ECGI Workshop
New Listing Rules for SPACs and Dual Class?

Dual Class Shares - Theory

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On the Agenda Again

- Dual-class shares have been controversial for quite some time
- The (policy) debates seem to come and go
- In Europe, question was last in the spotlight in the early 2000 when the EU consider a one-share one-vote rule
  - In late 2007 EU Commission decided against it
- What has changed since?
- Do recent experiences suggest a re-appraisal of dual-class shares

What has changed?

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

Why (more) publicly listed firms?

- Are non public firms financially (more) constrained?
  - Are dual-class shares an attractive funding source?
  - If yes, one share one vote rule may lead to suboptimal financing choices, foregone firm growth, or use of alternative CEMs (e.g., pyramids)
- Should general public be able to invest (directly or indirectly) in high-tech growth firms?
- Stock exchanges (e.g., LSE) competing to attract high-tech firms?
  - Since some exchanges allow dual-class shares, others must as well to attract these firms.

Do Dual-Class Shares Promote Listings?

- Recent US experience shows that quite a few firms opt to go public with dual-class share structures
  - In 2016-2018 35% of tech IPOs &15% of non-tech IPOs in the US used dual class shares (Ritter, 2018)
- It must be correct that permitting dual class shares does not deter firms from listing, but the one-share one-vote rule may deter some
  - This is not to say that dual-class shares are an effective means to increase listing
- (Possible loss of) control is only one dimension of listing decision

A Primer on Dual-Class Shares

- Allocation of votes across shares shapes governance mechanisms based on ownership & control
  - Active owners and shareholder interference
  - Control transfers (takeovers)
- Common view is that both mechanisms perform best under one share - one vote
  - Alignment of (voting) power and financial interest strengthens incentives to maximize firm value
  - It ensures efficient control allocation
- (Recent) caveat: Dual class shares protect “visionary” founders from short-termism of capital markets, enabling them to realize long-term vision

A Primer (cont'd)

- Wedge between (voting) power and financial stake increases insiders' ability to extract control benefits
  - Still, dominant shareholders have way more skin in the game than professional managers (in widely held firms)
- Disproportionate voting power makes it more attractive to be large active owners
  - Without private benefits, who wants to incur cost of owning large block (e.g., under-diversification)?
- Disproportionate voting power increases effectiveness of monitoring by large shareholders

A Primer (cont'd)

- Disproportionate voting power reduces or undermines control contestability
  - But control contestability also comes with costs:
    - Takeovers can be motivated by other reasons than value improvement, e.g. empire-building
    - Manager may resort to defensive actions or abstain from firm-specific investment
    - Prospect of remaining in control can enhance incentives (to create value)
- Compared to full acquisition, trading the controlling block makes both value-increasing and –reducing transfers more likely/cheaper

A Primer (cont'd)

- (Contended) finding that dual class shares are associated with lower firm value does **not** establish that
  - Dual class shares are inefficient/destroy value
  - Public investors are exploited
- Minority shareholder protection is not a compelling argument against dual class shares
  - Nobody has to invest in dual-class shares
  - Other (legal) safeguards against "excessive" diversion of corporate resources by insiders
  - If downsides are large(r) rational investors buy dual-class shares at "fair" discount, or dual class shares become unattractive funding source

A Primer (cont'd)

- Sunset provisions remove unequal voting rights
  - Time-based (after e.g., 7 or 10 years)
  - Event-based (e.g., stake falls below some cut-off)
  - Transfer-based (e.g., stake is sold)
- UK Listing Review proposes to limit superior voting rights to ensure board seats of insiders and to block takeovers
- Given control retention is purpose of dual class shares and heterogeneity among dual class firms, imposing uniform sunset provisions makes little sense.
- Voluntary sunset provision or unification remain options

Summing Up

- Economic theory does not support claim that one vote one share is unambiguously superior or let alone optimal
- Ultimately, it is question whether large owners or professional managers perform better
  - Owners are more aligned
  - Managers are more easily replaced
- Firms & circumstances are too diverse to impose uniform sunset provisions or outright ban of dual class shares
- If too many investors dislike dual class shares, inferior voting shares stop being attractive funding source.