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Striking a balance on differential voting rights

The Securities and Exchange Board of India (SEBI) recently issued a consultation paper seeking public comments on a proposed regulatory regime for issuance of equity shares with differential voting rights (DVRs) by listed and to-be-listed companies in India. Unlike conventional one share, one vote equity shares, DVRs allow promoters to have voting power that is disproportionate to their ownership interest, which enables growth companies to raise capital without promoters losing control, and insulating them from hostile takeovers.

SEBI is now seeking to re-examine the regulations applicable to DVR issuances by allowing superior voting right (SR) share issuances to promoters prior to the initial public offering (IPO) while permitting the issuance of fractional voting right (FR) shares within one year from the IPO.

DVR structures are common in the US, Canada and certain European countries, and have recently been introduced in Singapore and Hong Kong. In the US, Facebook, Alphabet, Snap and Alibaba went public with DVR structures, and it continues to be popular as seen from the recent listings by Lyft, Zoom and Pinterest. However, reservations are expressed against such structures (including the 2017 decision of two large index providers to partially or fully exclude such companies with DVR structures from their indices) given their potential negative impact on shareholder rights and corporate democracy. While such structures give promoters autonomy to take risks and implement their strategic vision without the pressure of investor scrutiny or intervention, they expose companies to mismanagement and self-dealing by promoters. Therefore, promoter control must be balanced against the need for investor protection.

ENHANCED INDEPENDENCE

The Hong Kong Exchange (HKEX) listing rules for DVR shares provide for the constitution of a corporate governance committee, comprised entirely of independent directors (IDs), which is empowered to review, monitor and make recommendations to the board on any matter where there is a potential conflict of interest between the company, its shareholders and beneficiaries of DVR shares. Similar measures should be considered by SEBI as well.

The Singapore Exchange's listing rules require the representation of at least a majority of IDs on major committees, including the remuneration committee, of companies with DVR structures. A similar requirement is also prescribed by HKEX. In India, the representation of IDs on the nomination and remuneration committee could also be increased to two-thirds from half currently.

VOTING ON SIGNIFICANT MATTERS

In order to mitigate the expropriation risk of DVR structures, the SEBI paper contemplates that for certain significant matters, such as material amendments in charter documents, related-party transactions, appointment or removal of IDs and auditors, change of control and voluntary winding up, holders of SR shares will vote on a one-share, one-vote basis. Matters requiring a special resolution (i.e., a majority vote of at least 75%), including capital issuances and reduction of share capital, could also be considered by the SEBI for voting on a one-share one-vote basis.

SUNSET CLAUSES

The SEBI paper contemplates a five-year sunset period for SR shares, with a possibility of a five-year extension subject to approval by the shareholders through a special resolution where all shareholders vote on one share, one vote basis. The SEBI paper also proposes event-based sunset provisions for SR shares in case of a merger or acquisition, death of the promoter and transfer of SR shares (the SEBI paper prohibits the transfer of SR shares). Additionally, other event-based triggers such as promoters' incapacity, termination of employment and directorship and disqualification from appointment as a director could also be considered by SEBI. SEBI should also ensure that similar sunset clauses are provided for FR shares (the paper contemplates extinguishment of such shares through company buyback and reduction of capital only).

VOTING DIFFERENTIALS

A higher voting differential results in a larger gap between equity ownership and control. Certain jurisdictions, including the US, do not mandate a cap on voting differentials. Lyft and Pinterest have issued DVR shares to its founders with 20 votes per share. Zynga's DVR shares had as many as 70 votes per share. Snap became the first issuer to issue non-voting shares. SEBI has proposed a cap of 10 votes for each SR share and one vote for 10 FR shares.

The success of DVR structures in India will depend on the mitigation of governance risks without unduly restricting promoters' ability to control and implement their vision.

*This insight/ article has been authored by **Juhi Singh**, Partner and **Tarinee Sudan**, Associate. They can be reached on jsingh@snrlaw.in and tsudan@snrlaw.in for any questions.* *It was first published by India Business Law Journal in its **May 2019 Issue**.*

S&R ASSOCIATES ADVOCATES

NEW DELHI
64 Okhla Industrial Estate
Phase III
New Delhi 110 020
Tel: +91 11 4069 8000

MUMBAI
One Indiabulls Centre
1403 Tower 2 B
841 Senapati Bapat Marg, Lower Parel
Mumbai 400 013
Tel: +91 22 4302 8000