally to the main board markets of both the SSE and the SZSE in February 2023.[22] In other words, the DCES is *legally* and *theoretically* available to *all* IPO applicant corporations in the Mainland China's stock exchanges, as long as these corporations pass the Chinese authorities' stringent permit system. Certainly, regarding the DCES, one of the primary challenges faced by corporations operating in the Chinese capital markets is the stringent permit system. In practice, this system

[19] PRC Company Law, *supra* note 7, art 131.

[20] *See* Guowuyuan Guanyu Tuidong Chuangxin Chuangye Gaozhiliang Fazhan Dazao "Shuangchuang" Shengjiban De Yijian (国务院关于推动创新创业高质量发展打造"双创"升级版的意见) [*Opinion of the State Council on Promoting High-quality Development of Innovation and Entrepreneurship and Building an Upgraded Version of "Double Innovation"*] (promulgated by the St. Council, Sep. 18, 2018), CENT. PEOPLE'S GOV'T., Sep. 26, 2018, https://www.gov.cn/zhengce/zhengceku/2018-09/26/content_5325472.htm.

[21] As discussed later, in Chinese capital markets, retail investors have a significant presence in terms of share ownership and trading activities compared to their counterparts in the U.S. *See infra* notes 47 and 53 and their accompanying text. One of the reasons for implementing the pilot DCES program in the STAR Market instead of the mainboard might be the lower portion of retail investors' shareholding and trading activities in the former, primarily due to the stringent investor qualification requirements.

[22] Shouci Gongkai Faxing Gupiao Zhuce Guanli Banfa (首次公开发行股票注册管理办法) [Measures for the Administration of Registration of Initial Public Offerings of Stocks] (promulgated by China Securities Regulatory Comm'n., Feb. 17, 2023), CHINA SEC. REGUL. COMM'N, Feb. 17, 2023, http://www.csrc.gov.cn/shanghai/c105565/c7282818/7282818/files/%E9%99%84%E4%BB%B61%EF%BC%9A%E3%80%8A%E9%A6%96%E6%AC%A1%E5%85%AC%E5%BC%80%E5%8F%91%E8%A1%8C%E8%82%A1%E7%A5%A8%E6%B3%A8%E5%86%8C%E7%AE%A1%E7%90%86%E5%8A%9E%E6%B3%95%E3%80%8B.pdf., art 43.

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demands considerably more rigorous ad-hoc, case-by-case criteria imposed by the government than what is officially outlined in written regulations.

Eventually, in the latest revised draft of the PRC Company Law (released for public comments on December 30, 2022), to accommodate various demands of different investors, Chinese lawmakers proposed to formally acknowledge and codify the existing practices of issuing different classes of shares, including shares that carry more or fewer votes than common shares.[23] Thus, if the latest draft revision is approved, the DCES will be available *explicitly* on the basis of a corporate law statute *specifying* the DCES.

B. DCES Examples in China

Although China's three stock exchanges have introduced the DCES to provide a flexible voting structure to its potentially *all* listing applicants, there are not many DCES cases. As of December 31, 2022, among 501 companies that had been admitted to the STAR Market,[24] only eight companies successfully issued dual-class shares. Also, as of December 31, 2022, among 412 listed issuers and 162 listed issuers respectively admitted to the ChiNext Market[25] and the BSE Market[26] after the trial of registration-based IPO regime, no issuers were allowed to adopt dual-class shares. In the ChiNext Market, one listing applicant company attempted to issue dual-class shares. Given that its controller already held 40.93% of voting rights,[27] however, the SSE

[23] *See* Zhonghua Renmin Gongheguo Gongsifa (Xiuding Cao'an Erci Shenyigao) (中华人民共和国公司法(修订草案二次审议稿)) [Company Law of the People's Republic of China (Revised Draft for Second Deliberation)] (promulgated by Standing Comm. Nat'l People's Cong., Dec. 30, 2022), art 144, https://sdxw.iqilu.com/w/article/YS0yMS0xMzkxNDEyMw.html. However, article 144 of the Revised Draft for Second Deliberation of PRC Company Law also explicitly prohibits a company from issuing dual-class shares after its public offering.

[24] Wind Information, Kechuangban Shangshi Gongsi Shichang Shuju (科创板上市公司市场数据) [*Listed Companies of STAR Market Data Set*].

[25] Wind Information, Chuangyeban Shangshi Gongsi Shichang Shuju (创业板上市公司市场数据) [*Listed Companies of ChiNext Market Data Set*].

[26] Wind Information, Beijiaosuo Shangshi Gongsi Shichang Shuju (北交所上市公司市场数据) [*Listed Companies of BSE Market Data Set*].

[27] Xiamen Meiyou Information Technology Co., Ltd., Shouci Gongkai Faxing Gupiao Bing Zai Kechuangban Shangshi Zhaogu Suomingshu (首次公开发行股票并在科创板上市招股说明书) [*Prospectus for the Initial Public Offering and Listing on Shenzhen Stock Exchange*], http://reportdocs.static.szse.cn/UpFiles/rasinfodisc/RAS_0001737FB608443FEC946BC6EB96803F.pdf (last visited Jul. 31, 2023).

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questioned the necessity and rationality of the applicant company's proposed DCES arrangement and eventually the company canceled the DCES arrangement. Table 2 lists the Chinese companies with the DCES in Mainland China.

Table 2: Companies Listing in Mainland China with the DCES (as of 31 June 2023)

Company	Listing date	Percentage of issued share capital controlled by founder(s)	Percentage of founder(s)' voting rights	Votes per Special Share
UClould (688158)	20/1/2020	23.12%	60.06%	5
Ninebot (689009)	29/10/2020	25.79%	63.47%	5
Huiyu Phar. (688553)	26/10/2021	31.27%	60.95%	5
Jing-Jin Electric (688280)	27/10/2021	16.04%	59.29%	10
Jingwei Hirain (688326)	19/4/2021	33.27%	50.76%	6
SmartSens (688213)	20/5/2022	13.71%	44.26%	5
Cloudwalk (688327)	27/5/2022	19.78%	59.67%	6
Orbbec (688322)	7/7/2022	35.73%	64.84%	5

C. Comparative Analysis: Mainland China, Hong Kong, and the U.S.

In sum, from the time the DCES was first allowed to the end of 2022, the total number of companies listed in the STAR, ChiNext, and BSE Markets was 1,075, and given the stringent permit system, only eight companies could successfully adopt the DCES. In this light, the DCES adoption rate in *innovative* markets in China (STAR, ChiNext, and BSE) is 0.74%. Moreover, it is important to emphasize that the total number of companies listed on the main boards and innovative markets in China amounts to 5,066. This figure encompasses all corporations operating in these sectors across the three major stock exchanges in Mainland China (SSE, SZSE, BSE). In light of this, the adoption rate of the DCES remains significantly low, standing at a mere 0.16%. It is noteworthy, however, that starting from February 2023, companies in the main board markets

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have been allowed to utilize the DCES.[28] Considering the limited time available for these companies to undergo the stringent permit system and successfully adopt the DCES, the current adoption rate of 0.16% might underestimate the actual rate. Nevertheless, it is imperative to recognize that the DCES among Chinese companies remains remarkably low.

On the other hand, in the U.S., during the comparable time period (since 2019 when the DCES was allowed in China), dual-class initial public offerings (IPOs) have accounted for approximately 25% of all IPOs.[29] Over a longer time period, among the 13,945 IPOs in the U.S. from January 1975 to December 2022,[30] it is reported that 1,611 IPOs adopted a DCES, accounting for 11.55% of all IPOs.[31] This data shows that the U.S. exchanges are more permissive to the DCES.

After losing Alibaba's listing in 2014, the HKEx has considered that allowing "weighted-voting-right (WVR) structures" is an essential factor in promoting its competitive position vis-à-vis other stock exchanges, particularly the U.S. capital markets.[32] The HKEx's amendment to the listing rules on the WVR came into effect on 30 April 2018. Therefore, we examined listings occurred from 1 May 2018 to 31 December 2022. During this period, although the concept of the WVR is not exactly the same as (but is functionally similar to) that of the DCES,[33] 624 companies were listed on the HKEx, among which, 21 companies completed their listing with WVR

[28] *See supra* note 22 and accompanying text.

[29] From 1 January 2018 to 23 December 2021, there were 183 dual-class IPOs out of 720 IPOs in the U.S. *See* Jay R. Ritter, *Initial Public Offerings: Dual Class Structure of IPOs Through 2022*, *University of Florida, Warrington College of Business*, June 22, 2023, https://site.warrington.ufl.edu/ritter/files/IPOs-Dual-Class.pdf (last visited Jul. 31, 2023).

[30] This number is from a list of IPOs from 1975-2022 with multiple share classes outstanding, which is maintained by Tim Loughran and Jay R. Ritter and deferring to their sampling methods. SPAC IPOs are screened out. *See* Tim Loughran & Jay Ritter, *Why Has IPO Underpricing Changed over Time?*, 34 FINANCIAL MANAGEMENT 5, 33 (2004).

[31] *Id*.

[32] *See News Release: Weighted Voting Rights Consultation Conclusions*, HONG KONG STOCK EXCHANGE (Jun. 19, 2015), p3, https://www.hkex.com.hk/-/media/hkex-market/news/news-release/2015/1506192news.

[33] For instance, Alibaba listed in the NYSE and the HKEx has often been *imprecisely* considered a corporation with the DCES. The controlling shareholder (or the controlling group, i.e., Alibaba Partnership) of Alibaba has used voting leverage based on the Alibaba Partnership's power to nominate the majority of Alibaba's directors. In this light, what Alibaba's voting leverage relies on is not a DCES but a WVR. Accordingly, it can be merely said that Alibaba's WVR is *functionally similar* to the DCES. For the further explanation, *see* Sang Yop Kang, *Rethinking Self-Dealing and the Fairness Standard: A Law and Economics Framework for Internal Transactions in Corporate Groups*, 11 VA. L. & BUS. REV. 95, 117 n. 92 (2016)(relying on Barusch (2013)) [hereinafter Kang, *Rethinking Self-Dealing and the Fairness Standard*].

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structures.[34] In this light, in the HKEx, listings with the WVR account for 3.37%. In addition, by the end of 2022, there were 2,595 listed companies in the HKEx along with 21 WVR companies: accordingly, the WVR adopting rate is 0.81%.[35] Table 3 summarizes the adoption rates for the DCES (or similar structures) in Mainland China, Hong Kong, and the U.S.

Table 3: DCES (or Similar Structures) in Mainland China, Hong Kong, and the U.S.

DCES adopting rate (since 2018)			DCES adopting rate among all listed companies (by the end of 2022)		
Mainland China	Hong Kong	U.S.	Mainland China	Hong Kong	U.S.
0.74%	3.37%	25%	0.16%	0.81%	11.55%

Regarding the DCES and its functionally similar system, the WVR, four crucial points deserve further consideration. First, as seen in the HKEx's limited number of WVR cases (i.e., 21 cases) and its low WVR adoption rate (i.e., 3.37%) since 2018, from the perspective of the Chinese companies' founders, the HKEx is not yet a satisfactory alternative. This is especially true when the option of accessing the U.S. capital markets is practically unavailable due to factors such as political tensions between China and the U.S. Second, nonetheless, when comparing the figures in Table 3 in percentage terms (0.74% versus 3.37% and 0.16% versus 0.81%), Chinese companies might simply perceive the HKEx as a more accessible platform for enhancing voting leverage compared to stock exchanges in Mainland China.

Third, an applicant seeking listing with a WVR structure in Hong Kong must satisfy the condition of innovativeness and the higher thresholds of market capitalization and revenue.[36] Thus,

[34] 10 out of these 21 companies had previously been listed in the U.S., with the DCES adopted prior to their secondary listing in the Hong Kong market. A prime example of these companies is Alibaba. *See* Wind Information, Xianggang Lianjiaosuo Shangshi Gongsi Shichang Shuju (香港联交所上市公司市场数据) [*Listed Companies of Hong Kong Stock Exchange Data Set*].

[35] It is noteworthy that special purpose acquisition companies (SPACs) are allowed to be listed in Hong Kong while they are not allowed in Mainland China. When comparing the DCES or WVR adoption rate in Hong Kong and Mainland China, we exclude five SPAC listed companies in Hong Kong.

[36] A market capitalization of at least HK$40 billion at the time of listing; or a market capitalization of at least HK$10 billion at the time of listing and revenue of at least HK$1billion for the most recent audited financial year. *Rules*

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the percentage terms in Table 3 should *not* be interpreted as a simple way for Chinese companies to achieve the WVR in HKEx, being 4.56 times (0.74% v. 3.37%) and 5.13 times (0.16% v. 0.81%) easier than the DCES in Mainland China's exchanges.

Fourth, as of January 2023, there were 252 Chinese companies listed on the three largest U.S. exchanges.[37] Among these companies, many rely on the DCES or its functionally similar mechanism. For instance, by the end of February 2023, 84 out of the top 100 Chinese companies listed in the U.S., ranked by their market capitalization, had DCES.[38] This 84% DCES adoption rate among Chinese companies listed in the U.S. sharply contrasts with the low adoption rate of DCES/WVR in both Mainland China and Hong Kong. Such a significant difference in adoption rate suggests that Chinese founders have incentive to adopt DCES but cannot easily adopt the system due to the stringent permit system. Moreover, the statistics indicates that, from the standpoint of Chinese companies looking for DCES and Chinese policymakers, the U.S. exchanges are capital markets that are difficult to give up or replace in the short-term. This situation poses a dilemma to the Chinese government at the time of serious tension between China and the U.S.

D. China's Need for the DCES

Under OSOV, controllers may be reluctant to rely on an IPO or equity injection due to the fear of losing control. Where the DCES has been adopted in China's legal system, controllers would be less concerned about dilution or the loss of control over corporations. Often, the founders of innovative enterprises are relatively young and smart (holding "human capital"), but under OSOV, they do not have sufficient "financial capital" to maintain their control. In this light, the DCES can function as an industry and capital-market policy in China to nurture founders' entrepreneurship.

Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited, HONG KONG STOCK EXCHANGE, art. 8A.06, https://en-rules.hkex.com.hk/sites/default/files/net_file_store/consol_mb.pdf [hereinafter HKEx Listing Rule].

[37] *Chinese Companies Listed on Major U.S. Stock Exchanges*, U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION, https://www.uscc.gov/research/chinese-companies-listed-major-us-stock-exchanges (last visited Jul. 31, 2023).

[38] *See* Wind Information, Zaimei Shangshi Zonggaigu Shichang Shuju (在美上市中概股市场数据) [List of Chinese Concept Stocks Listed on U. S. Stock Exchanges Data Set]

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Another reason to foment the DCES in China can be found in the changed capital-market environment. In the past, Chinese companies interested in the DCES went public in offshore capital markets, including the U.S. capital markets such as the NYSE and NASDAQ. As Table 3 indicates, the U.S. capital markets provided substantial opportunities to utilize the DCES.

E. US-China Tension

Due to the recently severe tension between the U.S. and China, however, the trend to list Chinese companies in the U.S. is no longer sustainable. For various reasons, the U.S. government imposes a serious set of regulations concerning Chinese companies listed in the U.S. For instance, securities market scandals such as the Luckin Coffee[39] case have worried U.S. government agencies in terms of investor protection in the U.S. capital markets. On the other hand, the U.S. government has an incentive to use such cases as a pretext to regulate or investigate Chinese companies listed in the U.S.

As seen in the Didichuxing story,[40] even if Chinese companies satisfy the listing requirements of a U.S. capital market, the Chinese government, due to its concern about personal data protection and national security, also does not want Chinese companies, particularly IT and platform companies, to be listed in the U.S. Under the Holding Foreign Companies Accountable Act (HFCAA),[41] companies listed in the U.S. are required to be audited by firms that the Public Company Accounting Oversight Board (PCAOB) has complete access to inspect and investigate. However, the Chinese government has concerns about the PCAOB's unrestricted access to audit

[39] Regarding Luckin Coffee's scandal and its settlement with the U.S. Securities Exchange Committee, *see* CNBC, *China's Luckin Coffee to Pay $180 Million Penalty to Settle Accounting Fraud Charges* (Dec. 16, 2020), https://www.cnbc.com/2020/12/17/chinas-luckin-coffee-to-pay-180-million-penalty-to-settle-fraud-case.html.

[40] For the more explanation of the Didichuxing's story, *see* Raymond Zhong & Li Yuan, *The Rise and Fall of the World's Ride-Hailing Giant*, NEW YORK TIMES (Aug. 27, 2021), https://www.nytimes.com/2021/08/27/technology/china-didi-crackdown.html.

[41] For the HFCAA, *see* U.S. CONGRESS, https://www.congress.gov/bill/116th-congress/senate-bill/945/text; U.S. CONGRESS, https://www.congress.gov/116/plaws/publ222/PLAW-116publ222.pdf. For the further explanation of the HFCAA, *see* Yue Yue & Tang Ziyi, *U.S. Audit Watchdog Moves Closer to Enforcing Law That Could See Chinese Firms Delisted*, CAIXIN (May 14, 2021), https://www.caixinglobal.com/2021-05-14/us-audit-watchdog-moves-closer-to-enforcing-law-that-could-see-chinese-firms-delisted-101713033.html.

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documentation of Chinese listed companies, including state-owned enterprises.[42] In this respect, the Chinese government has sought to prepare a domestic legal system and capital markets which enable the DCES. Nonetheless, as seen in Tables 2 and 3, so far, the opportunities for the DCES are still limited in both Mainland China and Hong Kong.

F. The Risks of the DCES in China

Despite advantages that the DCES can bring to an economy, the DCES could pose serious problems in terms of investor protection. Most of all, the DCES directly counters the concept of "corporate democracy" based on OSOV,[43] where shareholders' decision-making power are proportionate to their investment contribution.

In addition, under the DCES, controllers can exercise more decision-making power with a small percentage of ownership. Accordingly, controllers find that their financial stake is not aligned with that of the corporations. Such misalignment of interests may generate two problems. First, even if a corporation's business is *inefficient* in terms of maximizing firm value, the controller does not have a strong incentive to redress such a duty-of-care problem. Second, the DCES could function as a useful tool to facilitate controllers' tunneling, which is a duty-of-loyalty problem. In general, tunneling can take place more easily when controllers' cash-flow rights are smaller than their voting rights: indeed, the DCES widens the gap between controllers' cash-flow rights and their voting rights.[44]

For instance, the founder and other controllers of Renren, a U.S.-listed Chinese company, were alleged to have breached their duties to shareholders when spinning off Renren's investment holdings in a series of related-party transactions at prices that significantly undervalued the

[42] For the further explanation, *see* Chen Shiyin & Liu Coco, *Didi's Move From NYSE to Hong Kong - What to Know*, Bloomberg (Dec. 3, 2021), https://www.bloomberg.com/news/articles/2021-12-03/everything-we-know-about-didi-s-plan-to-delist-from-the-nyse#xj4y7vzkg.

[43] For the analysis of the OSOV, *see* Kang, *Taking Voting Leverage and Anti-Director Rights More Seriously*, *supra* note 2.

[44] The DCES enlarges the controller's "ownership gap." When the "ownership gap" widens, in general a controller can gain more private benefits of control. *See* Kang, *Rethinking Self-Dealing and the Fairness Standard*, *supra* note 33.

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assets.[45] Despite non-controlling shareholders' objections, the spin-off was approved at the shareholders' meeting, where the founder Joseph Chen, Soft Bank Group Capital Limited, and other holders of Class B shares attached with superior votes collectively exercised over 90% of votes.[46] In this case, it seems that the DCES facilitated controllers' expropriation of non-controlling shareholders' value. For a similar reason, the Chinese authorities are concerned that tunneling could worsen when the DCES is actively used.

G. China's Response to the Risk of the DCES: Eclectic Approach

The Chinese authorities' approach to the DCES was *eclectic*: (i) eventually, the government adopted the DCES; (ii) however, due to concern about investor-protection issues arising from tunneling and controlling-shareholder agency problems, the government equipped the DCES with heightened safeguards. As discussed in Introduction, the Chinese DCES is limited by "three numerically specified rules," sunset provision rules, rules on converting special-voting shares into shares with one vote, and founder-director rules. In this light, we call the Chinese approach DCES with enhanced investor protection.

Note that the U.S. DCES does not have, for example, the three numerically specified rules. Companies in the U.S. generally operate under relatively high-quality corporate governance. Securities regulation and the enforcement of the SEC are largely effective in regulating U.S. capital markets. Also, in the U.S., investors' litigation is more active in derivative suits and class actions. In addition, in the U.S., due to the sophisticated capital markets mechanisms, the malfunctions of DCES might be less serious. Furthermore, in the U.S., when corporate-governance problems, including problems relating to the DCES, arise, market-based sanctions can be imposed on the company, particularly through the mechanism of short selling, which is not practical in China.

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[45] Finally, defendants settled relevant suits in the New York Supreme Court by agreeing to pay investors at least $300 million. *See* NASDAQ, *Here's Why Renren Stock Skyrocketed 80.2% in October*, NASDAQ, https://www.nasdaq.com/articles/heres-why-renren-stock-skyrocketed-80.2-in-october-2021-11-03 (last visited Jul. 31, 2023).

[46] Feng Yiqing, *Liangnian 56 Bei, Renrenwang Zenme Jiu Chengle Zuiniu Zhonggaigu* (两年 56 倍，人人网怎么就成了最牛中概股) [*56 Times in Two Years: How Renren Became the Hottest Chinese Concept Stock*], EE TIMES CHINA (Oct. 18, 2021, 7:10 am), https://www.eet-china.com/mp/a83611.html.

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Moreover, investors in the U.S. capital markets can rectify the DCES-related problems at the IPO stage through market mechanisms and the negotiation about the IPO share price, which already reflects the rationality of voting leverage. For instance, if worrisome voting leverage for uncapable founder-controllers are proposed at the IPO stage, the IPO share price is subject to severe discount in the capital market: in other words, the "market" evaluates terms and conditions of specific DCES of different corporations, and if necessary, the "price mechanism" punishes an exorbitant DCES. In this regard, the U.S. DCES has a much more *laissez-faire* or *market-oriented* characteristic. By contrast, in China, the deficiency of a mature legal and market infrastructure protecting investors and "capital market efficiency" (in particular about the IPO share price) is rooted.[47] Hence, given this situation, we believe that the Chinese government's "eclectic approach" with heightened investor-protection regulation is a rational policy choice.

III. INVESTOR SAFEGUARD MEASURES I: THREE NUMERICALLY SPECIFIED RULES

Part III explains "three numerically specified rules"—10% equity rule, 10-time voting-right rule, and 2/3 voting right rule—which intend to weaken control enhancement and to improve investor protection. These rules indicate the Chinese authorities' stringent permit system with respect to DCES. If capital markets are close to perfect, these rules may not be necessary. Due to a relatively incomplete and suboptimal legal and market infrastructure in China, however, China's capital markets exhibit "market inefficiency" and suffer from numerous legal flaws concerning investor protection, particularly regarding tunneling. Under these circumstances, three numerically specified rules are necessary in China, at least for the time being, in order to address the investor protection issues pertaining to the DCES.

A. 10% Equity Rule

[47] Compared to other advanced capital markets, China's capital markets exhibit lower "market efficiency" due to several factors. These factors include the presence of large-scale retail investors and their significant influence in the market, government-led interventions that impede the normal functioning of the market's "invisible hand," and a pronounced information asymmetry resulting from inadequate disclosure and enforcement mechanisms. Market inefficiency in the Chinese capital markets can have significant implications for the IPO market with respect to the DCES. For the further explanation of the impact of market inefficiency on the IPO market and the DCES in China, *see infra* Part III.B.

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In a Chinese corporation with the DCES, a founder (or co-founders) who can exercise special-voting rights must hold at least 10% equity (i.e., "10% equity rule"). We view the 10% equity rule as a proper regulatory tool attempting to *align*, even if not perfectly designed, the interests of a founder and non-controlling shareholders when the corporation undertakes risky projects. Of course, there is no clear scientific rationale to support that the reference point should be set at 10%. In our interpretation, however, the 10% threshold indicates that, regarding the DCES, Chinese policymakers acknowledge and tolerate a controlling minority structure (CMS)[48] *in itself*, but do not allow a *deep* CMS where the equity of a founder-controller (or founder-controllers) is less than 10%.[49]

One may argue that under the Chinese circumstances, the 10% requirement might be still insufficient, which we believe is a fair point. Nonetheless, implementing the 10% equity rule is *preferable* to having no rule in place, if not *optimal*, since the rule provides at least the floor of controllers' financial contribution, which can reduce the discrepancy between controllers' cash-flow rights and voting rights. In addition, if substantial amount of equity (e.g., 30%) is required to founders of innovative companies, they find it difficult to found companies since potential founders of innovative companies usually hold extraordinary *human* capital but not sufficient *financial* capital. Also, due to the Chinese authorities' wide discretion and stringent permit system about DCES in a particular company, in reality, the minimum requirement for the founders' equity contribution is more than 10%. In other words, 10%-equity does not guarantee the government's approval of the company's DCES adoption. Among eight corporations with the DCES in Mainland China, as seen in Table 2, the minimum percentage of equity-capital contributed by founders is 13.71% in SmartSens. The average equity-capital contribution of the founders of these eight corporations is 23.28%.

[48] Regarding the CMS, *see* Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP 295 (Randall K. Morck ed., 2000).

[49] Theoretically the DCES, one of CMSs, can be combined with another CMS such as a pyramidal structure or circular shareholding. *See* Sang Yop Kang, *Unpacking Voting Leverage Mechanisms: Theoretical Analysis*, 2018 BEIJING CONFERENCE GERMAN AND EAST ASIAN PERSPECTIVES ON CORPORATE AND CAPITAL MARKET LAW (presentation; file on author)(March 22-23, 2018), p22 (explaining the coined concept of "multiple voting leverage (VL)" by illustrating its manifestations as VL^2 (the square of VL) and VL^3 (VL cubed), which signify the simultaneous adoption of two and three VL, respectively).

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B. 10-Time Voting-Right Rule

Also, in the Chinese DCES regime, special-voting shares are allowed to have at a maximum 10 times voting rights than ordinary common shares. We call this regulation the "10-times voting-right rule." This rule is designed to soothe voting leverage and prevents a founder from exercising quasi-absolute control with little invested capital. Regarding this rule, a few points are worth noting further.

Most of all, there is no such regulation in the U.S. For instance, in Coupang, Inc.'s IPO with DCES on the NYSE, Beom-seok Kim, the founder of the company held Class B shares carrying 29 votes per share.[50] Due to Class B shares, although his equity contribution was merely 10.2% of shares, he could exercise 76.7% of voting rights of the company.[51] The reason for the absence of the regulation in the U.S. lies in the reliance on market mechanisms during IPOs conducted by companies utilizing the DCES. The terms and conditions of these DCES-based IPOs, including stock prices and the voting leverage associated with special voting shares, are determined through arm's length negotiations between the issuer and investors.

Consider a scenario where special voting shares offer 29 votes per share instead of 5 votes per share. Through capital market mechanisms and negotiations in the IPO market, both capital market investors (buyers of shares) and the issuer (seller of shares) may engage in a process of determining an appropriate IPO share price that takes into account the founders' increased voting leverage. Accordingly, when voting leverage is strengthened in favor of founders (e.g., 29 votes per share), it is possible to establish a suitable discount, compared to the situation where voting leverage is relatively weak (e.g., 5 votes per share). This process of "price discovery" through adequate "price discount" serves as a means of providing "fair compensation" to investors for the dilution of their voting rights, ensuring a balanced outcome between the issuer (and its founders) on the one side and investors on the other side. In the absence of "market and legal-system failure and distortion," if investors *voluntarily* accept a specific level of voting leverage associated with DCES (e.g., 29 votes per share), it is not preferable to *paternalistically* impose regulations

[50] *See* Coupang, *Inc. Form S-1 Registration Statement*, SEC (Feb. 12, 2021), https://www.sec.gov/Archives/edgar/data/1834584/000162828021001984/coupang-sx1.htm (last visited July 13, 2023).

[51] *Id.*

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mandating the maximum level of voting leverage (e.g., 10 votes per share) as a means of protecting investors.

This explanation holds validity only when the legal framework effectively governs potential abuses such as tunneling, market mechanisms operate efficiently, and the capital markets demonstrate overall efficiency. Unfortunately, however, China's capital markets are plagued by pronounced "market failures," exemplified by the prevalent issue of "market inefficiency."[52] For instance, both in terms of stock ownership and trading volume, the proportion of retail investors in the Chinese capital markets is notably higher than that of other advanced capital markets.[53] When compared to institutional investors, retail investors are more prone to deviating from the investment patterns that the efficient market hypothesis predicts and displaying behavioral economics traits such as loss aversion and herding. As a result, Chinese capital markets may exhibit significantly lower levels of efficiency compared to other developed capital markets. Additionally, the legal mechanisms, including enforcement, remain insufficiently developed, exacerbating the challenges faced within these markets.

The Chinese IPO market, as a subset of the Chinese capital markets, also suffers from inefficiencies and market failures with the imperfections of the legal system: the IPO share price fails to adequately discount the voting rights of founders who hold a superior position, as the market's price-discovery mechanism in relation to the founders' voting leverage is undermined. In other words, when confronted with market inefficiency and a deficient legal system (including an ineffective enforcement system) exacerbating information asymmetry, relying solely on the IPO

[52] Market inefficiency within the Chinese capital markets can also exert a unique influence on the takeover regime in China. *See, e.g.*, Sang Yop Kang, *Hostile Takeover and Corporate Governance in China: Based on the Vanke Case*, 2018 Trans-Pacific Business Law Dialogue: Pioneering a Trans-Pacific Vision in Corporate Law and Capital Market Law held at Seoul National University (presentation; file on author)(2018), at 12 ("Also, in China, it is less likely that the stock price reflects the intrinsic value of a corporation [due to] the inefficient capital market and stock market turbulence."). This suggests that the Chinese takeover regime is also confronted with capital market inefficiency and market failure issues.

[53] *See* Kang, *Rethinking Self-Dealing and Fairness Standard*, *supra* note 33, 146 (2016)(explaining the dominance of individual retail investors and the limited role of institutional investors in China); Sang Yop Kang, *The Independent Director System in China: Weaknesses, Dilemmas, and Potential Silver Linings*, 9 TSINGHUA CHINA L. REV. 151, 179-80 (2016)("… institutional investors, who potentially are powerful non-controlling minority shareholders, are not well developed in Chinese capital markets[.]"). *Id.* at 180, n. 139 ("Unlike many of the world's stock markets, most trades on the Chinese stock market are made by individual retail investors, rather than institutional investors. About 85 percent of trades are retail, according to Reuters.")(Quoting CNBC 2015) [hereinafter Kang, *Independent Director System in China*].

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market mechanisms in the absence of regulations governing the founders' strengthened voting rights will likely result in market failures.

In this regard, China's DCES-related regulations, encompassing not only the 10-time voting-leverage rule but also the 10% equity rule and the 2/3 voting-right rule, hold significant value as policies aimed at remedying market failures. However, the failure of the price-discovery function within the Chinese IPO market substantiates the necessity for DCES regulation merely in a *broad, general* sense, rather than justifying regulations based on the *specific* numerical thresholds like the "10-time" voting-leverage rule. In other words, although the direction of regulating the founder's voting leverage is correct, for instance, the question of why the maximum voting multiplier should be limited to 10 times instead of 20 times lacks a scientific basis for argumentation.[54] 10-time voting-right rule (and 10% equity rule) can be viewed as a "rule of thumb" derived from the "experience" gained from advanced capital markets and the policymakers' "speculation."

Concluding that a "10-time" voting-leverage is common in the U.S. DCES cases,[55] the HKEx adopted the 10-time voting-right rule. Subsequently, the Mainland China authorities also adopted the same policy. Although the 10-time voting leverage *officially* sets the upper bound limit, *in reality* the CSRC often allows the voting leverage of 5 or 6 times. Of course, the outcome of the voting ratio between different classes of stocks is also influenced by the negotiation between founders and investors. In this respect, DCES's voting leverage ratio is a function of various factors, including the CSRC's intervention, investor negotiation, and characteristics of specific investors.[56]

Seven out of eight companies with DCES in Mainland China eventually adopted a 5- or 6-times voting leverage for special-voting shares.[57] The only exception to this practice is Jing-Jin

[54] The same questions can be raised regarding the 10% equity rule and the 2/3 voting-right rule.

[55] *See* HKEx Research Report, *supra* note 3.

[56] Large institutional investors such as Softbank sometimes even demanded special-voting shares for themselves to prevent their voting rights from being diluted, potentially resulting in lower voting leverage for founders. In the case of Renren's IPO in the U.S., Softbank was able to retain 33.6% voting rights (compared to its 34.4% equity interest) by holding the same Class B shares as the founder. *See* Renren Inc., *Registration Statement for Certain Foreign Private Issuers*, https://www.sec.gov/Archives/edgar/data/1509223/000119312511124874/df1a.htm (last visited Jul. 31, 2023).

[57] *Supra* Table 2.

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Electric, which was allowed to use 10-times voting leverage. This shows another example of the Chinese authorities' exercising of the stringent permit system. Given the severe controlling-shareholder agency problem in China as well as less developed capital-market infrastructure and weak market efficiency, for the time being, we believe that the 10-time voting leverage rule and its related stringent permit system are necessary and beneficial. Nonetheless, there is a potential concern regarding the Chinese authorities' discretion based on varying treatment given to IPO issuers: for example, why could only Jing-Jin Electric use 10-time voting leverage? The Chinese authorities might have adequate reasons, but seemingly unequal treatment may generate another controversy and uncertainty in the IPO market.

C. 2/3 Voting-Right Rule

1. Implications of the Rule

Another restriction of the Chinese DCES is what we call the "2/3 voting-right rule": after an IPO with the DCES, the beneficiaries of the special-voting shares are not allowed to *collectively* hold more than two-thirds of the issuer's total votes. The 10% equity rule and the 10-time voting-right rule are stipulated as laws-on-the-book. The 2/3 voting-right rule, however, is not formally written in any promulgated law or regulation. Instead, it is "soft law" derived from Chinese regulators' case-by-case monitoring practice. Regarding this rule, the following five points are worth mentioning.

First, in Chinese companies, to approve significant agendas, 2/3 votes of the total votes *present* at a shareholder meeting are needed. In this light, 2/3 is *perceived*–as explained later, however, mistakenly perceived—as a safety valve in favor of non-controlling shareholders. Due to the government's volition to prevent the usage of DCES as a founder's tool to exercise "quasi-absolute control," the 2/3 voting-right rule is expected to be *strictly* enforced by the CSRC. This market expectation (or almost market consensus) shows another example of China's DCES as a stringent permit system.

The Chinese authorities' *intent* (although it was *incorrectly* set as seen in the fifth point below) is to set the 2/3 voting-right rule as a counterbalance that protects founders from losing

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control in the IPOs and also protects investors from losing their veto power. As seen in Table 2, the 2/3 voting-right rule applied in all eight corporations with DCES in Mainland China.[58] Before the end of the first half in 2022, the maximum voting rights that founder-controllers could exercise was 63.47% in Ninebot. In July 2022, founder-controllers of Orbbec could exercise 64.84% voting rights. In this case, however, founder-controllers' equity contribution accounted for 35.73%, much higher than the threshold point of 10%. In this light, it seems that the CSRC was relatively relieved about Orbbec's investor-protection aspect: the equity contribution of the founder-controllers was significant,[59] and thus, the tighter application of the 2/3 voting-right rule was less necessary.

Second, in cases after Ninebot (except Orbbec), founder-controllers' total voting rights are approximately equal to or less than 60%. In the case of Huiyu Phar., the founders' equity-capital contribution is 31.27%, which is high compared to the standard set by the 10% equity rule; however, the founders' voting rights amount to 60.95%. Also, in the case of Jingwei Hirain, although the founders' equity-capital is 33.27%, even higher than that of Huiyu Phar., the founders' voting rights amount to 50.76%. In essence, the CSRC holds a firm, cautious policy stance about the 2/3 voting-right rule.

Third, while HKEx has the 10-times rule, it does not impose the 2/3 voting-right rule. In this aspect, the current DCES system in Hong Kong is more advantageous to founders than in Mainland China. For instance, at the time of its IPO on the HKEx, Lei Jun and Lin Bun, two founders of Xiaomi (a Mainland China company) who acted in concert, contributed 41.87% of equity-capital.[60] Under the 10-time voting rights based on the WVR structure in the HKEx, Xiaomi's two founders could exercise over 80% of voting rights of the company, 55.2% for Lei Jun and 29.52% for Lin Bun, respectively.[61]

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[58] *See supra* Table 2.

[59] *Supra* Table 2.

[60] Regarding Xiaomi's IPO in the HKEx, *see* also Vincent P C Kwan, *Anatomy of Xiaomi IPO - Listing of First Unicorn under the New Listing Regime*, FRA COLUMN (2018), https://www.chklc.org/images/Momentum/MO_Summer18_FRA.pdf ("[Xiaomi's] listing on the Hong Kong Stock Exchange (HKEX) is the first IPO under the new listing regime introduced on 30 April 2018 permitting the listing of companies with weighted voting right structures.").

[61] For the more information, *see* Xiaomi Corporation, *Listing Documents-Offer for Subscription Global Offering*, https://www1.hkexnews.hk/listedco/listconews/sehk/2018/0625/ltn20180625033.pdf?code=01810 (last visited Jul. 31, 2023).

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Fourth, if Xiaomi had listed in Mainland China, these two co-founders would be subject to the 2/3 voting-right rule (or even 60% limit based on the regulation practice). In other words, the rule and Chinese authorities' stringent permit system may *discriminate* against founders whose equity contribution is substantial (e.g., 41.87% in Xiaomi). Then, in Mainland China, founders looking for the DCES would not like to contribute the substantial amount of equity investment even if financial resources are available. Accordingly, the interests between founders and public shareholders in a corporation are less aligned than they can be, which is less optimal to the public shareholders. In this sense, it is ironical that the 2/3 voting-right rule, which is designed to protect investors, may sometimes weaken investors' interest.

Fifth, as opposed to the policymakers' intent explained in the first point above, even under the 2/3 voting-right rule, a controller with for example 50% voting rights can practically exercise quasi-absolute decision-making power in a shareholder meeting. This is because under the PRC Company Law, approval of significant agendas requires 2/3 of the total votes *present* at a shareholder meeting. Suppose a corporation has 1,000 votes outstanding, and the founder-controller holds 500 votes (i.e., 50% votes). Due to "rational apathy"[62] and other issues, however, not all non-controlling shareholders or proxies attend a shareholder meeting. On the other hand, since founder-controllers' economic interest in a corporation is severe to them, they exercise voting rights in the meeting. Suppose 750 votes, including the founder-controller's 500 votes, are present at a shareholder meeting. In this case, the founder-controller's votes *present* at the shareholder meeting amounts to 2/3,[63] meaning that the founder-controller can exercise the quasi-absolute control and determine the corporation's significant agendas.

2. Ucloud Example

The SSE's examination of Ucloud, the first company successfully listed with DCES in Mainland China, demonstrates how Chinese regulators enforce this soft law of the 2/3 voting-right rule. In its reply to the SSE's inquiry, UCloud explained that a ratio of 5:1 in favor of the shares with superior voting rights will allow the "visionary founders" to maintain more than 50%, but

[62] Regarding "rational apathy" of shareholders, *see* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983); ROBERT CHARLES CLARK, CORPORATE LAW (2nd ed. 1986).

[63] 500 / 750 = 2/3.

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less than two-thirds, of total voting rights of the issuer immediately before and after the proposed listing. Under the 2/3 voting-right rule, such a ratio relieved the regulatory agencies' concern on whether the founders could arbitrarily decide virtually all significant matters of the company that require a 2/3 supermajority vote. After listing, however, it turned out that the attendance rate of Ucloud's shareholder meeting ranged from 60% to 72%, meaning that a ratio of 5 was generally sufficient for the founders to exercise quasi-absolute control. For instance, when attendance was 72%, the founders' votes represented 75.86% of the votes *present* at the shareholder meeting.[64] Regarding Uclould's DCES, Table 4 shows the effective percentage of the founders' voting rights when setting ratios differently.

Table 4: Voting Rights of Ucloud Founders under Different Ratio Settings (from 2:1 to 10:1)

Number of votes for each superior voting rights share	Percentage of issued share capital held by three founders		Percentage of voting rights held by three founders		
	Pre-IPO	Post-IPO	Pre-IPO	Post-IPO	Post-IPO (if overallotment option is exercised)
2	26.83%	23.12%	42.31%	33.51%	32.49%
3			52.39%	43.05%	41.92%
4			59.47%	50.20%	49.04%
5			64.71%	55.75%	54.62%
6			68.76%	60.18%	59.08%
7			71.97%	63.81%	62.75%
8			74.58%	66.84%	65.81%
9			76.75%	69.39%	68.42%
10			78.58%	71.59%	70.64%

[64] 54.62 ÷ (72/100) = 75.86%.

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After the Ucloud case, the SSE continued to raise concerns about the rationality of the DCES adopted by new issuers. Fearing that the SSE's persistent questioning would delay their listing process, issuers after the Ucloud case established a "rational" ratio that seemingly aims to strike a balance between allowing founders to retain control and safeguarding the interests of non-controlling shareholders. For instance, Jingwei HiRain, an applicant newly approved for registration in the STAR Market in February 2022, opted for a voting ratio of 6. This decision resulted in its founder holding approximately 62.64% of the total voting rights immediately before the IPO and 50.76% after the IPO.[65]

IV. INVESTOR SAFEGUARD MEASURES II: SUNSET PROVISIONS

Part IV will explore the sunset provisions, which work as safeguards against founders' entrenchment.

A. Event-driven Sunset

1. Rules

Event-driven sunset provisions require special-voting shares to be automatically converted into OSOV shares upon the occurrence of certain events, such as controllers' death and the disposal of shares. Table 5 summarizes four types of mandatory event-driven sunset provisions in the HKEx and the SSE.

Table 5: Mandatory Event-driven Sunset Provisions

Events	HKEx	SSE

[65] *See* Beijing Jingwei Hengrun Keji Gufen Youxiangongsi Shouci Gongkai Faxing Gupiao Bingzai Kechuangban Shangshi Faxing Gonggao (北京经纬恒润科技股份有限公司首次公开发行股票并在科创板上市发行公告) [*Beijing Jingwei Hirain Technologies Announcement of the Initial Public Offering and Listing on the STAR Board*], SHANGHAI STOCK EXCHANGE (Apr. 6, 2022), http://www.sse.com.cn/disclosure/listedinfo/announcement/c/new/2022-04-06/688326_20220406_1_hHJFwm0w.pdf., p14.

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I	The beneficiary is no longer a director, or deemed incapacitated for performing his or her duties as a director, or deemed to no longer meet the requirements of a director.	Substantially same
II	The beneficiary is deceased.	Substantially same
III	Upon transfer of the beneficial ownership of, or economic interest in, special shares or the control over the voting rights attached to them (through voting proxies or otherwise)	Substantially same
IV	N/A	Upon change of control of the issuer.

2. Analysis and Implications

In Table 5, the first type of events limits the DCES to those who carry out directorate functions. The idea behind this rule seems that in exchange for voting leverage, DCES beneficiaries should discharge fiduciary duties as a director.[66] However, such rule needs further analysis.

First, suppose a founder-director, a beneficiary of special-voting rights, is prosecuted for tunneling corporate value, and is found criminally liable. Under the PRC Company Law, founder-directors would lose their directorship when they face a criminal penalty. Then, they would lose the special-voting rights as well, leading in many cases to the loss of control. Accordingly, in corporations with the DCES, founder-directors would be less incentivized to tunnel corporate value, protecting investors.

Second, the criminal penalties that take away a founder-director's directorship are broad, not limited to tunneling.[67] Thus, in the corporate control context, criminal prosecution might be a

[66] Mary Leung & Rocky Tung, *Dual-class Shares: The Good, the Bad, and the Ugly*, CFA INSTITUTE, https://www.cfainstitute.org/-/media/documents/survey/apac-dual-class-shares-survey-report.pdf (last visited Jul. 31, 2023).

[67] For instance, "any person who has been convicted of any criminal offense in the nature of corruption, bribery, disseizing, misappropriation or disrupting the economic order of the socialist market and five years have not elapsed since any penalty imposed has been completed, or any person who has ever been deprived of his political rights due to any crime and five years have not elapsed since the penalty imposed was completed." PRC Company Law, *supra* note 7, art 146.

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powerful weapon,[68] which may be relevantly used or sometimes abused by investors. Founder-directors are wary about whether they will lose benefits of the DCES due to potential crimes that might be irrelevant to management.

Third, in corporations with the DCES, the government—based on investigations by financial market regulators, police, and prosecutors, which could lead to criminal penalties—has the power and leeway to, consequentially, eliminate certain founder-directors' special-voting rights and control. In short, the Chinese government has another tool to regulate the private economy.

B. Time-based Sunset

In general, time-based sunset provisions require the automatic conversion upon the passage of a predetermined period of time following the IPO.[69] Time-based sunset is vigorously campaigned for by some investors and institutions as an effective investor safeguard to prevent the harms that may occur over the long term with the DCES.[70] Also, investors might be concerned about the possibility that the founder's managerial or technical talent and acumen will decline over time. So far, however, most major economies have not *required* time-based sunset provisions.

In the U.S., some companies *voluntarily* (or based on the negotiation with investors) elect to go public with time-based sunset provisions, with a fixed period of time, ranging from 3 to 20 years.[71] This phenomenon is commonly observed in the U.S. IPO market, where the market-

[68] Regarding criminal penalty in relation to management and control over corporations, *see* Kang, *Rethinking Self-Dealing and the Fairness Standard*, supra note 33 at 126 (explaining controlling shareholders' risk of facing criminal penalty) and at 138 (highlighting that in the absence of effective corporate law mechanisms, such as a derivative suit system, government agencies and prosecutors may resort to alternative means based on criminal or administrative law, potentially resulting in more adverse consequences from the perspective of controlling shareholders.); Li Xiaozheng & Wu Bangyu, *Yingdui the "Achilles' heel": Zhongguoqiye Kongzhiquanzhizheng De Xingze Sibian* (应对"阿喀琉斯之踵"：中国企业控制权之争的刑责思辨) [*Dealing with the "Achilles' Heel": Reflections on Criminal Liability in Chinese Corporate Control Disputes*], https://mp.weixin.qq.com/s/Q39bpFS5YzwYV-tb_su2oQ (last visited Jul. 31, 2023).

[69] Andrew William Winden, *Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures*, COLUM. BUS. L. REV. 852, 917 (2018).

[70] *See* Leung & Tung, *supra* note 66 at 22. *See also* Rick Fleming, *Dual-Class Shares: A Recipe for Disaster?* SEC, https://www.sec.gov/news/speech/fleming-dual-class-shares-recipe-disaster (last visited Jul. 31, 2023).

[71] Ken Bertsch et al., *Petition to NYSE on Multiclass Sunset Provisions*, COUNCIL OF INSTITUTIONAL INVESTORS (2018), https://corpgov.law.harvard.edu/2018/11/02/petition-to-nyse-on-multiclass-sunset-

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oriented system generally, if not entirely, prevails and arm's length negotiations facilitate price discovery. For instance, EVO Payment, Groupon, and Airbnb had 3-year, 5-year, and 20-year sunset provisions, respectively. According to the Council of Institutional Investors (CII), "a sunset of seven years or less offers an appropriate period to harness whatever benefits of innovation and control a dual-class structure may provide at newly public companies while mitigating the agency costs it imposes over time."[72]

In Hong Kong, although a sunset provision ranked third in a list of restrictions favored by respondents,[73] it is not mandated in the final governing rule. Similarly, under the SSE Listing Rule, a time-based sunset provision is not mandated. The BSE stipulated that the DCES arrangement shall "end when the implementation period expires,"[74] implying a mechanism similar to time-based sunset provisions. In general, companies and founders do not want to attach such restrictions. So far, unlike the practice in the U.S., almost no Chinese companies in Hong Kong or Mainland China with the DCES have proactively incorporated time-based sunset provisions. Regarding this phenomenon, we put forward the following interpretations or explanations.

First, in the U.S., as explained, with respect to the DCES, time-based sunset provisions are usually the outcome of arm's length negotiations between issuers and founders on the one side and investors on the other side. In contrast, the capital-market situation in China has been, so far, favorable to the founders of many tech companies. Chinese innovative capital markets such as STAR Market and ChiNext Market generally enjoy high price-to-earnings (P/E) ratios.[75] Because

provisions/#:~:text=CII%20has%20tracked%2025%20U.S.%20companies%20that%20went,2004-2018%20used%20sunsets%20of%20five%20years%20or%20less.

[72] *Id*.

[73] *See Consultation Conclusions To Concept Paper On Weighted Voting Rights*, HONG KONG STOCK EXCHANGE（Jun. 2015), p32, https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2011-to-2015/August-2014-Weighted-Voting-Rights/Conclusions/cp2014082cc.pdf.

[74] Beijing Zhengquan Jiaoyisuo Gupiao Shangshi Guize (Shixing) (北京证券交易所股票上市规则(试行)) [Listing Rules for Stocks of the Beijing Stock Exchange (Trial Implementation)] (promulgated by Beijing Stock Exchange, Oct. 30, 2021, effective Nov. 15, 2021) art 4.4.7(4), https://www.bse.cn/cxjg_list/200010908.html.

[75] "[T]he [STAR Market] board's average price-to-earnings (PE) ratio was nearly 90, much higher than the ratio of 42 on Shenzhen's ChiNext board, which mostly hosts tech companies, according to data from the Shanghai and Shenzhen stock exchanges." *See* CAIXIN GLOBAL, *Charts of the Day: One Month On, Shanghai Tech Board's Average PE Ratio Is Still Sky High* (2019), https://www.caixinglobal.com/2019-08-23/charts-of-the-day-one-month-on-shanghai-tech-boards-average-pe-ratio-is-still-sky-high-101454429.html. For the purpose of explaining the DCES, which was adopted in 2019 in China, we explain the 2019 situation.

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of these high P/E ratios, going public without time-based sunset provisions would often be in line with investors' interests as well.

Second, many early investors in China sell their shares immediately after the lock-up period.[76] Thus, these investors with short-termism are not very concerned about the absence of time-based sunset provisions. Of course, if the capital market is efficient[77] and other public investors in China understand that the absence of time-based sunset provisions has a negative impact on the value of a corporation, these early investors would take time-based sunset provisions into consideration in the first place. In China, as previously discussed in Part III.B., retail investors dominate the capital market trading: they account for approximately 85% of the overall share trading volume.[78] Given this situation, the impact of "noise traders"[79] makes the Chinese capital markets less efficient.[80] Also, as previously explained,[81] the deficiency in the disclosure system and its enforcement mechanism in China leads to a severe presence of asymmetric information, consequently exacerbating market inefficiency in the capital markets.

Third, in our opinion, for policy purposes, Chinese regulators are inclined to hold current controllers accountable for a long time. This is because it is more efficient and convenient to monitor and regulate "one person" (in the case of a founder-controller) or "a few persons" (in the case of cofounder-controllers) in the "repeated-games" manner. Under a 7-year sunset provision,

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[76] *See* Shen Junhan & Han Yali, *Tuichuqi Diejia Jiejinqi: PE Jigou Mangjianchi Celue Jiezou Geyoubutong* (退出期叠加解禁潮：PE 机构忙减持 策略节奏各有不同) [*Exit Overlapping with Lifting of Lock-up Periods: PE Institutions are Busy Reducing Holdings, each with Different Strategies*], https://finance.sina.cn/2020-07-30/detail-iivhvpwx8163496.d.html (last visited Jul. 31, 2023).

[77] Regarding the efficient (capital) market, *see* Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59 (2003); Burton G. Malkiel, *Reflections on the Efficient Market Hypothesis: 30 Years Later*, 40 FIN. REV. 1 (2005).

[78] In this sense, Chinese investors might be subject to behavioral finance issues. Regarding behavioral finance issues in general, *see* Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, *in* 1 HANDBOOK OF THE ECONOMICS OF FINANCE 1053 (George Constantinides et al. ed., 2003).

[79] For the explanation of "noise traders," *see* Andrei Shleifer, Lawrence H. Summers, *The Noise Trader Approach to Finance*, 4 J. ECON. PERSP. 19 (1990); J. Bradford De Long, *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703 (1990).

[80] Retail investors, rather than institutional investors, are likely to be noise traders. Regarding retail investors' dominance in the Chinese capital markets, *see* Kang, *Rethinking Self-Dealing and the Fairness Standard*, *supra* note 33 at 146. Regarding inefficiency of the Chinese capital markets, Sang Yop Kang, *Hostile Takeover and Corporate Governance in China: Based on the Vanke Case*, TRANS-PACIFIC BUSINESS LAW DIALOGUE PIONEERING A TRANS-PACIFIC VISION IN CORPORATE LAW AND CAPITAL MARKET LAW at Seoul National University (2018)(presentation; file on author) p12 and p22; Sang Yop Kang, *Analyzing Investor Protection in Chinese State-owned Enterprises: Law And Economics Approach*, 40 REV. BANKING & FIN. L. 821, 835-36 (2020).

[81] *See supra* note 47 and its accompanying text.

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for instance, the corporation's ownership structure may be dispersed without a controller, leaving Chinese regulators to face a situation where the management team they monitor and regulate could change from time to time.

Fourth, a mandatory event-driven sunset, such as a founders' death, can also function as a safety valve since it prevents the succession of control to the founders' children. In this respect, founders' death as a mandatory *event-driven* sunset can also function as a sort of *time-based* sunset since a person's death will eventually take place. Founders' death, however, differs from, for example, a 10-year time-based sunset in the sense that the timing is indefinite and thus more difficult to plan around.

V. INVESTOR SAFEGUARD MEASURES III: RULES CONVERTING THE SHARES WITH MULTIPLE VOTES TO THE SHARES WITH ONE VOTE

Part V will explore the rules for converting superior voting rights into OSOV when shareholders pass a resolution approving major matters directly relating to the fundamental interests of public investors.[82]

A. Rules

Concerning the WVR, the HKEx requires OSOV to be applied to five types of corporate decisions.[83] The SSE adopts similar requirements. Table 6 shows the HKEx and SSE's rules where shares with multiple votes are converted to shares with one vote under certain circumstances.

Table 6: Reserved Matters Requiring Voting on the OSOV[84]

[82] *See* HKEx Research Report, *supra* note 3.

[83] HKEx Listing Rule, supra note 36, art. 8A.24.

[84] *See* Shanghai Zhengquan Jiaoyisuo Kechuangban Gupiao Shangshi Guize (2020 Xiuding) (上海证券交易所科创板股票上市规则(2020 修订)) [*Listing Rules of Shanghai Stock Exchange Science And Technology Innovation Board (2020 Revision)*] (promulgated by Shanghai Stock Exch., Dec. 31, 2020, effective Dec. 31, 2020), art. 4.5.10

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No.	HKEx	SSE
1	changes to the listed issuer's constitutional documents, however framed	same
2	variation of rights attached to any class of shares	variation of the number of votes attached to each superior voting rights share
3	the appointment or removal of an independent non-executive director	same
4	the appointment or removal of auditors	same
5	the voluntary winding-up of the listed issuer	the merger, split-up, winding-up of the company or change of corporation form

When shareholders vote on specifically defined corporate actions, both the HKEx and SSE require all shares to be treated as shares with OSOV. Without undermining founders' pursuit of their long-term vision, these restrictions limit the founders' abusive behavior against public shareholders. Compared to the HKEx rule, the SSE places such restrictions on two additional matters, i.e., mergers and the split-ups.

B. Analysis and Implications

1. Changes to Articles of Association

Similar to the HKEx, the SSE requires the conversion rule be applied to any changes made to the listed issuers' articles of association (章程). However, in Mainland China, where amendments to a company's articles of association must be filed with the competent authority

http://www.sse.com.cn/lawandrules/sserules/tib/listing/a/20201231/1c6899258e0c7848ce356f22f41b393b.doc (last visited Jul. 31, 2023).

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(Administration for Market Regulation) within a specific time period,[85] such conversion rule may significantly compromise the effectiveness of the DCES because the implementation of certain non-reserved matters requires amendments to the issuer's articles of association.

For example, when a Chinese listed company seeks to use its stock as consideration in an acquisition deal, the total number of its issued shares will increase. To reflect this change, however, the company's articles of association would need to be amended[86] on a OSOV basis. As a result, it is possible that an acquisition deal involving the issuance of even non-special-voting shares can be blocked by ordinary shareholders, simply because of the conversion rule related to amendments to articles of association. Similarly, issues could arise in the context of the redemption of shares requested by investors, where a decrease in the total number of issued shares is required. Also, in a corporate control contest, when a bidder aims to eliminate existing takeover defense measures specified in the articles of association, such as staggered board mechanisms and stringent qualification for new directors, in some instances, the bidder may have an increased likelihood of success due to the conversion rule to OSOV. In sum, by broadly subjecting any amendment to the articles of association to the OSOV rule, the DCES is largely compromised.

Regarding amendments to articles of association, however, even when the conversion rule to OSOV is applied, it does not necessarily present a complete disadvantage to the founder. This is because amending articles of association necessitates the approval of at least 2/3 of the shares present at a shareholder meeting.[87] In other words, even under the OSOV rules, if the founders and their allies (as well as public shareholders who agree with the founders on a specific issue) collectively hold more than 1/3 of the total outstanding shares, the founders can effectively veto outsiders' attempt to amend the articles of association that may work against the founders. Accordingly, in the scenario where takeover defense measures in favor of the founders such as staggered board mechanisms and stringent qualifications for new directors are *already* stipulated in the articles of association, the founders' side can easily impede bidders from acquiring control of the corporations. As explained, to amend the articles of association, 2/3 of the shares *present* at

[85] Zhonghua Renmin Gongheguo Gongsi Dengji Guanli Tiaoli (中华人民共和国公司登记管理条例) [*Regulation of the People's Republic of China on the Administration of Company Registration*] (promulgated by the St. Council, Feb. 6, 2016, effective Feb. 6, 2016) art. 27, https://www.gov.cn/gongbao/content/2016/content_5139456.htm [hereinafter PRC Regulation on Company Registration].

[86] To increase its registered capital, a company shall apply for modification registration within 30 days, *see id.* art 31.

[87] *See* PRC Company Law, *supra* note 7, art. 103.

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a shareholder meeting are required. Therefore, in typical scenarios where a significant number of non-controlling shareholders do not attend the shareholder meeting (either physically in person or through proxies) abstain from voting, even founders with less than 1/3 of the total *outstanding* shares may still hold 1/3 of (or more than) the shares *present* at the shareholder meeting.

In some instances, however, when it comes to the amendment to the articles of association, OSOV based on the conversion rule may work unfavorably to the founders. This is especially true when the founders would like to amend the articles of association, while the founders, along with their allies and public investors who align with the founders, collectively hold less than 2/3 of the total outstanding shares. In light of this concern, the BSE Market Listing Rules have narrowly limited the application of the OSOV rule to amendments related to a weighted voting rights arrangement in the listed issuer's articles of associations. Unlike the BSE Market Listing Rules, the SSE STAR Market Listing Rules remained unchanged, and uncertainties persist with respect to corporate actions requiring amendments to articles of association.

2. Appointment and Removal of Independent Directors

In China, according to the CSRC's regulation on independent directors of listed companies, [88] independent directors should be not less than 1/3 of the directors.[89] A few points are worth analyzing further.

First, concerning the appointment and removal of directors, the rules for converting superior voting rights into OSOV does not apply to *inside directors*, who are, in most cases, up to 2/3 of the directors. Thus, even with the voting-right conversion rule, it is not very difficult for founder-controllers to exercise control over the board of directors. Second, regarding *independent directors*, even if the founder-controllers' votes are exercised based on OSOV, their votes, combined with their alliance's, suffice to elect *some*, if not all, independent directors from their side.

[88] Shangshi Gongsi Duli Dongshi Guanli Banfa (上市公司独立董事管理办法) [*Measures for the Administration of Independent Directors of Listed Companies*] (promulgated by China Sec. Regul. Comm'n., Aug. 1, 2023, effective Sept. 4, 2023) art. 5, http://www.csrc.gov.cn/csrc/c101953/c7424110/content.shtml.

[89] Regarding the independent director system in China, *see* Shen Sibao & Jia Jing, *Will The Independent Director Institution Work In China*?, 27 LOY. L.A. INT'L & COMP. L. REV. 223 (2005); *See* Kang, *Independent Director System in China*, *supra* note 53.

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Third, under the DCES with the voting-right conversion rule, founder-controllers, who sincerely would like to enhance the quality of corporate governance from hiring more independent directors, face a dilemma: if founder-controllers decide to have a board of directors consisting of *more independent directors*, there will be *less inside directors*; accordingly, the founder-controllers' influence is weakened. Although independent directors are not sufficiently independent in China, controlling shareholders' dominance over independent directors is weaker than their dominance over inside directors.[90] In this light, in terms of enhancing the quality of corporate governance, the presence of more independent directors is better than the presence of more inside directors.

If the founder-controllers are willing to accept this situation with higher corporate-governance quality, a reasonable policy should be designed to compensate some "carrots" to the founder-controllers who are willing to give up some inside directors that they could otherwise appoint. However, the direction of the current voting-right conversion rule is the *opposite*: when founder-controllers decide to have more independent directors in their controlled corporations, they are *penalized* again since their special voting rights transform into the OSOV. Under these circumstances, rational founder-controllers, in the first place, would not pursue the situation with more independent directors. In other words, *ironically*, the voting-right conversion rule, which is *intended* to *protect* public shareholders, *actually impedes* the board's independence and investor protection.

3. Mergers and Control Contest

Under the PRC Company Law, a "merger," together with a "split-up, winding-up of the company or change of corporation form," is treated as a "significant matter" that shall be decided by 2/3 of votes present at a shareholder meeting.[91] If founder-controllers, based on the DCES, can use special-voting rights, it is typically not a challenge to exercise the 2/3 of votes present at a shareholder meeting. The problem for founder-controllers, however, is that the conversion rule to

[90] *Id.*

[91] *See* PRC Company Law, *supra* note 7, art. 103.

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OSOV applies to merger cases and bidders have a better chance in hostile takeovers.[92] In this respect, it might be argued that the DCES is almost *meaningless* in a control contest where special-voting rights are most needed for founders. Let us analyze this argument.

For instance, when a bidder attempts to take over a target corporation, issuing new shares to the target corporation's insiders or to friendly third parties is an effective defensive measure for founder-controllers. In the context of the PRC Company Law, however, the issuance of new shares requires an amendment to a company's articles of association. Then, founder-controllers face three aspects of disadvantages: (i) amending the articles of association requires at least two-thirds of the shares present at a shareholder meeting on the OSOV basis; (ii) the founder's side (or the corporation) has to go through cumbersome administrative and tedious procedures to call and conduct a shareholder meeting to amend the articles of association; and (iii) the conversion rule to the OSOV is triggered in the merger's context.

By contrast, not all defense measures are related to the amendment to a corporation's articles of association. For instance, a golden parachute arrangement may be established, independent of the articles of association, through an agreement between a company and its executives. If that is the case, the first two aspects of disadvantages regarding the amendment of the articles of association do not arise. From the perspective of certain bidders, a golden parachute arrangement could be viewed as a significant barrier to a takeover.[93] Even if the approval of shareholders is necessary for a golden parachute arrangement, the founder can still exert special voting rights, as the arrangement is unrelated to the amendment of the articles of association.

In sum, while the conversion rule to OSOV applies to *mergers*, it does *not* apply to the cases where *defense measures* unless taking defense measures generates amendment to the articles of association. Based on these defense measures, founder-controllers may have a better chance to

[92] Historically, at least 32 A-Share listed companies were acquired through merger. Among them, 27 companies were merged by other listed companies and 5 companies were merged by non-listed companies. M&A by Li Hua, Agu Shangshi Gongsi Xishou Hebing Agu (Huo Bgu) Shangshi Gongsi (A股上市公司吸收合并A股（或B股）上市公司) [*A-share Listed Companies Acquiring and Merging A-share (or B-share) Listed Companies*], https://mp.weixin.qq.com/s/IuYN7E8eCgaCOkKcvDmm2w (last visited Jul. 31, 2023).

[93] However, in China, golden parachute arrangements are typically smaller in scale compared to the U.S. If the size of these arrangements is significantly small, bidders (potential acquirers) may perceive them as ineffective as a takeover defense measure.

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successfully defend their control over the corporations. In other words, the argument that the DCES is almost *meaningless* in a control contest is half-true.

In this light, regarding the "market for corporate control (or hostile takeovers)," whether the Chinese authorities intended it or not, we evaluate that the DCES system is set at the *intermediate* position. This is because the on the one hand, founders *can* utilize their special-voting rights in implementing *defense measures* and on the other hand, they are *unable* to rely on the special-voting rights on the *merger*.

Regarding control contests, last but not least, we propose two additional points. First, if a corporation's *original* articles of association already include takeover defensive measures like the staggered board system, it is not the founder but the bidder who seeks to amend the articles of association. In such a scenario, the three aspects of disadvantages are incurred by the takeover bidders; founders can leverage their advantage in relation to the amendment of the articles of association. Second, in a hostile takeover situation, we expect that a bidder is incentivized more to rely on mergers than acquisitions (without mergers) since mergers are subject to OSOV and acquisitions are not. If a bidder chooses acquisitions, the target corporation founder's special-voting rights are still available, and the bidder's chance of succeeding acquisitions would be significantly lower.

VI. CONCLUSION

This article explores the justification and the risks associated with the DCES. Additionally, it examines investor safeguard measures, such as the "three numerically specified rules," "sunset provisions," and "rules converting special-voting shares into shares with one vote," and presents a unique view about the implications of these investor safeguard measures. Given the Chinese capital markets' underdevelopment and market inefficiency as well as prevalence of tunneling, the Chinese authorities' current approach to *enhanced* investor protections regarding the DCES is appropriate, at least, in the short term. However, various regulations associated with China's DCES, such as the 10-time voting-right rule, are predominantly guided by a rule of thumb rather than being grounded in a rigorous scientific basis. In addition, another concern is that the cautious

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implementation of a stringent permit system by the Chinese authorities, if it is extended for a long time, may constrain founders' entrepreneurship. With the growing difficulties and weakened attractiveness of listing in the U.S. capital markets,[94] the availability of listing in Mainland China with DCES becomes crucial for many Chinese technology companies. Therefore, we suggest that the Chinese authorities gradually relax the implementation of the current DCES regime with the stringent permit system. For instance, policymakers should contemplate loosening the 2/3 voting-right rule in the near future. This rule cannot prevent founders from exercise "quasi-absolute control", while deterring some technology companies from going public in China due to founders' concern of dilution and loss of control after listing and refinancing. Of course, as the 2/3 voting-right rule is relaxed, the discrepancy between cash-flow rights and voting rights might widen and the risk of tunneling is enhanced. However, such tunneling risk can be reduced if the legal system adequately punishes tunneling. Thus, the two-prong approach—relaxation of DCES-related regulations and heightened tunneling enforcement—is the proper policy combination in China. Regarding founders' exploitation of private benefits from a corporation, the importance of civil remedies, in addition to administrative and criminal penalties, should be simultaneously considered. In this regard, for instance, discussions surrounding the DCES should also incorporate considerations for reforming the derivative suit system, a principal mechanism for civil remedies against tunneling, which remains largely dormant and ineffective in China.

[94] Chinese IPOs have raised five times more capital than the U.S. in the first four months of 2023, *see* Brian Neeley, *China Dominates Global IPO Market as Wall Street Fails to Rebound*, https://www.ft.com/content/e5a43d1d-b62c-4428-b16f-c1fe6b4fb9d9(last visited Jul. 31, 2023).

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