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Should securities regulators allow companies going public with dual-class shares?

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In the past years, several companies, such as Google, Linkedin, Facebook, and Alibaba, went public with dual-class share structures, that is, share structures that typically include two classes of ordinary shares carrying unequal voting rights. Those shares with more voting rights (eg, 'class A' shares) are usually held by the company´s founders and executives, while the rest of the company´s share capital, formed by stock with regular voting rights (eg, 'class B' shares), is generally sold to outside investors.

These structures have been very controversial. Whereas some countries such as the United States, Canada, Sweden, Denmark and the Netherlands have allowed the use of dual-class shares, other jurisdictions such as the United Kingdom, Singapore or Hong Kong have prohibited or strongly discouraged companies from going public with dual-class shares structures.

However, factors mainly associated with regulatory competition and the desire to attract IPOs have reopened the debate about the possibility of allowing companies to go public with dual class-shares. For this reason, some jurisdictions traditionally reluctant to allow the use of this legal device (such as Hong Kong, which rejected Alibaba´s request to go public with dual-class shares), are reconsidering their positions on this issue.

There are several arguments supporting the use of dual class shares. First, by allowing companies to go public with dual-class shares, a securities regulator may make a capital market more attractive to the company´s founders. Therefore, the use of dual-class shares may attract IPOs, especially in jurisdictions with many family businesses, since the fear of losing control is likely more intensive in family-owned firms as a result of several factors (eg, profits and private benefits of control for the entire family, emotions, etc.).

Second, the use of dual class shares is an easy and affordable way to allow founders to pursue their 'idiosyncratic vision' – that is, their projects or ideas. And when the founder´s vision is value-creating, it can be in everybody´s interest to let them manage the corporation.

Third, market forces incentivize founders to choose efficient corporate governance structures at the IPO-stage. Therefore, if founders and controlling shareholders do not want to be punished by the market, they will only go public with dual-class shares when the gains associated with their particular expertise can exceed the potential costs associated with these shares structures.

Finally, if a country allows the separation of cash-flow rights and control rights through other legal devices (such as preferred shares, stock pyramids and cross-ownership structures), why should dual-class shares be prohibited when they fulfil a similar goal?

Despite this optimistic view of the use of dual-class shares, several arguments seem to suggest an opposite conclusion. First, the existence of dual-class shares may increase agency costs between insiders (ie, directors and controlling shareholders) and outsiders (mainly minority investors). On the one hand, these legal devices allow managers to be isolated from the market for corporate control. Therefore, this circumstance may not only reduce the managers' performance, but it will prevent a potential new acquirer with a superior business plan taking over the company – unless a 'breakthrough rule' is implemented, in which case the company´s insiders would not be able to use their weighted voting rights to fight a hostile acquisition. On the other hand, the existence of dual-class shares may allow controlling shareholders to keep extracting private benefits of control regardless of the value added to the corporation as a whole.

Second, while allowing companies to go public with dual-class shares may sound appealing for attracting founders and IPOs, it may end up harming the market if minority investors are not properly protected or if these shares structures are permitted simply in response to the request of a particular company. Indeed, if minority investors are not adequately protected, they may end up leaving the market, which can be harmful not only for a country/stock exchange itself, but also for firms and founders – since it will make it more difficult for them to raise capital. Likewise, if a regulation is amended just to attract a particular company (as the United Kingdom was considering with Saudi Aramco, or Alibaba probably expected from Hong Kong), the reputation, credibility and independence of the regulator can be questioned by investors. So it can also be harmful in the long-run.

Third, the use of dual-class shares structures may create moral hazard due to the fact that, while founders will fully enjoy the private benefits of control, they will not fully internalize the costs associated with value-destroying decisions.

Fourth, according to the efficient capital markets hypothesis, prices reflect all publicly available information. Whereas this hypothesis remains controversial in the United States, it becomes weaker in countries with less developed capital markets with fewer or less sophisticated players. In other words, in these countries, the ability of the market to price information might not be as good as it is in the United States. Therefore, the market might not price the "desirability" of dual-class shares accurately.

Finally, even if the founders' idiosyncratic vision may be value-creating at an early (or even medium-term) stage of the firm, this vision could become obsolete or value-destroying at some point in the future. So the benefits of allowing companies to go public with dual-class shares are far from clear.

In my opinion, the desirability of using dual-class shares may differ across companies and countries. However, there are several factors that may affect the desirability of this legal device. For this reason, securities regulators should take into account these factors when deciding whether or not to allow companies to go public with dual-class shares.

First, the type of market players generally existing in a particular jurisdiction can be relevant factors when considering the desirability of dual-class shares. In a country with more sophisticated investors (for instance, due to the presence of institutional investors), analysts, proxy advisors, and advisors, the implementation of dual-class share structures will be less risky. In these countries, markets will punish value-destroying founders going public with dual-class shares. As a result, founders will have incentives to go public with dual class-shares only when they really think they can create value for the shareholders as a whole. By contrast, in less sophisticated markets, the use of dual-class shares can be risker for investors, due to the inability of the market to effectively punish value-destroying founders going public with dual-class shares.

Second, securities regulators should also consider how outside investors are protected in a particular jurisdiction. The more protected minority investors are (eg, through a system of enhanced independent directors, control of related party transactions, class actions, etc), the less risky it will be to allow dual-class share structures.

Third, it may also be relevant to take into account the level of private benefits of control existing in a particular jurisdiction. Namely, in jurisdictions with large private benefits of control (as exist in countries such as South Korea, Mexico, Italy, or Brazil), it may be riskier to allow companies to go public with dual-class shares, since the controller will be in a better position to extract value from minority investors. By contrast, in countries with lower private benefits of control (as occurs in Northern Europe and the United States, where the use of dual-class shares is allowed, this risk of (higher) expropriation will be lower.

In addition to taking into account the aforementioned factors, a country considering the implementation of dual class-shares should also impose some limitations. Namely, as it has been suggested in a very interesting paper recently published by Bebchuk and Kastiel, regulators may impose ‘sunset clauses’ that may depend on certain events (eg, the founder´s death) or a specified period of time (eg, 5-10 years). So, after this trigger event occurs, the dual-class share structures will disappear, unless a majority of the minority shareholders decide otherwise.

Second, in countries with less sophisticated capital markets, an additional regulatory intervention may also seem desirable. Namely, in these countries I would suggest implementing a system by which companies should be required to submit a request to the supervisor stating their reasons for going public with dual-class shares. Then, the supervisor would make a decision based on the particular features of the corporation, its business model, the founders/managers´ expertise, and the potential risks associated with dual-class share structures (especially in terms of investor protection). Even though supervisors might sometimes fail in their judgment (allowing companies to go public with dual-class shares when they shouldn´t and the other way around), the potential gains associated with this measure will likely exceed its costs, especially in countries with an independent and qualified supervisory body.

In my opinion, through this regulatory model, many countries with unsophisticated capital markets may end up having what happens in the United States, where market forces encourage more efficient outcomes: in practice, most companies going public with dual-class share structures are tech companies and other firms in which the founder´s ideas and expertise can create value for the shareholders as a whole.

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