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Differentiated Voting Rights Arrangement under Dual-Class Share Structures in China: Expectation, Reality and Future

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Abstract

Following other leading financial centres in Asia, China also recently relaxes restrictions on one share – one vote and starts to allow companies with differentiated voting rights (“DVR”) arrangement under dual-class share (“DCS”) structures to list on its newly established Sci-Tech innovation board, also known as Star Market. The DVR arraignment and DCS structures sever insiders’ control from their equity shareholdings in the company, as their voting rights can be disproportionately greater than their cash flow rights. The move primarily aims to provide more flexible capital structures to support a sustainable development of high-tech and innovative companies and to increase stock exchanges’ competitiveness in attracting/retaining companies that prefer going public with DCS structures. However, the reality deviates from scholars and policymakers’ expectation as only one company applies for and gets listed with a DCS structure since the official permission of such share structures in March 2019. Rather than simply looking into the evolution of and debate over DCS structures, this paper examines underlying reasons for the discrepancy between the expectation and reality of China’s implementation of DCS structures. Moreover, this paper also critically discusses the role and future of DCS structures in the Chinese context.

Keywords

Capital market; dual-class shares (DCS); differentiated voting rights (DVR); special voting share; Star Market; UCloud

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I. Introduction

On 13 June 2019, China's Sci-Tech innovation board, a Nasdaq-style board, is officially launched as an addition to the Main board in Shanghai Stock Exchange, to better support the development of innovative firms in science and technology sectors by providing a more flexible capital market. Among many changes, the revised listing rules allow listing applicants to adopt differentiated voting rights ("DVR") arrangement. According to the *Rules Governing the Listing of Stocks on the Science and Technology Innovation Board of Shanghai Stock Exchange*, DVR arrangement is defined as a mechanism whereby a listing applicant makes an offering of shares with special voting rights in addition to ordinary voting shares.¹ Except that each special voting share has more voting rights than each ordinary voting share, holders of special voting shares shall have the same rights as those of ordinary voting shares.² Hence, the DVR arrangement is essentially based on dual-class share ("DCS") structures where issued share capital typically includes two classes of ordinary shares carrying unequal voting rights at shareholder general meetings.³ The DVR arrangement based on DCS structures offers a group of shareholders, normally founders and entrepreneurial managers as corporate insiders, certain share classes with special voting rights. Different from the one share – one vote ("OSOV") principle, the special voting rights enable these insiders to retain their control of the firm that is disproportionate to their equity shareholdings through decoupling their voting rights from cash flow rights.

This move is welcomed by domestic scholars in Mainland China and seen as a positive development to improve the competitiveness of Shanghai Stock Exchange and the width of capital markets.⁴ The change is however far-reaching and worth much further investigation, especially considering the traditional stance of Chinese company laws on shareholder voting. While separation of voting rights from cash flow rights may protect visionary entrepreneurs/founders from undue influence of short-term investors, such insulation would also potentially increase corporate governance risks. In other words, we should not only focus on the upsides of DCS structures, but also potentially deteriorated managerial entrenchment and agency costs caused by the separation of control and ownership.

¹ *Rules Governing the Listing of Stocks on the Science and Technology Innovation Board of Shanghai Stock Exchange (Revised in April 2019)*, art. 2.1.4.

² *Ibid.*

³ For example, the newly revised *Listing Rules of Singapore Stock Exchange* defines DCS structure as a share structure that gives certain shareholders voting rights disproportionate to their shareholding. Shares in one class carry one vote, while shares in another class carry multiple votes.

⁴ Qiong Fu & Hegzhi Wei, 'Differences in Voting Rights and Governance of the "SSE Star Market" (表決權差異安排與科創板治理)' (2019) 41 *Modern Law Science* 91, 91; Meng Yang, 'The New Economy Needs to Accommodate Dual-Class Share Structure (新經濟需包容雙重股權結構)' [2018] 2 *Securities Market Herald* 1, 1.

Therefore, it is important to examine whether there are adequate means under new listing rules in checking these increased governance risks. Hong Kong and Singapore's recent reforms in permitting initial public offerings ("IPOs") with DCS structures provide good opportunity for us to evaluate and compare the listing regime in Mainland China.⁵ Following the stock exchanges in Hong Kong and Singapore, Shanghai Stock Exchange also imposes stringent safeguarding measures in order to neutralise potentially exacerbated agency problems associated with DCS structures.

Ironically, since the establishment of the Sci-Tech innovation board, also known as Star Market or Star Board,⁶ there is so far only one listing application for DCS IPO as of 1 July 2020.⁷ Such reality largely deviates from academics' prediction and policymakers' mania for DVR arrangements and DCS structures. Flexible capital structures, potential gain from entrepreneurs' idiosyncratic visions and long-term focus brought by DVR arrangements do not stimulate a wave of DCS IPOs as expected. The stringent regime of mandatory measures including admission criteria, disclosure requirements, constraints on the exercising of special voting rights and alike may have direct effects on the popularity of DCS listing in the Sar Market. In order to have a thorough understanding of the discrepancy between the expectation and the reality of DCS structures in China, especially the impact of the safeguarding measures designed to protect holders of inferior voting shares, this paper is going to closely examine UCloud Technology Co., Ltd., the only DCS company out of the 117 newly listed companies on the new board so far. This is followed by a critical analysis of the future of DCS structures in China. Beyond a listing perspective, the potential role of DCS structures in transforming China's concentrated ownership structure is also investigated.

The remainder of the paper is organized as follows. Section II discusses the shareholder voting in China and examines its development from single-class share to DCS structures. Section III investigates both advantages and disadvantages of DCS structures to provide a more balanced picture of such share structures. Section IV then critically analyses the

⁵ Hong Kong, Singapore and Shanghai are ranked as Top 5 global financial centers (just behind New York and London) according to the latest *Global Financial Centres Index* ("GFCI 26"), a widely quoted source for ranking financial centres. Mark Yeandle & Mike Wardle, *Global Financial Centres Index 26* (September 2019) at 4, <https://www.longfinance.net/media/documents/GFCI_26_Report_v1.0.pdf>. Another three Asian financial centers Tokyo, Beijing, Shenzhen are ranked 6, 7 and 9 respectively. Ibid.

⁶ The word 'STAR' selects S from 's'cience, T from 't'echnology, A from innov'a'tion and R from boa'r'd.

⁷ This is far less than the case in the United States. For example, there are 25 out of 134 newly listed companies in 2018 and 16 out of 110 newly listed companies in 2019 adopted DCS structures. See Jay R. Ritter, *Initial Public Offerings: Updated Statistics* (December 2019) <https://site.warrington.ufl.edu/ritter/files/2020/01/IPOs2019Statistics_December-24_2019.pdf>. Council of Institutional Investors (CII), 'Dual Class Companies List' (March 2020) <[https://www.cii.org/files/FINAL%20format%20Dual%20Class%20List%203-16-20\(1\).pdf](https://www.cii.org/files/FINAL%20format%20Dual%20Class%20List%203-16-20(1).pdf)>.

mandatory safeguards that aim to control the increased governance risks associated with DCS structures. In particular, the approaches adopted by Shanghai Stock Exchange would be critically examined, compared with the experience from other jurisdictions. In order to seek for reasons why the demand for DCS structures in real business world deviates from scholars and policymakers' expectation in China, and better understand how a stringent regime of mandatory safeguards affect DCS listing applicants, Section V conducts a case study of the only company that adopts DCS listing. This is followed by a discussion of the role and future of DVR arrangements and DCS structures in China in Section VI. Finally, Section VII provides the concluding remarks.

II. Transformation from Single-Class Shares to Dual-Class Shares

One share – one vote (“OSOV”) rule, which is regarded as a bedrock principle of corporate voting in the West,⁸ is also an enshrined law in China, the second largest economy in the world. Since the first Chinese Company Law promulgated in 1993, it has been clearly stipulated that every share has one vote at shareholder general meeting.⁹ This clause remains largely unchanged in the subsequent company law amendments. For instance, the latest Chinese Company Law 2013 mandates that shareholders present at a general meeting shall be entitled to one vote for each share held.¹⁰

This is not surprising. Similar to the mainstream economic justification for OSOV in the West,¹¹ the residual proprietary rights of shareholder are also used to justify the proportionate voting principle in China, that is granting shareholders voting rights commensurate with their shares of residual gains and losses.¹² In order to control agency costs, each element of the residual proprietary interest is supposed to carry an equal voting right on the ground that shareholders would be affected as residual proprietary claimants is in proportion to their economic stakes in company. The proportionate voting principle under OSOV rule endeavours to match and align shareholders' voting power with their residual proprietary claims, and shareholders are thereby expected to be appropriately incentivized

⁸ For example, see Frank H. Easterbrook & Daniel R. Fischel, ‘Voting in Corporate Law’ (1983) 26 *Journal of Law & Economics* 395, 409.

⁹ *Chinese Company Law 1993*, art. 106.

¹⁰ *Chinese Company Law 2013*, art. 103.

¹¹ Easterbrook & Fischel (n 8).

¹² Ciyun Zhu & Zhaohui Shen, ‘Classified Shares and the Evolution of Chinese Corporate Law (類別股與中國公司法的演進)’ [2019] 9 *Social Science in China* 147, 153.

into choosing, and wholeheartedly supporting, optimal decision-making for the success of the company.¹³

Before considering the evolution of shareholder voting in China, it must be recognized that there are two types of company forms under Chinese company laws, namely limited liability company (“LLC”) and joint stock limited company (“JSLC”).¹⁴ As there is no shareholding in LLC, shareholder voting at general meetings is based on the proportion of their capital contribution, which is not materially different from the proportionate voting principle under the OSOV rule.¹⁵ Compared with JSLC, LLC is normally much smaller and not appropriate for large businesses as it cannot raise capital from the general public. Accordingly, there are less restrictions on the voting arrangements for LLC, leaving more flexible room. This is reflected by the second half of article 42 of Chinese Company Law 2013, which provides an exception to the default position of OSOV if the company’s articles of association stipulate different voting rules. That is to say, if an LLC provides disproportionate voting rules in its company’s constitution,¹⁶ shareholders’ voting rights can be disproportionate to their cash flow rights in the company and differentiated voting rights may then be arranged.

However, JSLC which is extensively adopted by large businesses does not have the same flexibility. Especially for those companies that intend to raise capital from the general public or via stock exchanges, OSOV restrictions would hardly be avoided. The prior-2019 listing regime in China also clearly prohibits companies from going public with a DCS structure or offering DVR arrangement. Such OSOV restrictions forced Alibaba, Baidu, Tencent, Xiaomi and other Chinese technology giants to choose IPO in the United States (“U.S.”) or lately in Hong Kong to adopt a DCS structure.

In order to support a sustainable development of high-tech and innovative companies and retain them in the domestic capital markets, it turns out to be essential to allow more flexible capital structures. Meanwhile, lucrative IPO fees incurred during the listing to bankers, lawyers and other professionals are difficult to resist either. Take Alibaba’s IPO in the U.S. in 2014 for example, Alibaba handed out more than US\$300 million to investment

¹³ Shareholder democracy is also utilized to justify the OSOV rule in China. Ibid, 154. As already well established elsewhere, the shareholder democracy argument for OSOV is untenable, so this article would not discuss this point. For example, see Min Yan, ‘A Control-Accountability Analysis of Dual-Class Share (DCS) Structures’ (2020) 46 *Delaware Journal of Corporate Law* (forthcoming).

¹⁴ The liability of a shareholder in LLC is limited to the extent of their capital contributions, while the liability of a shareholder in JSLC is limited to the extent of the shares subscribed by them. *Chinese Company Law 2013*, art. 3.

¹⁵ For example, if a shareholder contributed 10% of capital to a company, then her voting would be weighed at 10% of all votes. *Chinese Company Law 2013*, art. 42.

¹⁶ This is essentially same as allowing different classes of shares with differentiated voting rights.

banks involved,¹⁷ and US\$15.8 million to lawyers.¹⁸ Alibaba's enormous trading volume also contributes huge fees to the New York Stock Exchange ("NYSE"). Besides these fees, stock exchanges are well motivated to make their capital markets more attractive for corporate founders and to host some of the most sought-after companies like Google, Facebook, Alibaba which all preferred going public with DCS structures. So, in addition to adapt to the ever-changing market and provide more flexible capital structures, relaxing OSOV restrictions arises out of the peer pressure from competing stock exchanges as well. The "catch-up" game in Mainland China is fuelled by Hong Kong Stock Exchange ("HKEx") and Singapore Stock Exchange ("SGX"), both of which altered their listing rules in 2018 to accommodate DCS IPOs, an effort to attract technology and new economy companies from Mainland China to list.¹⁹ In order to retain those companies to list domestically, China also eases its OSOV restrictions and permits DCS IPOs by creating a Sci-Tech innovation board, also known as Star Market, in the Shanghai Stock Exchange ("SSE").

In March 2019, the *Rules Governing the Listing of Stocks on the Science and Technology Innovation Board of Shanghai Stock Exchange* (hereafter "*SSE Star Market Listing Rules*") allow eligible listing applicants to have DVR arrangement.²⁰ Though the law on OSOV restrictions remains unchanged, the new listing rules justify the circumventing by referring to article 131 of Chinese Company Law 2013, which provides that the State Council may formulate separate regulations for issuance of shares of types other than those provided for in the Company Law. In other words, the exception created by article 131 is used by the listing rules to justify the permission of a class of shares with special voting rights that disproportionate to their economic stakes in company.

In the *Opinions of the State Council on Promoting the High-Quality Development of Innovation and Entrepreneurship and Creating an Upgraded Version of Entrepreneurship*

¹⁷ See 'Trefis Team, Alibaba Hands Out Generous Fees to Investment Banks Involved in Its IPO' *Forbes* (1 October 2019) <<https://www.forbes.com/sites/greatspeculations/2014/10/01/alibaba-hands-out-generous-fees-to-investment-banks-involved-in-its-ipo/#5819bb56e936>>.

¹⁸ See Natalie Stanton, 'Why Alibaba's switch to a New York listing left Freshfields out in the cold' *The Lawyer* (23 September 2014) <<https://www.thelawyer.com/issues/online-september-2014/why-alibabas-switch-to-a-new-york-listing-left-freshfields-out-in-the-cold/>>.

¹⁹ In fact, other top financial hubs in Asia are also motivated by the market competition. For example, in Hong Kong, the Chairman of the Securities and Futures Commission said: "[allow companies with DCS structures to list in Hong Kong] is a competition issue. It is not just the U.S. — the U.K. and Singapore also want to attract technology and new economy companies to list. Hong Kong needs to play catch up." Enoch Yiu, 'Securities Commission Backs Introduction of Dual-Class Shares on Hong Kong Stock Exchange' *South China Morning Post* (20 December 2017) <<https://www.scmp.com/business/companies/article/2124972/securities-commission-backs-introduction-dual-class-shares-hong>>.

²⁰ *SSE Star Market Listing Rules*, art. 2.1.4 stipulates: "For the purpose of these Rules, the DVR arrangement means a mechanism whereby an issuer makes an offering of shares with special voting rights in accordance with article 131 of the Chinese Company Law, in addition to ordinary shares as generally provided for thereunder. Except that each special voting share has more voting rights than each ordinary share, the shareholders of special voting shares shall have the same rights as those of ordinary shares".

and Innovation among all the People (hereafter “*State Council Opinion*”),²¹ the State Council explicitly permits DCS structures. Accordingly, in January 2019, China Securities and Regulatory Commission (“CSRC”), the national watchdog of stock exchanges, allows high technology and innovative companies to get listed on the Star Market to adopt a DVR arrangement under DCS structures.²² This CSRC policy is then subsumed by the *SSE Star Market Listing Rules* in March 2019.

Although article 103 of Chinese Company Law 2013, which mandates one vote per share for JSLC, remains in effect, the above changes lead to a *de facto* acknowledgment of DVR arrangement under DCS structures within the existing corporate law framework in China. Of course, the potential conflict between article 103 and article 131 is problematic. It would be reasonable to foresee such clash can only be settled by an amendment of the wordings of article 103 on OSOV restriction.²³ However, the existing vagueness may not stop people concluding that, after the above *State Council Opinion*, JSLCs are now able to deviate from OSOV and separate voting rights from cash flow rights contained in shares. For listed companies, in addition to the ordinary shares with standard voting rights (*i.e.*, one vote per share), shareholders with special voting shares can have weighted voting power though their other rights remain same as those with non-special voting shares.²⁴ In a nutshell, despite obscure compared with other Asian jurisdictions that recently approved DCS structures, DCS IPOs are now explicitly permitted under the *SSE Star Market Listing Rules*.

III. Debate over Dual-Class Share Structures

Not solely in China, the recent wave of high-profile DCS IPOs of high-tech companies in the U.S. and the rising popularity of DCS structures in other leading financial centres in Asia also bring back the spotlight on the debate of such share structures. Proponents praise that the separation of control rights from cash flow rights protects visionary entrepreneurs/founders from undue influence of short-term investors and markets and thereby gives them the freedom to pursue and implement their idiosyncratic business ideas.²⁵ Even when a controlling shareholder’s ownership stake and thereby cash flow rights

²¹ No. 32 [2018] of the State Council.

²² CSRC, *Implementation Opinions on Setting up the Science and Technology Innovation Board and Launching the Pilot Program of the Registration System on the Shanghai Stock Exchange* (Announcement No. 2 [2019] of CSRC).

²³ Article 131 currently says shareholders present at a general meeting shall be entitled to one vote for each share held. However, it can be altered to accommodate DVR arrangement under DCS structures by adding “unless otherwise stipulated in the articles of association of the company” as we observe in article 42 of *Chinese Company Law 2013*.

²⁴ *SSE Star Market Listing Rules*, art. 2.1.4.

²⁵ Zohar Goshen & Assaf Hamdani, ‘Corporate Control and Idiosyncratic Vision’ (2016) 125 *Yale Law Journal* 560, 577.

fall below 50 percent, she can still retain the control via the special voting rights contained in her special voting shares. The degree of control retained by insiders with special voting shares help them to be insulated from external markets. For example, Larry Page and Sergey Brin, founders of Google (now Alphabet) defended the offering of DCS structure in their Registration Statement with the U.S. Securities and Exchange Commission, saying *outside pressures too often tempt companies to sacrifice long-term opportunities to meet quarterly market expectations. Sometimes this pressure has caused companies to manipulate financial results in order to “make their quarter”*.²⁶ The insulation from disciplinary forces of the market for corporate control, *inter alia* takeover threats, is therefore seen beneficial for long-term corporate performance. Such insulation together with the differentiated voting power inherent in DCS structures will also lower costs of retaining control while diversifying risks.²⁷

Further, due to the collective action problems and rational apathy, most shareholders would prefer not to exercise their voting rights but choose to free ride on other investors' action.²⁸ And when they do vote, their lack of information, coupled with “principal conflict costs” such as pro-management bias and self-serving conduct, make their votes unlikely value-enhancing.²⁹ In China, apathetic minority shareholders are more prevalent due to the highly concentrated ownership structure,³⁰ which means they are much keener on capital gains and dividends rather than voting rights attached to their shares. These weakly motivated voters lack both firm-specific information and incentive to devote appropriate resources in informed voting. Empirical research has shown that the mean of general meeting attendance rate for shareholders with less than 5 percent of shares is 4.797 percent compared to 46.868 percent for shareholders with more than 5 percent of shares.³¹ Statistics also showed that more than 90 percent of shares held by minority shareholders do not participate

It is argued that “entrepreneurs value corporate control because it allows them to pursue their vision or say “business strategies that they believe will produce above-market returns by securing the ability to implement their vision in the manner they see fit.” Ibid, 565.

²⁶ Google Inc., *Registration Statement (Form S-1) No.333 (29 April 2004)* <<https://www.sec.gov/Archives/edgar/data/1288776/000119312504073639/ds1.htm>>.

²⁷ That is to say DCS structures allow insiders to obtain the benefits of outside equity financing while still retaining control over the corporation. Daniel R. Fischel, ‘Organized Exchanges and the Regulation of Dual Class Stocks’ (1987) 54 *University of Chicago Law Review* 119, 139-140.

²⁸ Dorothy S. Lund, ‘Nonvoting Shares and Efficient Corporate Governance’ (2019) 71 *Stanford Law Review* 687, 696.

²⁹ Ibid.

³⁰ Roman Tomasic & Jane Fu, ‘Legal Regulation and Corporate Governance in China’s Top 100 Listed Companies’ (2006) 27 *Company Lawyer* 278, 282; Min Yan, ‘Obstacles in China’s Corporate Governance’ (2011) 32 *Company Lawyer* 311, 316. Apart from China, according to Moody’s Investor Service, the so-called passive investment, namely following index only, will continue to outpace active investments and achieve a leading share of the US market by 2024, or sooner. Available at <https://www.moodys.com/research/Moodys-Passive-investing-to-overtake-active-in-just-four-to--PR_361541> accessed 1 July 2020.

³¹ Huasheng Gao, Jun Huang & Tianshu Zhang, ‘Can Online Annual General Meetings Increase Shareholders’ Participation in Corporate Governance?’ (2020) 49 *Financial Management* <<https://doi.org/10.1111/fima.1230.1>>.

or vote in the shareholder general meetings.³² In other words, the value of voting rights may be significantly underestimated than expected for those rationally apathetic investors, and the voice of informed voters in exercising discretions would subsequently be diluted. In this regard, DVR arrangements under DCS structures can reduce agency costs by pressing management more accountable to the informed investors, who value their right to vote, while minimizing the transaction costs associated with voting.³³

There are also empirical studies showing that companies with DCS structures outperform the market.³⁴ In particular, DCS companies have significantly higher growth in sales and number of employees, significantly higher ratios of R&D expenditures as well as significantly higher increase in industry-adjusted operating incomes.³⁵ In addition to the role of DCS structures to materially increase the value of high growth firms,³⁶ the rising popularity of DCS structures also reflects the demand to maintain such long-term vision and control of these insiders.³⁷ Empirical evidence indeed shows that IPOs with DCS structures are not only attractive for founders and entrepreneurial managers, but also popular among outside and public investors.³⁸

Whilst proponents see the insulation between voting rights and cash flow rights under DCS structures protects visionary entrepreneurs/founders' idiosyncratic vision and promotes long-term value, opponents are worried about the insulation of controlling insiders from market discipline would make it easier for those with special voting rights to entrench themselves. Shareholders with special voting shares are normally incumbent management. Insulating them from disciplinary forces of the market for corporate control among other governance mechanisms would inevitably exacerbate agency problems. For example, the insulation makes DCS companies unattractive takeover targets. Like other takeover

³² Ibid. See also Stefan Voß & YiWen Xia, 'Corporate Governance of Listed Companies in China' (2005) at 14 <https://www.researchgate.net/profile/Stefan_Voss/publication/256000571_Corporate_Governance_for_Listed_Companies_in_China/links/565c9c9608aeafc2aac716d2/Corporate-Governance-for-Listed-Companies-in-China.pdf>.

³³ Lund (n 28) 697.

³⁴ Dimitris Melas, 'Putting the Spotlight on Spotify: Why Have Stocks with Unequal Voting Rights Outperformed' *MSCI* (3 April 2018) <<https://www.msci.com/www/blog-posts/putting-the-spotlight-on/0898078592>>.

³⁵ Kenneth Lehn, Jeffrey Netter & Annette Poulsen, 'Consolidating Corporate Control: Dual-Class Recapitalizations versus Leveraged Buyouts' (1990) 27 *Journal of Financial Economics* 557, 559-560.

³⁶ Bradford Jordan, Soohyung Kim & Mark Liu, 'Growth Opportunities, Short Term Market Pressure, and Dual-Class Share Structure' (2016) 41 *Journal of Corporate Finance* 304, 318-320.

³⁷ For example, in 2017, 43.3% of 30 Tech IPOs and 22.1% of 77 non-Tech IPOs in the U.S. adopted DCS structures; and in 2018, 34.2% of 38 Tech IPOs and 12.5% of 96 non-Tech IPOs in the U.S. adopted DCS structures. Ritter (n 7). For situations outside the U.S., see Pey-Woan Lee, 'Dual-Class Shares in Singapore — Where Ideology Meets Pragmatism' (2019) 15 *Berkeley Business Law Journal* 440, 445.

³⁸ Ronald Anderson, Ezgi Ottolenghi & David Reeb, 'The Dual Class Premium: A Family Affair' *Fox School of Business Research Paper No. 17-021* (2017).

defences, DCS structures would lead to conflicts of interest.³⁹ It is also fair to say such insulation would not help to align control with ownership incentive as the classic economic rationale for OSOV. Critics' concern is that the lack of ownership incentive together with the increased entrenchment may provide controllers twisted incentives to exercise their discretion and oversight.

Nonetheless, even in the context of OSOV, temptations for controlling shareholders to obtain *private benefits of control* still exist.⁴⁰ Unless a controller has 100 percent of ownership stake in a company, she may always have incentives to pursue private benefits since she could obtain all the private benefits but only bear a fraction of costs.⁴¹ The economic rationale offered by Easterbrook and Fischel for OSOV can further be rebutted on the basis that the shareholder homogeneity is a false promise. Different shareholders do have different interests from risk preferences to expected returns.⁴² Granting shareholders voting power commensurate with their shareholdings cannot necessarily guarantee appropriate incentives in the context of shareholder heterogeneity.

It may be, however, fair to say when the percentage of ownership stake goes down, costs of self-serving conducts will correspondingly decrease, and the incentives of extracting private benefits would be higher.⁴³ So, the DVR arrangement under DCS structures are likely to exacerbate such distorted incentives. If a controlling shareholder holds a portion, p , of company's equity capital and faces action that would decrease firm value by the amount of V , but increase her private benefits by the amount of B , following Bebchuk and Kastiel's model, this shareholder would choose the value-reducing action only if her pro rata share of loss ($p * V$) is smaller than the gain in private benefits (B), that is when $p * V < B$ or $V < B / p$.⁴⁴ Consistent with Gilson's comment that "the less equity the

³⁹ Such as the job security of target firm's incumbent management *versus* the substantial premium for target firm's shares. For example, see Jeffrey Gordon, 'Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice' (1988) 76 *California Law Review* 1, 18.

⁴⁰ Such benefits can be either pecuniary like tunnelling corporate asset or opportunities, or 'non-pecuniary' that can vary from luxurious office to a desirable social status and political influence. Ronald Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy' (2006) 119 *Harvard Law Review* 1641, 1663-1664.

⁴¹ Similarly, the controller may also choose to sacrifice some firm value in order to maintain the private benefits of control. See Paul A. Gompers, Joy Ishii & Andrew Metrick, 'Extreme Governance: An Analysis of Dual-Class Firms in the United States' (2010) 23 *Review of Financial Studies* 1051, 1085.

⁴² First, shareholders with different expected holding periods would have divergent preferences over the corporate decision-makings. Secondly, diversified shareholders care much less about firm-specific risk compared to undiversified shareholders, but shareholders who invest in a given company without also diversifying would be very sensitive to such risks. Thirdly, heterogenous expectations between inside shareholders and outside shareholders, hedged shareholders and unhedged shareholders also demonstrate shareholders may have very different interests. Min Yan, 'Corporate Social Responsibility vs. Shareholder Value Maximization: Through the lens of hard and soft law' (2019) 40 *Northwestern Journal of International Law & Business* 47, 55-56.

⁴³ Gilson (n 40) 1651.

⁴⁴ Lucian Bebchuk & Kobi Kastiel, 'The Perils of Small-Minority Controllers' (2019) 107 *Georgetown Law Journal* 1453, 1467.

controlling shareholder has, the greater the incentive to extract private benefits”,⁴⁵ the equation implies when the portion of equity capital decreases, the likelihood that a controller would favor value-reducing actions increases geometrically. Accordingly, the likelihood of expropriation by controlling shareholders with minority ownership stake but special voting rights to the detriment of other shareholders would be higher as well.⁴⁶ In fact, there are also empirical research finding the negative correlation between DCS structures and firm valuations.⁴⁷ And it is argued that an increased discrepancy between controllers’ voting rights and cash flow rights would lead to lower firm valuation.⁴⁸ Thus, although the ownership incentive under OSOV cannot eliminate controlling shareholders’ incentive to seek private benefits, the distortions inherent in DCS structures are potentially much severer.⁴⁹

As a result, the debate over the viability of DCS structures is essentially the weighing of the merits and detriments of such structures. The critical part is whether we can strike a balance between benefits and costs of such structures — namely, whether an institutional framework could provide flexible capital structures and at the same time effectively restrain the associated governance risks.

IV. Safeguarding Measures

As well argued elsewhere, safeguarding measures can effectively mitigate, if not solve, exacerbated agency problems.⁵⁰ The recent examples in Singapore and Hong Kong are good starting point for a thorough discussion on available safeguarding measures. In Singapore, following the change of *SGX Mainboard Rules* in permitting DCS listing, SGX has adopted multiple strategies to control increased governance risks associated with DCS structures. First of all, sunset clauses where special voting shares will automatically convert to single

⁴⁵ Gilson (n 40) 1651.

⁴⁶ For example, see Mike Burkart & Samuel Lee, ‘One Share – One Vote: The Theory’ (2008) 12 *Review of Finance* 1, 34.

⁴⁷ See Gompers, Ishii & Metrick (n 41) 1084.

⁴⁸ See Stijn Claessens, Simeon Djankov, Joseph P. H. Fan & Larry H. P. Lang, ‘Disentangling the Incentive and Entrenchment Effects of Large Shareholdings’ (2002) 57 *Journal of Finance* 2741, 2764-2765; Ronald W. Masulis, Cong Wang & Fei Xie, ‘Agency Problems at Dual-Class Companies’ (2009) 64 *Journal of Finance* 1697, 1703-1705.

⁴⁹ Moreover, differentiated voting rights arrangement would also undermine market monitoring function, leading to increased extraction of private benefits. See Lund (n 28) 715. For example, controlling insiders with special voting rights, who are normally incumbent management, are more easily to entrench themselves and insulate themselves from disciplinary forces of markets.

⁵⁰ For example, it is argued that the mainstream policy debate over DCS structures has begun to pivot more on adopting appropriate means to safeguard holders of inferior voting shares from manifest managerial unaccountability and associated self-dealing risk. Marc T. Moore, ‘Designing Dual Class Sunsets: The Case for a Transfer-Centered Approach’ (2020) 12 *William & Mary Business Law Review* (forthcoming).

voting shares are mandated for the events including (i) transferring shares with special voting rights to persons not in the permitted holder group; and (ii) the holder of special voting rights ceases services as director.⁵¹ Secondly, SGX caps each special voting share at ten votes per share and limits the holders of such shares to named individuals or groups.⁵² Thirdly, on the ground that independent directors are deemed as an effective mechanism to mitigate governance risks,⁵³ independent directors are required to constitute a majority of each of the board sub-committees performing the functions of an audit committee, a nominating committee and a remuneration committee, and to serve as chairmen of these sub-committees.⁵⁴ Fourthly, special voting shares are limited to one vote each regardless of their class on matters in relation to (i) appointment and removal of independent directors and/or auditors, (ii) variation of class rights, (iii) takeover, (iv) winding-up or (v) delisting.⁵⁵ In addition, holders of inferior voting shares are in effect provided means to convene general meetings.⁵⁶ There are many other measures including enhanced disclosure and continuing obligations adopted to align controllers' interest with that of public shareholders for ensuring the accountability.⁵⁷

In Hong Kong, similar safeguarding measures are also designed and adopted. First, there also exist sunset provisions to provide protection to holders of inferior voting shares under DCS structures. A controller's special voting rights in a listed DCS company would be terminated if that person is i) deceased; ii) no longer a member of the issuer's board of directors; iii) deemed by the SEHK to be incapacitated for the purpose of performing his or her duties as a director; or iv) deemed by the SEHK to no longer meet the requirements of a director set out in these rules.⁵⁸ The weighted voting rights attached to special voting

⁵¹ *SGX Mainboard Rules*, 210(10)(f).

⁵² *SGX Mainboard Rules*, 210(10)(d).

⁵³ While many scholars and policymakers see the independent director system can mitigate governance risks under DCS structures, the role of independent directors in the internal governance system remains largely mysterious. Empirical evidence shows that independent directors may not prevent firms' excessive risk taking and there were serious deficits in understanding the business. For example, see Wolf-Georg Ringe, 'Independent Directors: After the Crisis' (2013) 14 *European Business Organization Law Review* 401-424. Research also indicates positive correlations between the likelihood of corporate failure and the proportion of independent directors on corporate board. For example, see Hwa-Hsien Hsu & Chloe Yu-Hsuan Wu, 'Board Composition, Grey Directors and Corporate Failure in the UK' (2014) 46 *British Accounting Review* 215-227. Therefore, although independent directors potentially have a role to play in safeguarding shareholders with inferior voting rights in DCS companies, this paper cautions that further research is needed to prove the correlations between the independence of directors and governance risks associated with DCS structures.

⁵⁴ *SGX Mainboard Rules*, 210(10)(i).

⁵⁵ *SGX Mainboard Rules*, 730B.

⁵⁶ *SGX Mainboard Rules*, 210(10)(g) provides: "Holders of ordinary voting shares holding at least 10% of the total voting rights on a one-share-one-vote basis must be able to convene a general meeting." Further, Rule 210(10)(h) provides: "In any general meeting, the number of votes that may be cast by holders of ordinary voting shares who are not also holders of multiple voting shares must be at least 10% of the total voting rights of the issuer."

⁵⁷ For example, see *SGX Mainboard Rules*, 225, 610, 753, 1206 and 1207.

⁵⁸ *HKEx Main Board Listing Rules*, 8A.17.

shares will also cease upon the transfer to another person.⁵⁹ Secondly, same as the limitation of maximal voting differential under SGX, the special voting rights in listed DCS companies are also capped at ten times of the voting power of ordinary shares.⁶⁰ Thirdly, in order to guarantee the independence of the board, rule 8A.30 requires a ‘Corporate Governance Committee’ comprised entirely of independent non-executive directors to monitor whether the listed DCS company operated and managed for the benefit of all its shareholders. Fourthly, like SGX where certain resolutions would require all shares to carry one vote each regardless of class, HKEx also requires OSOV principle to be applied for *i*) amendment of company’s constitution, *ii*) variation of class rights, *iii*) appointment or removal of independent non-executive director or auditors, and *iv*) voluntary winding-up.⁶¹ Further, listed DCS companies are required to entitle holders of inferior voting shares to cast at least 10 percent of the votes at shareholder general meetings.⁶² Rule 8A.23 again emphasizes that holders of inferior voting rights must be able to convene an extraordinary general meeting and add proposals to the meeting agenda. And among other enhanced disclosure requirements, a listed company with a DCS structure must include the warning “*A company controlled through weighted voting rights*” on the front page of all listing documents, periodic financial reports, circulars, notifications and announcements.⁶³

Above mandatory safeguarding measures can be categorized into (A) entry requirements, (B) disclosure requirements, (C) restriction on controller’s special voting rights, and (D) other protection for shareholder with inferior voting shares. The aim of this categorization is not to provide an authoritative taxonomy but simply offer a heuristic framework for thinking about the mandatory measures deployed to safeguard non-controllers’ interests. Not surprisingly, the permission of DCS listing on the SSE Star Market also comes with a robust regime of mandatory safeguards. The following discussion would follow these four categories.

A. Entry requirements

To start with, like both SGX and HKEx,⁶⁴ SSE Star Market sets market capitalization criteria for listing applicant to adopt a DVR arrangement based on DCS structures.

⁵⁹ HKEx Main Board Listing Rules, 8A.18(1).

⁶⁰ HKEx Main Board Listing Rules, 8A.10.

⁶¹ HKEx Main Board Listing Rules, 8A.24.

⁶² HKEx Main Board Listing Rules, 8A.09.

⁶³ HKEx Main Board Listing Rules, 8A.37.

⁶⁴ The minimum market capitalization threshold in Hong Kong is 10 billion HK dollars (*circa* US\$1.3 billion) in Hong Kong, and 300 million Singapore dollars (*circa* US\$214 million) in Singapore.

According to article 2.1.4 of the *SSE Star Market Listing Rules*, any company intending to adopt a DVR arrangement must (i) have an estimated market capitalization of no less than RMB ¥10 billion (*circa* US\$ 1.4 billion); or (ii) have an estimated market capitalization of no less than RMB ¥5 billion (*circa* US\$ 0.7 billion) and made an operating revenue of no less than RMB ¥500 million (*circa* US\$ 70 million) during the last year. This threshold is significantly harsher than those non-DCS listing application.⁶⁵

While there are no explicit entry requirements in the *SSE Star Market Listing Rules* relating to specific industry or innovativeness requirement for DCS listing applicants,⁶⁶ only companies eligible for the SSE Star Market, namely the Sci-Tech innovation board, can apply for DCS IPO. Thus, only those companies meet the high technology or innovative criterion of the Star Market can be eligible for choosing DCS listing. This is not surprising as one of the main purposes of permitting such DVR arrangements and DCS structures is to support the better development of innovative firms in science and technology sectors as discussed in Section II above. As we can find, most companies get listed on the Star Market are in sectors such as new generation information technology, advanced equipment, new materials, new energy, biomedicine and alike. In March 2020, CSRC as the national securities watchdog launched an evaluation index system of science and technology innovation for the Star Market to help quantify the high-tech and innovative nature of listing applicants, by referring to the scientific and technological achievements, research & development investment and alike.⁶⁷ Therefore, a company intending to list in the Star Market with DCS structures would also need to meet the high-tech and innovative requirement, not materially different from the requirement under HKEx.

B. Disclosure Requirements

Similar to SGX and HKEx,⁶⁸ enhanced disclosure is mandated by SSE to increase the transparency and public awareness of DVR arrangement under DCS structures. Article 4.5.1 of the *SSE Star Market Listing Rules* requires companies adopting a DCS structure to make full and detailed disclosure of information especially in relation to the governance risks

⁶⁵ *SSE Star Market Listing Rules*, art. 2.1.2(1) specifies a listing applicant shall have an estimated market capitalization of no less than RMB¥1 billion and made a positive net profit during the last two years totaling to no less than RMB¥50 million, or have an estimated market capitalization of no less than RMB¥1 billion and made a positive net profit and an operating revenue of no less than RMB¥100 million during the last year.

⁶⁶ For example, in Hong Kong, a company intending to list on HKEx with DCS structures needs to prove it is an innovative company. See HKEx, *Guidance Letter (GL93-18)* (April 2018) at 2 <https://en-rules.hkex.com.hk/sites/default/files/net_file_store/new_rulebooks/g/lgl9318.pdf> accessed 1 July 2020.

⁶⁷ CSRC, *Evaluation Index System of Science and Technology Innovation Announcement (trial)* (No. 21 [2020] of CSRC).

⁶⁸ For example, see *SGX Mainboard Rules*, 610 & 1207; *Main Board Listing Rules* (HKEx), 8A.32 & 8A.37-41.

associated with the DVR arrangement and corresponding shareholder protection mechanisms. Details of shareholders holding special voting shares and the quantity of these special voting shares should be disclosed to all shareholders in a notice of shareholders' general meeting.⁶⁹ The implementation and change of such arrangement as well as the implementation of measures for protecting holders of inferior voting shares is also required to disclose in company's periodic reports. But unlike Singapore and Hong Kong,⁷⁰ no unique stock code is provided to DCS company.

The board of supervisors under China's dual-board structure is also required to play a role. If a listed company adopts a DCS structure, then the specific opinion of its supervisory board on compliance of shareholder protection mechanisms and abuse of special voting rights among others is solicited and required to publish in the company's annual reports,⁷¹ which also aims to provide more check on the controllers.

C. Restriction on Special Voting Shares

As seen, special voting shares can be converted into single voting shares at a particular future date if there is a time-based sunset provision or when a pre-specified event is triggered in the context of event-based sunsets. Same as SGX and HKEx where special voting shares would be converted into single voting shares on the transfer of shares with special voting rights and controllers' cease of services as a director as discussed above,⁷² event-based sunset provisions are also adopted by SSE to restrain holders of special voting shares. Article 4.5.9 of the *SSE Star Market Listing Rules* specifies the Chinese version of sunset provision. There are four different pre-specified situations: (i) failing to meet the eligibility⁷³ and minimum shareholding requirements; (ii) the holder with special voting rights loses the actual control of shares; (iii) the holder with special voting rights transfers these special voting shares or delegates the exercise of the special voting rights to others; and (iv) the control of the company is changed. As a main value of DCS structures is the protection of visionary controllers from external market pressure, which in turn enables them to implement their idiosyncratic business ideas without worrying unduly about short-term

⁶⁹ *SSE Star Market Listing Rules*, art. 4.5.1.

⁷⁰ *SGX Mainboard Rules*, 753 & 1206; *Main Board Listing Rules* (HKEx), 8A.37.

⁷¹ Details could be found in the *SSE Star Market Listing Rules*, art. 4.5.12.

⁷² Also see *SGX Mainboard Rules*, 210(10)(f); *Main Board Listing Rules* (HKEx), 8A.17.

⁷³ *SSE Star Market Listing Rules*, art. 4.5.3 requires only directors who made and can continue to make material contribution to the development or business growth can hold the special voting shares under DCS structures.

performance,⁷⁴ these sunset provisions make sense in stopping controllers' special voting rights if they can no longer participate in management or contribute to the firm.

Apart from the event-based sunset, we can also see when the portion of special voting shares fall below 10 percent of all outstanding voting shares, all special voting shares would be converted into single voting shares.⁷⁵ Such ownership-based sunset provision is designed to avoid extreme situations where minority controllers with special voting shares reducing their equity stake to a negligible level, an effort to restrain the discrepancy between controllers' voting rights and their cash flow rights.⁷⁶

Following the logic that underlying the ownership-based sunset provisions, another key measure is to limit maximal voting differentials, namely the ratio of high voting to low voting rights.⁷⁷ The high to low voting ratio determines the fraction of equity shareholding a controller needs in order to retain the control of the company, namely more than 50 percent of votes.⁷⁸ If the discrepancy gets wider, it normally implies the percentage of controllers' equity shareholding can go down while retain the lock on control. For example, if high/low ratio is 2:1 — that is shares in the superclass have two votes per share and shares in the other class have one vote per share, then a controller would need to hold no less than 33.4 percent of equity stakes to retain the control.⁷⁹ If the ratio changes to 5:1 or 10:1, then a controller needs not less than 18.2 percent or 9.1 percent of equity stakes respectively.⁸⁰ If shares in the superclass have 20 votes per share, namely high/low voting ratio becomes 20:1, then a controller only needs 4.8 percent of equity shareholding to maintain a control.⁸¹ It is clear to see that when the ratio increases, a controller can geometrically decrease her equity holding without losing control, which would then enlarge the gap between control and ownership.⁸² Same as the limitation set in SGX and HKEx, article 4.5.4 of the *SSE Star Market Listing Rules* sets the maximum voting differential at 10:1, *i.e.*, the high/low vote ratio should not exceed ten to one.

⁷⁴ See Goshen & Hamdani (n 25) 577.

⁷⁵ *SSE Star Market Listing Rules*, arts. 4.5.9 (1) & 4.5.3.

⁷⁶ This is not materially different from the limitation of maximal voting difference as discussed below.

⁷⁷ Bebchuk & Kastiel (n 44) 1505.

⁷⁸ For most resolutions including removal of directors, only a simple majority (*i.e.*, more than 50 percent) of the total voting rights.

⁷⁹ Bebchuk & Kastiel (n 44) 1478.

⁸⁰ If the high voting to low voting right ratio is 10:1, 5:1, 4:1, 3:1, or 2:1, then controller would need to hold at least 9.1 percent, 18.2 percent, 20 percent, 25 percent, or 33.4 percent of equity shares with high voting rights, respectively, to retain the majority control. *Ibid.*

⁸¹ $4.8\% * 20 > (100\% - 4.8\%) * 1$.

⁸² For example, TerraForm Global, Inc. a NASDAQ listed firm that owns and operates contracted clean power generation assets, has a DCS structure with Class A share having 1 vote per share while Class B share having 100 votes per share. See CII (n 7). This means a holder of Class B shares merely require 1 percent of equity shareholding to retain the majority control over the firm.

There are also constraints on controllers in exercising their special voting rights in relation to fundamental corporate changes or matters that most likely to cause a conflict of interests as provided in article 4.5.10 of the *SSE Star Market Listing Rules*. The former circumstance includes amendment of company's constitution, merger, division, dissolution, and change of legal form of the company. The latter circumstance includes appointment and dismissal of independent directors and external auditors, changing the number of voting rights contained in the special voting shares.⁸³ For all these decision-makings, controllers' special voting shares will temporarily convert to single voting shares in order to provide shareholders with inferior voting rights more protection.⁸⁴

D. Other Protection for Shareholder with Inferior Voting Shares

In order to justify visionary entrepreneurs/founders' control, holders of special voting shares are restricted to persons who are directors both before and after IPOs and those who have made material contribution to the development or business growth of the company as mandated in article 4.5.3 of the *SSE Star Market Listing Rules*. The second half of the same article also mandates the equity stake of the shareholder with special voting rights should not be less than 10 percent of all issued voting shares of the company, an effort to increase the ownership incentive to better align interests of controllers with outside/public investors. Different from the 'Minimum Economic Interest at Listing' requirement under HKEx, where 10 percent of minimum shareholding is only required at the time of initial listing,⁸⁵ the minimum ownership requirement under SSE is a continuous obligation, non-compliance of which would trigger ownership-based sunset.⁸⁶

On the other hand, for protecting shareholders without special voting shares, article 4.5.7 of the *SSE Star Market Listing Rules* further mandates that shareholders with inferior voting rights shall have at least 10 percent of the corporate voting rights. Any shareholder(s) holding more than 10 percent of the issued ordinary shares either alone or in aggregate can call for extraordinary shareholder general meeting. This effectively means even these shareholders have less than 10 percent of voting rights, they can call for extraordinary shareholders' general meeting as long as they have 10 percent of all issued voting shares.⁸⁷

⁸³ *SSE Star Market Listing Rules*, art. 4.5.10.

⁸⁴ This is again almost identical to the constraints imposed on controllers' exercise of special voting rights on SGX and HKEx. See *SGX Mainboard Rules*, 730B; *HKEx Main Board Listing Rules*, 8A.24.

⁸⁵ *HKEx Main Board Listing Rules*, 8A.12.

⁸⁶ Also see the discussion on the ownership-based sunsets in the foregoing subsection.

⁸⁷ *SSE Star Market Listing Rules*, art. 4.5.7.

Table 1

Mandatory Safeguarding Measures		SSE	HKEx	SGX	NYSE/ NASDAQ
Entry Requirements	Restriction to particular industries	Yes	Yes	No	No
	Minimum market capitalization	RMB¥10 billion (US\$1.4 billion)	HK\$10 billion (US\$1.3 billion)	S\$300million (US\$213 million)	No
Disclosure Requirements	Enhanced disclosure	Yes, plus supervisory board opinion	Yes	Yes	No
	Unique stock code	No	Yes	Yes	No
Restriction on special Voting Shares	Event based sunsets	Yes	Yes	Yes	No
	Maximum voting differentials	10:1	10:1	10:1	No
	Temporary conversion on certain corporate decisions	Yes	Yes	Yes	No
Other Protections	Minimum equity threshold held by special voting shareholders	10%	10%, but only at the time of initial listing	No	No
	Minimum voting rights for inferior voting shareholders	Yes	Yes	Yes	No

As we can see the comparison among different jurisdictions as summarized in the Table 1 above, in contrast to NYSE and NASDAQ, the two largest stock exchanges in the U.S. where no additional mandatory safeguards adopted,⁸⁸ the permission of DCS listing in Asian markets comes with more precautionary measures. Based on the mandatory safeguards in SGX and HKEx, SSE Star Market has adopted commensurate measures to safeguard those holders without special voting shares. Furthermore, in order to protect comparatively inexperienced investors, SSE sets up an entry requirement for individual retail investors to directly participate in the SSE Star Market. To become a “qualified” investor, an individual needs to have at least RMB¥500,000 (*circa* US\$70,000) in her security account and not less than 24 months of equity trading experience. This means the vast majority of retail investors are excluded from trading on the Star Market.⁸⁹

⁸⁸ Robin Hui Huang, Wei Zhang & Kelvin Siu Cheung Lee, ‘The (Re)Introduction of Dual-Class Share Structures in Hong Kong: A Historical and Comparative Analysis’ (2020) 20 *Journal of Corporate Law Studies* 121, 142-143.

⁸⁹ For example, 86.92% of retail investors invests below RMB¥500,000 by the end of 2018. See SSE, *Shanghai Stock Exchange Statistics Annual* (上海證券交易所統計年鑑) (Shanghai Far East Publishers 2019) at 583.

V. Case Study of UCloud technology Co.

As of 1 July 2020, there are 117 companies get listed on the SSE Star Market, another 403 listing applications are currently in progress.⁹⁰ Among all these companies, only one adopts DCS structure. This reality largely deviates from academics' expectation and policymakers' mania for DCS structures. Flexible capital structures, potential gain of entrepreneurs' idiosyncratic visions and long-term focus brought by differentiated voting arrangement do not stimulate the wave of DCS listing as expected. In fact, SSE is not alone. It is also the case in other Asian financial centers like Hong Kong and Singapore that recently changed their listing rules to accommodate DCS listing. For example, since the approval of DCS structures on HKEx in April 2018, there are only 2 out of 218 newly listed companies in 2018 and 1 out of 183 newly listed companies in 2019 adopted DCS structures.⁹¹ And there is so far none DCS IPO on SGX.⁹²

A closer examination of the IPO application process of UCloud Technology Co. (hereafter "UCloud"), the only company adopting a DCS structure listed on SSE Star Market, may help to shed some light. UCloud, a cloud storage and data analytics services provider, was co-founded by three persons, namely CEO Xinhua Ji, COO Kun Hua, and CTO Xianfeng Mo in 2012. Shortly before the listing application, UCloud changed its share capital structure from single-class share structure to DCS structure in its shareholder general meeting on 17 March 2019.⁹³ There are two classes of ordinary shares after this change, Class A shares have five votes per share and Class B shares have one share per vote. All Class A shares are held by the three co-founders. Prior to the change, the three co-founders held 26.83 percent of shares and 26.83 percent of voting rights. After the change, the three co-founders have gained 64.71 percent of voting rights although their percentage of equity capital remains unchanged.

In order to meet the mandatory safeguarding requirements set by the *SSE Star Market Listing Rules*,⁹⁴ the revised company's articles of association have intentionally mimicked the restrictions on special voting shares and specify that the special voting rights contained

⁹⁰ SSE, *SSE Market Data Overview* <<http://star.sse.com.cn/en/marketdata/overview/>> accessed 1 July 2020.

⁹¹ HKEx, *HKEx 2019 Annual Market Statistics* (December 2019) <<https://www.hkex.com.hk/-/media/HKEX-Market/Market-Data/Statistics/Consolidated-Reports/Annual-Market-Statistics/2019-Market-Statistics.pdf>>.

⁹² See SGX, *SGX Stock Screener* <<https://www.sgx.com/zh-hans/securities/stock-screener>> accessed 1 July 2020.

⁹³ UCloud Technology Co., Ltd., *Prospect of IPO Stocks on the Science and Technology Innovation Board* (Registration Document) (首次公開發行股票並在科創板上市招股說明書(註冊稿)) at 1-1-5 & 1-1-305.

⁹⁴ *SSE Star Market Listing Rules*, art. 4.5.10.

in Class A shares would only have one vote per share same as Class B shares in relation to important corporate decisions namely, (i) the amendment of the company's articles of association; (ii) the change of number of voting rights for Class A shares; (iii) the appointment or dismissal of independent directors; (iv) the engagement or dismissal of a Certified Public Accountant firm which issues audit opinions on the periodic reports of the company; and (v) the merge, division, dissolution, and change of legal form of the company.⁹⁵ These constraints on special voting shares are aimed at limiting controllers' ability to exercise their control in relation to fundamental corporate changes or governance standards. Further, the revised company's articles specify sunset clause to terminate special voting shares.⁹⁶ In other words, Class A shares would be converted into Class B at a ratio of 1:1, if (i) the holder of the special voting shares no longer meets the eligibility and minimum shareholding requirements specified under Listing Rule or the company, or becomes incapable of performing corresponding duties, leaves office, or dies; (ii) the shareholder actually holding Class A shares loses actual control over the shares; (iii) the holder of Class A shares transfers these shares to any other person, or delegates the exercise of the voting rights of such shares to any other person; or (iv) there is a change in the control of the company. All these are to mimic the safeguards mandated in listing rules, but SSE seemed not satisfied and required more assurance.

On 12 April 2019, SSE Star Market Listing Review Center, the unit in charge of examining and approving IPO applications, formally inquired UCloud regarding how it is compliant with the safeguards required in the listing rules and CSRC's guideline⁹⁷ on the necessity and rationality of co-founders' special voting rights, as well as these holders' contribution to the management, business development or business growth.⁹⁸ A month later, on 14 May 2019, the second round of inquiry specifically focused on the DVR arrangement, and the number of voting rights for each special voting share is entitled.⁹⁹ In response, apart from emphasizing the necessities and rationality of adopting a DVR arraignment under DCS structures, i.e., the importance for the visionary co-founders to retain control after IPO, the founders have made personal promises on matters relating to lock-up shares and

⁹⁵ UCloud (n 93) 1-1-305.

⁹⁶ Ibid, 1-1-307.

⁹⁷ See CSRC (n 22).

⁹⁸ SSE Star Market Listing Review Centre, *Inquiry regarding UCloud's listing documents for IPO on the Star Market* (關於優刻得科技股份有限公司首次公開發行股票並在科創板上市申請文件的審核問詢函) (Review No.35, 2019).

⁹⁹ SSE Star Market Listing Review Centre, *Second Round Inquiry regarding UCloud's listing documents for IPO on the Star Market* (關於優刻得科技股份有限公司首次公開發行股票並在科創板上市申請文件的第二輪審核問詢函) (Review No.121, 2019).

shareholding reduction in the listing application. For example, the three co-founders have promised not to transfer their special voting shares or delegate the exercise of the special voting rights of such shares to any other person they hold prior to IPO, either directly or indirectly, within 36 months since IPO. They have also made self-restrictions on the shareholding reduction within 4 years since the expiration of lock-up period for share transfer.¹⁰⁰ Further, the co-founders have promised to not receive dividends, among other adverse consequences, if they break these promises contained in the registration documents.¹⁰¹ It is not difficult to see the stringent regime's impact on the holders of special voting shares may even go beyond the literal requirement in the listing rules. The personal promise from the founders can well reflect the pressure to satisfy stock exchange's stringent attitude.

In relation to the justification of the number of voting rights for each special voting share, namely the high to low voting ratio, UCloud argued 5:1 could help the visionary founders to secure the control by having more than half but less than two thirds of all voting rights as shown in Table 2.¹⁰² The compromise is to avoid a supermajority control¹⁰³ and to achieve a balance between retaining control and protecting other shareholders.¹⁰⁴

Table 2

The number of voting rights for each special voting share	Xinhua Ji		Xianfeng Mo		Kun Hua		Aggregate	
	Voting Percentage (%)		Voting Percentage (%)		Voting Percentage (%)		Voting Percentage (%)	
	Pre-IPO	Post-IPO	Pre-IPO	Post-IPO	Pre-IPO	Post-IPO	Pre-IPO	Post-IPO
2-votes-per-share	22.02	17.43	10.15	8.04	10.15	8.04	42.31	32.49-33.51
3-votes-per-share	27.26	22.40	12.56	10.32	12.56	10.32	52.39	41.92-43.05
4-votes-per-share	30.94	26.12	14.26	12.04	14.26	12.04	59.47	49.04-50.20
5-votes-per-share	33.67	29.01	15.52	13.37	15.52	13.37	64.71	54.62-55.75
6-votes-per-share	35.78	31.32	16.49	14.43	16.49	14.43	68.76	59.08-60.18

¹⁰⁰ UCloud (n 93) 1-1-598 & 1-1-599.

¹⁰¹ The controlling shareholders also promise to use their personal assets to compensate the direct loss suffered by public investors in the transactions relied upon the above promises. See *ibid*, 1-1-620.

¹⁰² *Ibid*, 1-1-310.

¹⁰³ Under China's company law, a supermajority vote means two thirds or more of the voting rights held by the shareholders present at the general meeting, which is required for resolutions of a general meeting to amend the company's articles of association, to increase or reduce the registered capital, or on merger, division, dissolution or change of the corporate form of the company. *Chinese Company Law 2013*, art. 103.

¹⁰⁴ UCloud (n 93) 1-1-310.

7-votes-per-share	37.45	33.21	17.26	15.30	17.26	15.30	71.97	62.75-63.81
8-votes-per-share	38.81	34.78	17.89	16.03	17.89	16.03	74.58	65.81-66.84
9-votes-per-share	39.94	36.11	18.41	16.64	18.41	16.64	76.75	68.42-69.39
10-votes-per-share	40.89	37.25	18.84	17.17	18.84	17.17	78.58	70.64-71.59

Although the above arrangements would undoubtedly increase the protection for external investors and shareholders with inferior voting rights, they will at the same time compromise the very insulation created by DCS structures, thus make such structures less valuable. For example, giving up a supermajority control and making personal promise is directly influenced by stringent safeguards, which would inevitably compromise founders' ability to control over decisions like increasing capital or merger. When those visionary founders' ability to exercise special voting rights is over constrained, it would become more difficult for them to create more value by implementing the project with high rather than low near-term uncertainty without worrying unduly about the short-term performance. That is why too many safeguards can potentially weaken the value of DVR arrangements and DCS structures.

The extremely low take up of DCS structures in the new IPOs in Shanghai, Hong Kong and Singapore shall at least partly reflect the compromised attraction of DCS structures when mandatory safeguards are stringent.¹⁰⁵ This is contrasted with the increasing DCS IPOs in the U.S. where no such mandatory safeguards exist.¹⁰⁶ There are for example 25 out of 134 newly listed companies in 2018 and 16 out of 110 newly listed companies in 2019 adopted DCS structures.¹⁰⁷ In particular, the U.S. has attracted US\$34 billion of DCS listings by Chinese firms alone in the past decade.¹⁰⁸

¹⁰⁵ Unfortunately, existing literature shows no company other than UCloud had strong incentive to go public with DCS structures but ultimately chose to forgo such share structures in the actual listing due to the stringent safeguards. Although lack of such comparison would affect the persuasiveness of the argument, this outcome is not surprising. First, DCS listings are just allowed over a year in Mainland China, and it takes time for companies to get familiar with disproportionate voting. Secondly, though the additional compliance costs and oversight under a stringent regime of mandatory safeguards, as opposed to OSOV rule, undoubtedly exist, it may hardly see any company would publicly announce the enhanced corporate governance standards for DCS listing is a main reason for it to forgo DCS structures because of the potential negative publicising.

¹⁰⁶ See Table 1 in Section IV.D.

¹⁰⁷ Ritter (n 7); CII (n 7).

¹⁰⁸ Benjamin Robertson & Andrea Tan, 'Dual-Class Shares: Second-class investors?' *Bloomberg* (January 2019) <<https://www.bloomberg.com/quicktake/dual-class-shares>>. This also reflects that the demand for Chinese firms to go public with DCS structures does exist.

VI. Future of DCS Structures in China

Nowadays, continuous economic growth increasingly relies upon new technology and innovative companies, who normally have large capital demand for their fast development and expansion. Due to the inherent flexibility in the DVR arrangement based on DCS structures, especially the ability to avoid the dilution of control after raising external equity capital, DCS structures are expected to accommodate and facilitate the new economy in China.¹⁰⁹ In fact, one of the main purposes of permitting DCS listing in China at the institutional level is to better support the development of innovative companies in science and technology sectors by allowing a more flexible capital market. Moreover, DCS structures are also expected by scholars and stock exchanges to attract and retain Chinese innovative and high growth businesses to list domestically, and to compete with NASDAQ, NYSE, SGX and HKEx.¹¹⁰ So if no or very few companies choose to list with DCS structures, the purpose of the institutional design of DCS structures would not be realized.

Apart from values such as flexible capital structures and insulation from short-term market pressure, the foregoing sections also investigate the concerns of increased governance risks associated with DCS structures. Different jurisdictions adopt different strategies in relation to the safeguarding measures. As exhibited, while the U.S., the most prominent DCS structure jurisdiction, chooses not to adopt additional requirements and maintain the minimal mandatory safeguards,¹¹¹ China among other leading financial hubs in Asia take much more stringent measures to balance the public shareholder protection with increased flexibility and competitiveness. However, both intended and unintended impact of these safeguarding measures may over restrain the controllers' ability of control, hence compromise the value of DVR arrangements and DCS structures.

For example, the sunset provisions, limitation of maximal voting differentials, enhanced internal corporate governance standards including disclosure requirements and the like are all designed to make the conventional internal governance check and external market for corporate control functioning, thereby ensure the accountability of those who hold shares with special voting rights. However, the value of the controllers' control will be reduced. Increased disclosure obligation means increased compliance costs, restricted voting differentials and automatic conversion of special voting shares mean decreased

¹⁰⁹ For example, see Yang (n 4).

¹¹⁰ Similarly, a main motivation for two other Asian financial hubs, *i.e.*, Singapore and Hong Kong to permit DCS listings is also to attract listing applicants who prefer DCS structures.

¹¹¹ It is also noteworthy that the traditional approach of the U.S. Securities and Exchange Commission is to focus on disclosure as a means of addressing issues rather than mandating governance safeguards.

flexibility for founders or entrepreneurial managers and perhaps higher costs to retain control. A core of all safeguarding measures is to weaken the controllers' insulation from disciplinary forces of the markets, making them more vulnerable and then more obedient to such pressure.¹¹² The value and thereby attractions of DCS structures would then be reduced. This perhaps also explains why the reality largely deviates from scholars and policymakers' expectation for DCS structures. The mania for DCS structures at stock exchanges' level fails to stimulate the wave of DCS listing in China or other Asian financial hubs.

The future of DCS structures largely lies on the market acceptance. A stringent regime of safeguarding measures will discourage prospective listing applicants to choose DCS IPOs in order to avoid the additional compliance costs or oversight. After all, the essence of DCS structures is to help entrepreneurs and founders alike to retain the control and the ability to monitor when raising external equity capital for corporate development through allowing voting rights disproportionately greater than the cash flow rights.¹¹³ When such capacity is over restrained by the safeguarding measures as we see above, the ability to issue shares with differentiated voting rights would become less valuable. Furthermore, unlike SGX or HKEx where companies can get listed on the Main board with a DCS structure, companies choose to DCS IPO on SSE can only get listed on the Sci-Tech innovation board rather than the Main board, which would in turn restrict their access to the capital market. Companies intending to have a more flexible capital structure and fewer restraints can always choose other less stringent jurisdictions as a destination for DCS IPOs. As a result, over protection for shareholders with inferior voting rights would compromise the attractiveness of capital markets even for domestic firms.

Considering China does not have an effective and robust *ex post* regime like a class action and contingency fee system in U.S. legal framework,¹¹⁴ *ex ante* safeguards are certainly necessary in checking agency costs and protecting investors. Nevertheless, the key to the successful institutional design of DCS structures here is to strike a fine balance between the flexibility and accountability.¹¹⁵ The debate over the viability of DCS structures is essentially evaluating and weighing the values and costs of the separation between control and ownership stake. The costs (or values) to controller and the values (or costs) to non-controllers stand on both ends of the spectrum. Every time when a mandatory safeguarding

¹¹² In this regard, DCS structures can be understood as a design to make shareholders with special voting rights less vulnerable to the market disciplinary force including hostile takeover, while the safeguarding measures are intended to reverse such trend by placing restrictions on controllers' insulation from market discipline.

¹¹³ See Burkart & Lee (n 46) 29 & 40-41.

¹¹⁴ For example, see Huang, Zhang & Lee (n 88).

¹¹⁵ Of course, it would never be an easy task to find such a balancing point.

measure is added to the equilibrium for increasing the protection of non-controllers, the values of DCS structures to the controller will be compromised a bit. Thus, a premise for the thriving of DCS structures is to *restrict* the restrictions over the eligibility of DCS listings and how shareholders with special voting rights can exercise their control. Put differently, one approach of developing DCS structures in China is to reduce mandatory *ex ante* constraints on DCS listings to allow more flexibility. This approach can be coupled with an enhanced *ex-post* mechanism similar to the class action in the U.S., *i.e.*, providing aggrieved shareholders with inferior voting rights means to seek remedies from the abuse of differentiated voting rights under DCS structures.

In fact, there are signs of positive development in the newly revised *Chinese Securities Law* in relation to the *ex post* remedies.¹¹⁶ Article 95 of the revised Securities Law allows aggrieved investors to initiate representative civil litigation against the company for fraudulent disclosure.¹¹⁷ And more can be done in the near future to allow inferior voting shareholders, who feel aggrieved in DCS companies, to elect a representative from among themselves to proceed with the lawsuit against wrongdoing controllers. Besides, despite the weak protection and enforcement of shareholder rights in China, CSRC as the securities regulator has adopted an innovative approach to protect the vast number of retail investors in China's securities markets. It creates the China Securities Investor Services Center (ISC) in December 2014 to hold shares for the sole purpose of exercising shareholder rights on behalf of minority investors and to represent them in court.¹¹⁸ ISC has bought 100 shares in each listed company in China, which in turn allows it to exercise shareholder rights. In this way it is also seeking to educate shareholders as to the way to exercise their rights and to influence governance practices of listed companies. ISC has thus far supported 24 lawsuits in relation to minority shareholder protection and directly initiated one lawsuit as a minority shareholder itself.¹¹⁹ By the same token, ISC can also potentially play a role in DCS companies to either directly or indirectly influence their governance practices, and bring legal actions against misuse of special voting rights as an *ex post* mechanism.

¹¹⁶ *Chinese Securities Law* is revised in December 2019 and comes into force on 1 March 2020.

¹¹⁷ According to article 95, where the purpose of litigation is of the same category and the persons comprising one of the parties is large in number at the commencement of the litigation, aggrieved investors may elect representatives from among themselves to proceed with the litigation. Alternatively, the court may issue a public notice, stating the particulars and claims of the case and informing those entitled to participate in the action to register their rights with the court within a fixed period of time. The judgments or written orders rendered by the court shall be valid for all those who have registered their rights with the court. Also, investor protection organizations who are entrusted by not less than 50 investors can participate the litigation as a representative.

¹¹⁸ International Monetary Fund, 'People's Republic of China: Financial Sector Assessment Program' *IMF Country Report No. 17/404* (December 2017).

¹¹⁹ ISC, *Shareholder Protection* <<http://www.isc.com.cn/html/wqfw/>> accessed 1 July 2020.

Alternatively, if nothing changes, or more safeguarding measures are introduced to protect investors, it would be hard to see the claimed attractions of DCS structures for those visionary founders and entrepreneurs. They will probably vote with their feet and choose a less stringent regime like the U.S. to go public with DCS structures.

On a different footing, and beyond DCS listing and capital markets, DCS structures may also potentially help alleviate China's concentrated ownership structure. In China, an important reason for either state-owned enterprises ("SOEs") or family-owned firms choosing to not raise equity capital from public is the fear of losing control.¹²⁰ That is partly why China remains to be featured with highly concentrated ownership pattern.¹²¹ DCS structures, which separate voting rights from ownership stakes within the company, may reduce the obstacles in transforming concentrated ownership structure to a more dispersed structure.¹²² For example, the state or government no longer needs to be worried about losing control over SOEs when raising capital from public or foreign investors for corporate development and expansion if a DVR arrangement under DCS structures can be adopted.¹²³ The flexible capital structure and voting arrangement offered by DCS structures would help those SOEs or family-owned firms with strong desire for long-term control to overcome the reluctance to accept external equity capital. DCS structures can provide them more flexibility in raising external capital and retain control. In short, DCS structures can be adopted by states and family owners, in addition to entrepreneurs, to avoid their control being diluted or destroyed when raise external equity capital, which is more cost effective than debt capital financing. The constraints imposed upon by the *SSE Star Market Listing Rules* on DCS listings would obviously not apply to firms not intending to get listed, thus this prospective role of DCS structures may stand alone and deserve further attention.

VII. Conclusion

DCS structures sever the relation between the control and the equity ownership, make DVR arrangement possible. While it allows the entrepreneurs and founders to maintain control

¹²⁰ Min Yan, 'Agency Problem, Ownership Structure and a Lesson for China' (2020) 41 *Company Lawyer* 162, 168-169. See also Burkart & Lee (n 46) 40-41.

¹²¹ Min Yan, *Beyond Shareholder Wealth Maximisation* (Routledge 2018) at 125.

¹²² While there is no empirical evidence regarding the de-concentration of ownership in DCS companies, the special voting rights inherent in DCS structures would undoubtedly help controlling shareholders to retain control even her ownership stake is lowered. In other words, holding a majority of shares is not the only way to maintain the control under DCS structures.

¹²³ For example, Mr. Li Rongrong, the chairman and party secretary of the *State-owned Assets Supervision and Administration Commission of the State Council*, claimed: "public ownership is the foundation of the socialist market economic system." Yan (n 30) 318. However, what Mr Li actually meant and cared about shall be the control of SOEs. Therefore, if the control can be maintained, there is no reason to reject much needed equity capital. John Armour & Jeffrey Gordon, 'Systematic Harms and Shareholder Value' (2014) 6 *Journal of Legal Analysis* 35, 35.

over the strategic corporate direction focusing on the long-term growth of the company regardless of immediate financial performance, the special voting rights under DCS structures may also help entrench control and deteriorate agency problem between insiders and outside investors. In order to constrain the increased corporate governance risks associated with the separation between control and equity ownership, restrictions are imposed to limit holders of special voting shares, which can be seen as safeguards protecting holders of inferior voting shares.

Like Singapore and Hong Kong, China adopts a stringent regime of safeguarding measures to restrain the exercising of special voting rights when permits DCS listings. Mandatory measures including sunset provisions, maximum discrepancy between controllers' voting rights and cash flow rights, minimum equity shareholding by controllers, enhanced entry and disclosure requirements among others, are designed and deployed to mitigate the potential agency costs. After analyzing the evolution of shareholder voting rights and development of DCS structures in China, this paper finds and discusses the remarkable discrepancy between the expectation and the reality of implementation of DCS structures in China. Considering the original purpose of allowing DCS structures — *i.e.*, attracting/retaining high-technology and innovative firms to list with a DVR arrangement domestically, it may be worth thinking about relaxing mandatory safeguards. On the one hand, restrictions currently imposed by the mandatory safeguarding measures can also be achieved via private ordering at firm level on an individual case-by-case basis as they see fit. On the other hand, *ex post* measures can be developed to provide means for aggrieved shareholders with inferior voting rights to seek remedies, thereby reduce the reliance upon *ex ante* restrictions. The relaxing can go even further by allowing companies to get listed on the Main board, rather than solely the Sci-Tech innovation board,¹²⁴ in order to extend their access to capital markets.

If the safeguarding measures on DCS listing are not going to be eased in the near future, then the expected wave of DCS IPOs may not arrive in China. But this may not affect the potential role of DCS structures in transforming the concentrated ownership structure in China. This often-neglected issue merit more academic attention if diversified ownership structure is sought after to help diversify unsystematic risks and lower investment risks and capital costs. The DVR arrangement under DCS structures may potentially help SOEs and family-owned firms, in addition to those high technology and innovative companies, to

¹²⁴ Namely, the Star Board or say Star Market.

retain corporate control after raising external equity capital, and thereby ameliorate ownership structures.