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**Plenary 4: Dual Class Shares**

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- Professor Marco Becht, Professor of Finance and the Goldschmidt Professor of Corporate Governance, Solvay Brussels School for Economics and Management, Université libre de Bruxelles
- Alan Brett, Head of Corporate Governance Ratings Research, MSCI ESG Research

Chaired by George Dallas, Policy Director, ICGN

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**George Dallas:** Dual class shares seem to have become almost axiomatically linked to the tech sector. It's become a popular form of ownership structure, guiding IPOs in Silicon Valley with the likes of Facebook, the Alphabet, Google, Tesla, Alibaba, Uber, all have dual class share arrangements. What are these strengths and where the weaknesses that might come from this form of ownership? Is it a question of protecting young creative companies from the potentially distracting short term animal spirits of the financial marketplace? On the other hand, what about those who might fear that dual class share structures, even if they are benignly structured and intended, might create autocracies or entrench controlling owners with little or no accountability to other external shareholders? We see that in the technology sector, many companies are interested in the benefits of dual class, whether to promote long termism or simply to insulate companies from shareholder pressures.

In the tech sector, for whatever reason, the way we grant certain advantages, whether it is the cult of the entrepreneur or the idolatry of the innovators, this type of ownership structure is granted as one of their options. At ICGN, we advocate against dual class share. We see the benefits and the disadvantages on both sides, but we see this is problematic, even though we are also seeing that the road with dual class shares continues to build in markets around the world. In our viewpoint on the tech sector, which looks at the economic, social and governance issues, we speak about those companies that have particularly strong market power or influence in their own

economic sphere of activity that may not be regulated and to compound this by increasing the degree of resilience or degree of protection that entrepreneurs might have from shareholders or other stakeholders is a concern that we have and so in the application of the tech sector, this could create a perfect storm, where this concentration of power may be acute and open to potential abuse. Also, the typical circuit breakers or the gatekeepers that might protect investors from this, which not only include investors own investment decisions, but also the role that regulators, stock exchanges, indices and information providers have to play in this debate of dual class as a potential issue of controversy and division within the finance community.

**Nandini Sukumar:** The members of ICGN constitute an incredibly important stakeholder for us as an industry. We represent stock exchanges around the world and our members have probably 55,000 companies listed who range widely. So we represent over 300 market infrastructures, in every corner of the world, we have not just the Colombo Stock Exchange and the Colombia Stock Exchange, but we have the Chicago Board Options Exchange and CME, or certainly we represent within our line all the largest stock exchanges in the world and the smallest. That is an important point to remember when we think about dual class. So, if you look at the way the stock exchange industry thinks about it, you will find it's actually quite similar to the way investors think about it. There is not necessarily a common or harmonized approach from a regulatory perspective, and this is important because the stock exchange is a regulated market, within the broader regulatory framework of the nation. It is an expression of the regulatory soul of a nation. So within that, you have a divergence of approaches. Some exchanges live in jurisdictions and nations where dual class is permitted and some where it is not. So, we have no commonality of approach, a bit like the investors.

For all our members, listing is important. The concept of the public market is important. We believe as an industry, that a company that is listed in a public market does have higher standards of disclosure. It is an evolution in governance of a company. Then if

you think about the broader ecosystem within which that sits, Exchanges have to balance three sacred responsibilities; 1) is the need to protect investors; 2) they need to maintain fair, efficient, and orderly markets, and 3) they must facilitate capital formation. It is important to speak of the three, because we speak of the three in unison. We cannot see one that is more important than the other, so you have to look at the three together.

The second point for this conversation is that Exchanges believe that they must find a way to bring companies to market, because if companies remain in the private market, there is no conversation that we would be having at all of this nature. So we have to find a mechanism. And the ‘We’ is the entire capital market ecosystem. It's not just the Exchange, it's multiple parties, including the regulator and the investor. We must find a way to encourage companies to list on Exchanges. If every company in the world listed on an Exchange, corporate governance would be better.

And finally, there is a profound difference in corporate governance of companies that are in private markets and those that are in public markets. So one of the questions or one of sort of solutions, when we think about how do we solve some of the issues that dual class specifically poses to corporate governance is to think about how we might address some of some of those challenges in the private market. How do we make corporate governance and private markets akin to those of companies in public markets? Because inherently then you take away some of the temptation for companies to remain indefinitely in private markets.

I want to briefly touch on something that we refer to in the industry as the paradox of stock exchanges; there is an excellent paper written by William Wright of New Financial who talks about the paradox of stock exchanges. The thesis is very simple, as markets over the last 50 years have grown bigger with more capital, fewer and fewer companies are listed, it seems like more companies are staying private. So if you look at it, if the value of stock markets in the UK and the US has risen more than six-fold in real terms

in the past 50 years and if you look at the value of trading in listed companies in the UK and US, it's increased more than 50 times in real terms. But the number of companies that are listed on stock exchanges in the UK and US has roughly halved over the same period. How do we change that?

**George Dallas:** Your point about bridging private companies into the public in a seamless way and how one does that is a good point. You made the point that being a listed company is a social good and I think we would agree with you on that. Trying to crack that is one of the challenges that we have, and I think you were very careful to say that there is not one doctrinaire view that dominates in your world, that it is a balance in achieving that balance.

**Sacha Sadan:** I do feel like I'm showing my age than we have in these debates again, because we've been here before and one statistically significant part is, it always happens near the top of a bull market. It does not happen in a bear market that we have these big debates about needing to float these wonderful kinds of companies on different and unique structures, but they're not unique. We've been here many, many times before, over 100 years, so this is not new. There is lots of academic evidence and some both ways, about Tech, that's where the debate is, but we shouldn't forget this is about protecting clients' assets. So, it won't just be Tech companies that might want some of these dual class shares. Of course, why wouldn't you want to have control and get someone else's money? So I understand but this is about financial regulations and protection.

Now, you can say some of institutional investors, we should know better. We can do that and we can value things. Well, lots of money is with retail investors, private investors and other investors and that's why there are things like financial regulations. They are there for a reason. This is not new.

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First of all, absolute power corrupts absolutely, that's 19th century, Lord Acton. Revered founders know all. What do they say, these people who understand Tech at the moment? Well, they might not understand Tech in a few years' time, and we have seen what happened with companies like Wework, that were about to float 50 billion and now supposedly being worth four billion within a few weeks later. As other statistical examples, five of the largest listed tech companies, Pinterest, Gift, Snap, Uber, Doordash, have the most stock compensation, compared to their sales, not even profits. An average of over 100%, 50% per annum of giving stock out. All of the stock they're giving out for the next five years are dual class shares. I can't do anything about that, because it's at 20 to 1 voting shares.

Secondly, regulators and asset owners are saying to us all the time, we want asset managers to be more active stewards. When there's a problem, we want you to vote and we want to analyse your voting records. Well, you want us to vote and then we don't have any votes, we can't balance those two things. We are talking about premium listing rules, where retail investors and pensioners put their money where they think that's there and they don't understand the difference between these different standard market listings in that. They want to buy the big premium indices; they trust doing that and they trust their asset managers to then look after their money on their behalf.

In the prospectus for the company Lift, the two co-founders have 20 times voting rights until they die. Then after one of the founder dies, the other founder keeps the shares until they die. Once both have died, it is given to a trustee for another 18 months. The founders are both 37 years old. How can that be for the right period of time? Academic evidence says we need checks and balances; we need independence on boards, we've done academic evidence on minority investors and board governance; Chairman and CEO split. Lift has the has control for 50 years. But it's not about just giving power to one person. There are many nuances to try and help promote stock market. If these investment banks want to promote new companies, why don't they take shares in these

companies over the long term? Why don't they own the shares in those companies rather than take cash immediately and just do the number of volume of IPOs?

**George Dallas:** You have a global perspective on this, but this issue is cropping up in the U.K. and I believe that in a standard listing can accommodate a dual class share structure. But the concern is really the premium listing and that seems to be linked to the index. I think an investment firm that has passive focus such as yours is just caught up with the index, or are you?

**Sacha Sadan:** The people who are selling their shares don't want to go on some of those other markets. Of course, the argument is you don't have to be in the index or another can buy another index. But the everyone wants to float on the major indexes, because they want the demand, and demand for that at the moment is high and that's where there is buying power. This is not what the investor wants, but what the issuer wants, but without the normal standards of due diligence or regulatory standards.

**George Dallas:** How does the debate over dual class shares affect the nature of the ratings that MSCI produces in corporate governance?

**Alan Brett:** When we look at our scoring model, which contributes to the ESG rating, we have what is called a key metric, which looks at whether there are dual class, or even multiple equity classes with unequal voting rights. We score this negatively in the model because of the elevated risks faced by minority shareholders. There's been a lot of debate about who should it be the regulators; should it be the index providers, should it be the asset owners and managers; should it be the stock exchanges?

I find myself asking two questions. Firstly, if we regulate against dual class shares, what will be the unintended consequences? We've already seen markets where they tried to do this. In 2009, India banned the use of dual class shares and if you look at the ownership structures in those markets now, a lot of the families and founders have

found another way to maintain the control. There is still that separation between their voting control and the capital entitlement. That imbalance is there through stock pyramids and is there using mechanisms such as cross shareholdings as part of their control structure.

It's useful check on what are we looking to achieve, because with all these Tech companies, will they just switch to a different mechanism if we regulate it against the dual class shares? We see in other markets some companies using other types of mechanisms. Naspers has historically had shareholdings as part of its control structure. Some of the European Markets have started to use allow the use of loyalty shares and Spotify is an example of a recent IPO where they have used loyalty shares.

Others have gone for a holding company structure. At Softbank in Japan, it's extended into more of a stock permit approach. With these stock permits, when we evaluate them, they can be just as detrimental or even in some cases a worst outcome for shareholders than the dual class might have been. So it's important to look at the consequences of making negative regulations against dual class shares.

Also, not all dual class shares are the same. Some of the structures within company ownership and control structures can be fairly benign. In Sweden, there's a company in the Tech sector, that has a dual class share, 10 vote class in a one vote class. It's a widely held company, the largest owner has just under 9% of the votes, so we do see cases where it's pretty benign. There's no real impact on the skew in terms of the control of the company.

Facebook is at the opposite end of the scale. It has its three share classes, 10-1-0 votes per share with one of the highest degrees of skew. When we compare it to the stock firm, the level of skew is about the same as a four-level stock pyramid, so it's at the extreme end. They've achieved this by having the balance of shares across the different classes, distributing those shares among the insider owner group, which has then led to

that very high degree of skew. It's important to look at each specific case and evaluate what is the impact on the control structure before automatically saying that this is a bad situation.

An example of terrible practice when looked at it from the point of view of investors, is JD.com. They have a dual class share, their a VIE identity, they're incorporated in the Cayman Islands and listed in the US and they've got regulatory arbitrage for the max. From a governance perspective, you need 33% of the votes to call an AGM and yet there's no such thing as an AGM in those companies. They don't call one, there's no requirement in the law. When you combine that with dual class shares, not only do you have no votes, but you've no ability to even ask questions at an AGM. So, in those sorts of situations you have to look at the impact of the structure in the round and understand what the impact is on you to and the shareholder. I'm certainly sympathetic to institutional investors being asked to vote, but if they have no votes, what can they do about it.

**George Dallas:** You might call the sadder but wiser view of the world in which if you abolish dual class shares people will figure out a way to work around them.

**Alan Brett:** If you look at the campaign for majority voting in the US, it may seem that investors won because more and more companies have majority vote standards. But if you look at the practicalities of it, the companies won because the nomination committees now effectively have a veto, because the elections have become a non-binding vote. So every time you legislate for something or seek could change something, it's important to look at what might be the other outcomes that you may end up with.

**Professor Marco Becht:** So first of all, the argument for allowing dual class is really quite simple. It says people should be free to contract investors and founders of families should be free to contract when they are allowed to do this in private markets, which we

know they do. VCs and private equity do that with founders, so why not extend that principle to public markets? As long as they disclose what the arrangements are and so as long as investors know they know what they're getting themselves into, why shouldn't the founder have the right to commit the company to pass on control to their children? In countries around the world, founders do want to pass on control to their children.

So then the question is, do people contract optimally and do these bargains lead to the maximum valuation and so forth? Even if this doesn't lead to the optimal in terms of shareholder value, bargain founders should still be able to commit the company to the purpose or the vision that they have. This is particularly relevant today when we talk about ESG and moving away from Friedman, because the founder could have the vision of putting the company onto the market and never using plastics, for example. We know that that is not value maximizing, but the founder wants the company to do that anyway, not just today, but for a very long time. The founder never wants the company to use plastics. Now, how can the founder guarantee this? Well, the founder needs to lock in control because otherwise the market for corporate control would come along and break that basic bargain. Now whether or not people buy into that company that is trading below market potential/value, that's really up to these investors.

Investors point out two problems with this structure. The first problem is that people have imperfect ability to process information. You can call this bounded rationality. For example, retail investors don't really know exactly what they're getting themselves into and they don't read prospectuses. Listing segments are supposed to solve that problem. Now, that then leads to the exchanges. And I have to ask the questions, are we labelling the listing segments in the right way? Should we not have, for example, a segment for family firms versus one share/one vote firms that are open to the market for corporate control? Should we in the U.S. not have a separate segment for SPAX, which are really a very different thing to the companies we are talking about? So it really then depends on what people think the distinguishing characteristics of the segments are. Sacha clearly gave a view of what he thinks should be in the premium segment and if

you take that view, Lord Hill suggestions are really unhelpful because Sacha's definition of 'premium' is not what Lord Hill is now made the premium market to be. So that contaminates that segment and it becomes unhelpful in that sense.

The principle is the same segments are helpful if they're provide information, sorting things for people who don't know. Indices are similar, except here we have a problem that people, although they don't like certain structures, they don't have a choice like an active investor not to buy into this because the index forces them to do that. Now, that assumes that they can't choose between indices for the reasons that Sacha implied. But that's a bit of a challenge for index producers, because in which world do we live? Do we have to use a golf club equivalent? Do you buy your golf clubs off the shelf or are we moving to a world of custom-made even for retail investors? Should you not be able to click together your index on your smart app, on your Robinhood Smart app, which people seem to be able to use now? That's for retail investors, I would assume that LGIM and other institutional investors are sophisticated, so you can choose the index you want to track and for ESG you are already doing this; you're screening out companies you don't like on E, you're screening out companies you don't like on S. Why can you not screen out the dual class?

**Sacha Sadan:** An asset manager, we give the service that the client wants and the problem is 97% of our clients still want to buy the one the consultants or the trustees said that everyone else buys. In academia, people who want to go to certain universities, there are other universities are doing a fantastic job with some amazing courses that are more innovative, but everyone wants to go to particular ones. There is more supply and demand and that's why we see the conflicts that the banks have. I understand this could be the high growth segment or a special segment. But I want to get hold of the access to all of the market and all of the flow of capital. But I also want to have control at the same time. You also have founders that say, "I believe oil is still the best thing. I've made oil for 50 years" but in 30 years, it won't be and maybe we need a

new management team, but I can't move that management team because the founder is entrenched, and entrenched management teams can be part of a problem.

**George Dallas:** The issue is raised on whether some of the risks or may be fairly or unfairly labelled in markets, and maybe the point being if it's fairly labelled, all buyers should be warned. Is it a concern that you have or your constituents' members, but particularly the ones that may not be offering to acquire shares that that potentially those that do may be wittingly or unwittingly offering investors in the market who aren't customers of the exchanges? Investors are more stakeholders in this debate, we often approach this debate as a shareholder, but here we are effectively a stakeholder because we're buying what's on offer, but it's on offer under certain categorizations or labelling. How much of this how much of this issue do you see as a question of labelling and giving potential investors the right information?

**Nandini Sukumar:** So I would say that good corporate disclosure is the lifeblood of markets. In a public market that's part of the mandate. The second thing is that education, financial literacy, investor education, the stuff that needs to happen around retail is a lifetime's task. You must have good clear disclosure and this will help some of these problems and concerns that you have identified. It's hard to say if it will solve the problems because the retail investor, is going to the investor saying, "this is what I want because everyone is". Tesla is the one that everyone talks about because many retail investors want to buy Tesla and it's more of a motive. It's more motive purchase as opposed to buying a high dividend stock. There are the two complexities, but you must have disclosure. Will that always work? I don't think so. I don't know what we can do beyond having good disclosure. Do you have a solution?

**Sacha Sadan:** Who is going to disagree with good disclosure? Take this example: we have we have a new company, it does a prospectus. It comes in 20 to one voting sheet. What you didn't know was three years after they come in, they said we're going to give

another 100 percent of the value of the company to the founders if they hit certain targets. Do you agree? We've only got five percent of the company. So you have the disclosure. You now know they want to do this, but you can't do anything about it. And it's now in the public market. Yes, you can sell, but someone will have to buy because it's in the market.

Doordash is now issuing 420 million dollars of stock to the founder who already owns most of it or the voting rights and they disclosure this. It said it will be eligible to vote based on achievement of certain stock price goals. But we recognize the stock-based compensation over the requisite period, regardless of whether the stock price goals are achieved. I can't do anything about it. It's in the index. I see the disclosure, but I can't vote or do an AGM. Disclosure is good but is not everything.

**George Dallas:** If the UK goes in this direction of endorsing dual class shares, there's a potential issue that it's almost a signalling device to other markets around the world is this sort of makes it OK for emerging markets to start to adapt to dual class structures more robustly, saying if it's OK for London or Silicon Valley, what are we doing by not endorsing this? Do you take this contextual issue into consideration when you're looking at the potential influence of this type of share structure and some of the smaller and still developing markets?

**Nandini Sukumar:** Big listings markets are, American, Hong Kong, Singapore and London. On the one hand, investors are being told to be responsible by voting, the exchange is being told you must compete and listing is competitive. These are regulated public markets. So the exchange will do within the context of law and order. They must encourage listing, because if you don't have listing, we don't have anything. If you look across the world, there are many markets. There are emerging markets and typically family run businesses and state-run enterprises, constitute the largest pipeline of IPOs in many emerging markets, where the state where the nation is developing and as a consequence, step by step, state run enterprises are coming into the market.

We did a paper a couple of years ago with the WFP where we pulled a group of issuers that were private family run companies and we asked why are you not prepared to step from the private market into the public market? You can finance for cheaper, better disclosure, greater transparency, the corporate governance benefits that public markets bring. It was a homogenous response, we're concerned about giving up control. How do you align the incentives, so it is not attractive to remain in private markets? The USP of the public market is to have better corporate governance. So how do we make it less attractive to stay in private markets, where you don't have to surrender control and make disclosures?

As a community, we spend time talking about public markets and how to fix them, but part of the answer is we need to fix what's happening in private markets. We need to we need to narrow that spread. If you put you said to all private companies, you have to be you have to have the same disclosure requirements that companies and public markets have, you would have an immediate improvement in disclosure but suddenly companies would be saying in the private market it's not so difficult to have quarterly earnings and to disclose information. What can we do as a capital market community to together make that a better process.

**Professor Marco Becht:** The dilemma or the problem of index funds when investors are faced with a situation where they're confronted with a controlling owner and they don't like what the controlling owner does, be it dual class or not dual class, and we know that most listed companies in the world still have a controlling owner. So it's not an uncommon problem and it's essentially a problem of voice versus exit, because for the reasons that you mentioned, voice doesn't work. So the only thing you have is exit. But of course, as an index fund, normally you don't have exit. Now, this could be G, this could be S could be E. The broader question this raises is how do we think about exiting these situations? If you're an index fund, should index funds have the right when they're faced with situations, which they think are really egregious they can actually exit and

divest from those companies? If you have a situation like the one described, maybe that's what you should have. We can talk about the retail clients, what do you tell them? Should they really be giving you a mandate. What product should you be selling them? For institutional clients? For pension funds? I have I have less understanding because when you get a mandate from pension fund trustees, you can explain this to them and you can say, I need to have the power to exit when I'm not getting where I want to be in any other way.

**George Dallas:** We really haven't talked about mitigants and one of the most often talked about is featuring sunset provisions. Alan, talking in your methodology when you do your governance assessments, you made the point that you score against a company because of the risks of these structures in place. Is that structure offset? Is that rating in some ways improved to the extent that a sunset provision might be in place?

**Alan Brett:** We when we last looked at our universe and looked at how many companies actually had a sunset, it was 2. I think there's a few more now maybe than there was 18 months ago / two years ago, but it made it really difficult to come up with something in terms of the model, but it's something we continue to keep under review. If you look at some of the published lists of who has sunset provisions, they're starting to get a little bit longer. So it may be something that's more viable for us to look at in the future.

**Sacha Sadan:** This is not just about particularly about index positions, it's about active fund managers not wanting to take that. We've been told everywhere that we should be staying in the tent and influencing, which I think is the best way. On systemic risk, let’s focus on plastic. If we want to change something like plastic, you have to engage with plastic providers and help them to transition, we did that with coal, but you can't influence if you haven't got any votes. Everyone leaving the table doesn't change anything, it leaves people to do whatever they want.

On sunset provisions, have it over a period of time, not 50 years, that's too long. Secondly do things by allowing minority shareholders to have a vote at the AGM on something so that you can make a voice. Don't put them in the premium index if they are dual class, wait till they do the sunset, but that's a bit more draconian.

**Professor Marco Becht:** If the founder is there in order to have long term control or even pass it on to the children, sunsets defeat the purpose. So I don't see why founders would ever want a sunset if they have that mindset and if they do accept a sunset after five or six years, well you wonder what the dual class is all about.

**Nandini Sukumar:** I would to talk about appropriate structures that align the incentives properly. So on the one hand, if we accept that, we need to bring companies to market and on the other hand, we do want to have the best possible corporate governance, why don't we as an industry collectively engage on what could be appropriate incentive structures that would align this journey best?

**Alan Brett:** MSCI was here at the time that we supported one share one vote principle and this was overwhelmingly accepted by our index clients. But when it came to changing the index, there was a significant degree of opposition because a lot of clients use it to benchmark their performance, and they wanted that benchmark to have the full opportunity set available to them so that they could track whether or not they were outperforming the market for their custom index or whatever was their asset allocation policy. So it was a little bit of a dilemma and I think that the best alternative devised, was to have an alternative Index and it goes back to this, do you need a custom index, but it stands off the shelf options available to even for exclusion of dual class?

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