

Sustainable development of the dual-class share structure in China

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Abstract. Sustainable development is a goal shared by all nations across the globe in the 21st century. Companies with a dual-class share structure in China face problems in their pursuit of sustainable development, such as unclear definition of laws and regulations, increased costs of agencies, defective supervision mechanisms, and insufficient information disclosure. Therefore, it is necessary to identify rules, optimize corporate governance, strengthen the supervision mechanism, and improve information disclosure to safeguard the investors' legitimate rights, maintain market stability, and secure economic sustainability.

1 Sustainable development: orientation of Chinese enterprises with a dual-class share structure

“Sustainable development” derives from the theory of “development” and is philosophically defined as a process from small to large, from simple to complicated, from lower to higher, and from old to new. The theory of “development” is first proposed to resolve poverty in the world, and with material wealth growth as the central idea, it states that economic growth will lead to increases in social wealth and civilization revolutions.

In the age of capitalism, industrialization sweeps the globe, resulting in an obsession over fast development. This is particularly true after WWII when people, driven by the desire to restore their countries, showed unprecedented eagerness to pursue more wealth. However, as the pressure from population rise, environmental degradation and depletion of resources increases, the

understanding of “development” evolves and gives birth to the idea of “sustainable development”. Thus, the concept of “sustainable development” derives from people’s pondering over the environment, resources, and development problems caused by industrialization.

On the 1972 United Nations Conference on the Environment held in Stockholm, the idea of “sustainable development” was first discussed. As stated in “Our Common Future” drafted by G. H. Brundtland, Chair of World Commission on Environment and Development (WCED), in 1987, “sustainable development” is defined as “development which meets the needs of the present without compromising the ability of future generation to meet their own needs”. It was widely acknowledged once it was proposed. In June 1992, the United Nations Conference on Environment and Development has brought discussions of sustainable development to a record high; the Rio De Janeiro Declaration and the Oneness of Humanity (also termed The Earth Charter) and “Agenda 21” released on this summit furthered the theory of sustainable development.



Figure 1. Evolvement of sustainable development

Listed companies, the most advantageous group in the economic matrix of China, is the source of investment values in the capital market. After years of development,

listed companies in China have gained momentum, with their operations standardized and quality improved, rising to be the central force that boosts corporate innovation and

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industry progress. As reported by China Securities Journal, as of the end of 2020, the total market value of the Shanghai and Shenzhen stock market had reached 79.72 trillion yuan. Listed companies are the cornerstone of the capital market, and their quality and sustainable development is concerned with the appeal and competitive force of the capital market, and they also account for a key link in the sustainable development of the capital market. The history of China's listed companies has revealed that they have injected capital and vigor into China's economic

growth. They have not only played an increasingly important role in generation of social capital, industry restructuring and optimization, promotion of strategic industry agglomeration, and establishment of modern enterprise policies, but also serve as the leading power of the national economy. Listed companies are the microscopic entities for sustainable development of national economy. Only when listed companies achieve sustainable development can the national economy and the whole society realize sustainable development.

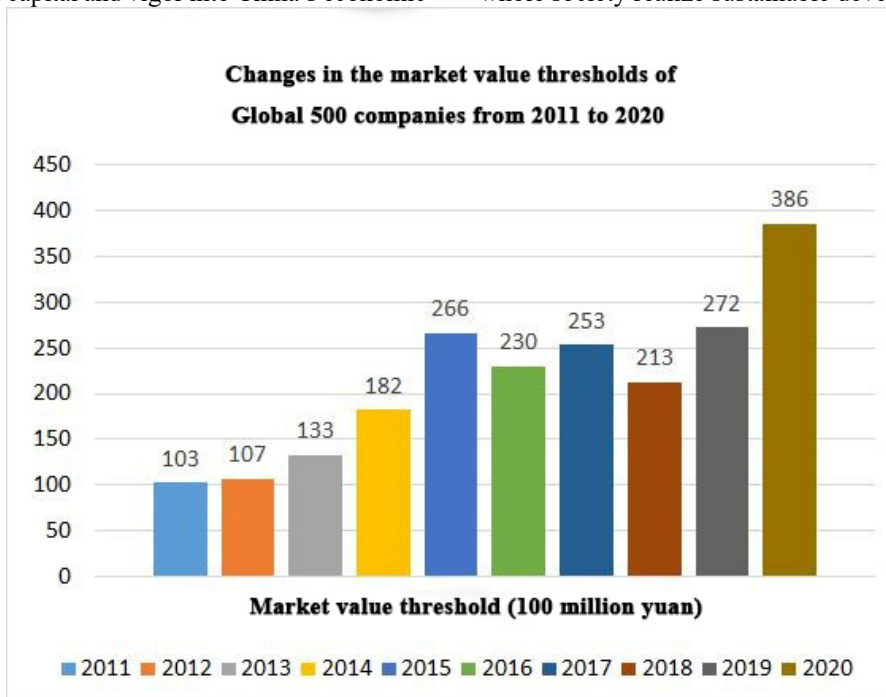


Table 1. Changes in the market value thresholds of Global 500 companies in 2011 – 2020^[1]

The dual-class share structure is an old policy established by modern enterprises, but the single-class structure is an innovation of the modern times. In history, the dual-class share structure offer two types of shares, the debilitating type and the enhancement type. The dual-class share structure of modern enterprises has gone through three ups and three downs, and the underlying logic is the game between financing and control under different external constraints. The dual-class share structure, accompanied with new economy, has experienced a rise again, which is the extension of the above-mentioned logic in the new external conditions.^[2]

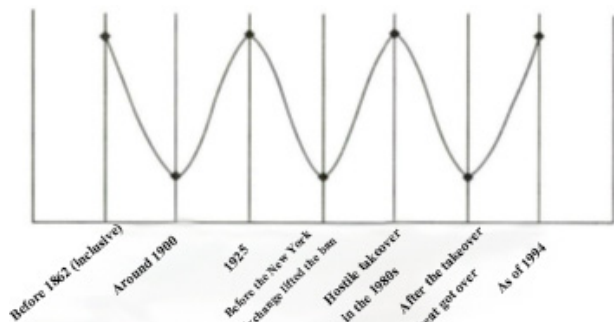


Figure 2. Vicissitude of the dual-class share structure^[3]

The IPO of Alibaba in the U.S. with its dual-class share structure stirred up heated discussions over whether the dual-class share structured companies can get listed. The Science and Technology Innovation Board (STAR

Market), a new board China offered in support of high-tech industries and strategic new industries, was announced to be established on the opening ceremony of the 1st China International Import Expo by President Xi Jinping, and it was formally established on 13th June, 2019. As the high-tech and innovative companies supported by the STAR market have different financing channels from traditional enterprises, and they rely mostly on stock financing, the STAR market innovates on the share structure and has different arrangements to improve the market service and boost market vigor. Dual-class share structured companies in China suffer from problems in their pursuit of sustainable development, such as unclear laws, increased costs of agencies, defective supervision mechanisms and insufficient information disclosure. Only when these problems are solved can the companies with the dual-class share structure develop in a sustainable way.

2 Problems facing Chinese companies with the dual-class share structure in their pursuit of sustainable development

2.1 Unclear laws and regulations

The laws and regulations of the dual-class share structure

in China are short of clarity. In legal terms, the dual-class share structure is not legally prohibited for limited liability companies in China, but generally, the joint-stock companies are required to adopt the single-class share structure. It has long been under debate as to whether the dual-class share structure should be adopted, though there are some laws and regulations in this regard.^[4]

Among the laws are the specifications about the voting rights of limited liability companies. As prescribed in Corporate Law of the Peoples Republic of China (hereinafter referred to as Corporate Law), limited liability companies can flexibly arrange the stock structure by their

own rules and regulations. The charters can specify the proportion of voting rights of each share, irrespective of the investment of capital. Limited liability companies are free to offer shares with no voting rights, limited voting rights and super voting rights. In terms of the procedure and process, the Corporate Law stipulates that limited liability companies can decide as per the company charters the procedures and process of the board of shareholders. It shows that the limited liability companies are not prohibited against the dual-class share structure by the Corporate Law.

Table 2. Rules on the voting rights of shareholders^[5]

1	Article 16 of Corporate Law	Limits of external guarantee of voting rights
2	Articles 20 and 22 of Corporate Law	The voting rights should be used in accordance with the law and do not undermine the interests of the companies, shareholders and debtors.
3	Articles 21 and 216 of Corporate Law	Abuse of trading-related voting rights by stockholders
4	Articles 35 and 91 of Corporate Law Articles 16 and 17 of Corporate Law Interpretation III	Limits on the voting rights against withdrawal of capital and defective capital contribution
5	Article 37 of Corporate Law	Limits on the procedural rules of the board of shareholders
6	Article 166 of Corporate Law; Article 15 of Corporate Law Interpretation IV	Limits on benefit distribution
7	Article 9 of Corporate Law Interpretation IV	The corporate charter should not deprive the shareholders of the right to know

Another is the laws about the voting rights of stock companies. Though the Corporate Law has not strict rules about stock companies, the structure of these companies should abide by the “one-share one-stock” or the single-class structure; the stock release conditions and the prices should be appropriate, and the price of each share should be the same, and the voting right of each share should also be the same. Article 106 of Corporate Law, however, makes some concessions: it states that the shareholders have the right to entrust the voting right to agencies, so the founding shareholder can require the external shareholders to sign voting rights agreements with agencies to maintain the shareholders’ impact and position

in the company.

As of 2019, to offer chances for hi-tech firms and strategic innovative companies to get listed, and boost integration between the capital market and technological innovation, China has been improving the commercial environment, and lowered the bar for IPOs. Meanwhile, China Securities Regulatory Commission (CSRC) and Shanghai Stock Exchange released a series of rules for the STAR market, such as “Rules for Listing on the STAR Market of Shanghai Stock Exchange”, in which the rule of “differentiated arrangement of voting rights” marked that China allowed companies listed on the STAR market to adopt the dual-class share structure.^[6]

Table 3. Rules in favor of the dual-class share structure^[7]

18 th Sept. 2018	The State Council released “Opinions for upgraded development of innovative and entrepreneurial companies”, which formally allowed technology companies to implement the structure of same stocks for different rights
5 th Dec., 2018	President Xi announced trial registration and setting of the STAR market on Shanghai Stock Exchange to support construction of the Shanghai Finance Center and technology innovation center.
1 st Mar., 2019	The CSRC released “Management of IPO

	Registration on the STAR Market (Trial)”; Shanghai Stock Exchange released the “Rules for IPO on the SMART Market of Shanghai Securities Exchange”, which proposed requirements for setting and operation of the dual-class share structure.
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The “Sunset Provision” is considered as an effective measure to boost efficiency attenuation, and also a solution to agency problems; as the joint link of these two problems, the “Sunset Provision” has received attention from different parties.^[8] The Sunset Provision stipulates that a company needs to shift from the dual-class share structure to the single-class share structure after a given period of time or after a specific event, and it involves provisions based on time, events or share proportions. So far, a series of event-based provisions and proportion-based sunset provisions have been incorporated into legal systems as compulsory decrees, but the incorporation of time-based sunset provisions is under controversy.^[9] Despite the many supporters of time-based sunset provisions, incorporating these provisions into laws is controversial, and they are yet to be made compulsory in legal systems.

2.2 Increase of agency costs

The agency cost involves the following concepts. First, the costs can be divided into “agent costs” and “principal costs”, and each involves two sub-concepts: “capacity costs” and “conflict costs”.^[10] The “capacity costs” are costs for errors caused by insufficient capacities or for prevention of errors; the “conflict costs” are costs for self-serving behaviors or for prevention of these behaviors. The sum of agent costs and principal costs is the corporate governance costs. Due to the high level of professionalism for corporate managers, the principal cost can be effectively reduced. Though the managers may blunder sometimes and cause an increase in the principal cost, but the impact is largely neglectable. Moreover, as the investors do not have the control power, the conflict costs of the principals will not show large changes, and it is the conflict cost of the agents that deserves more attention.

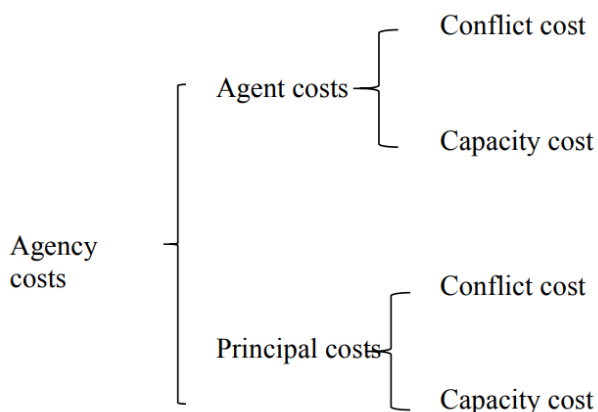


Figure 3. Categorization of agency costs

The increase in the conflict cost in agent costs derives from the dual-class share structure. As the investors are the less-privileged in terms of information disclosure and

cannot have efficient supervision over the company’s internal shareholders who may undermine the investors’ interests for the sake of their own interests. Though the agency problems derive from information asymmetry, and the root cause is the inconsistency between the earnings rights and the control rights of the company.^[11] The higher the degree of inconsistency is between the earnings rights and the control rights, the more serious the problems of corporate governance are. The dual-class share structure will add to the inconsistency and lead to more agency problems. The premium of the voting right leads to the earnings paradox: on one hand, the voting right premium will bring benefits to the voters, and the investors’ payment of the voting right premium conforms to the economic rationality; on the other hand, if the voting right premium can bring benefits to the voters, it means that the secondary shares and the super shares enjoy different earnings rights, but the underlying logic of the dual-class share structure is equal earnings right for two different shares. As the internal shareholders that enjoy super voting rights pay extra but cannot have corresponding earnings rights, it is hard to believe that they are willing to pay to cover the extra cost. To make up for the loss, they are likely to leverage their control power for their own interests. In other words, they have strong motivations to abuse the control power, resulting in more serious agency problems than the single-class share structure.^[12]

2.3 Internal supervision: defective independent-director system

Concentration of control power in the dual-class share structure can help fight against hostile takeovers, but may also disable regular takeovers or other external supervision measures. Even if the corporate controller makes wrong decisions which undermine corporate development and lead to a drop in the company’s stock price, the company will not be merged by others without consent from the controllers who enjoy concentration of the control power, but the non-controlling shareholders will be informed of the losses.^[13] Therefore, internal control is of great importance. When the shareholders assign their power to the board of directors, the board manages the company. The most important task of the board is to elect proper representatives to speak for the board to secure the interests of the company and shareholders, so election of the members of the board is the key to implementing the shareholders’ rights.^[14] The special voting right is set to help the shareholders with this right to control the company’s board of directors and hence control the company. In general, the members of the board of directors are the shareholders with the special voting rights or controlling entities of the company, so the independent directors play a significant role in protection

of medium and small investors. The independent-director system in China is yet to be improved: the independence level is low, and the independent directors know less about the company than the internal directors; the independent directors seldom disagree with the internal directors, and they are often termed “nominal directors”; the proportion of independent directors required for IPO in China is lower than 1/3, so the independent directors play a rather insignificant role in the company’s decision-making, and can be circumvented by the internal directors in decision-making initiatives.^[15] As stipulated in the corporate governance rules of listed companies in China, the independent directors should take the majority in the auditing committee, nomination committee, salary and appraisal committee of the company, and they should be the governor of these committees. This system enables the supervision of the independent directors over the company, but they still cannot supervise the use of the special voting rights.

2.4 External supervision: insufficient information disclosure

The differentiated voting system assigns the voting rights and earnings right to the shareholders in a disproportionate manner, and the largest difference can be 10 times, which increases the likelihood of opportunism among shareholders with super voting rights, and undermine the legitimate interests of medium and small shareholders who are in the disadvantaged position in information disclosure. Therefore, the legal systems of advanced capital markets have raised the standard for information disclosure of companies with the dual-class share structure, but the standards are still different from those for companies with the differentiated voting system. For instance, listed companies with the dual-class share structure are not required to state clearly the “dual-class share structure warning” in IPO proposal documents, regular reports, promotion materials, and announcements. In trial decisions for trading, the shareholders with super voting rights and those disadvantaged voters may run into conflicts. One detrimental consequence is that the general public investors will not be provided sufficient information to make right investment decisions.

3 Measures for Chinese companies with the dual-class share structure to achieve sustainable development

3.1 Clarifying relevant rules

To clarify the legitimacy and appropriateness of the dual-class share structure, ensure its integrity, systematicity and coordination, prevent conflicts and divisions, China should draw lessons from the legislation cases in other countries, and improve specifications of the dual-class share structure in the Corporate Law. Overall, the Corporate Law should specify the categories of differentiated voting shares, and expand the categories beyond the existing categories including the preferred

shares, special voting right shares, limited voting right shares, and veto shares. Meanwhile, the procedural rules of generation, altering and termination of different types of shares should also be specified to protect the interests of shareholders with less voting rights.^[16]

3.2 Optimizing corporate governance

Companies that adopt the dual-class share structure suffer from the agency problems inside. Though the IPO Rules have specified compulsory regulations for the same-class share structure as to the modification of company charters, alteration of the number and employment of shareholders with special voting rights, the decruitment of independent directors and auditing firms that provide regular auditing reports, the merge, separation, dissolution of companies as well as the companies’ structure. The clauses that prohibit abuse of voting rights in the IPO Rules cannot solve the problems of the current “entrust-agency” pattern, and the traditional incentive compatible constraint mechanism fails to take effect. It also fails to resolve the conflicts between the common shareholders and shareholders with special voting rights. Requirements for performance can serve as constraints for shareholders with special voting rights. The traditional incentive compatible constraint mechanism fails to work, which means the principals cannot improve their conditions by sharing their interests, so setting constraints over the performance provides a way to increase their voting rights. If the shareholders with special voting rights fail to deliver the expected outcomes, unfavorable consequences will follow, which increases the cost of abuse of voting rights by shareholders with special voting rights. Therefore, companies can set up quarterly, half-year and yearly standards for performance, and if the shareholders fail to meet the standards, a specified proportion of shareholders with special voting rights are required to transform into common shareholders.^[17] The standards for performance are flexibly set as per the conditions of the company, and exemption clauses should be provided.

3.3 Improving the independent-director system and drawing lessons from abroad

The “Main Board Listing Rules” of Hong Kong Stock Exchange require companies with differentiated voting rights to set up a corporate governance committee, the members of which should be independent directors, to supervise whether the shareholders with special voting rights “will operate and manage the company for the sake of the interests of all shareholders”. The Hong Kong Stock Exchange also requires that the independent but non-executive directors be the president of the nomination committee and employ standing compliance consultants. The corporate governance committee and the standing compliance consultants can improve the internal supervision of companies, and are worth to be learnt by inland companies in China.

3.4 Strengthening information disclosure

As information asymmetry bulks large in the agency problem, information disclosure becomes the key to such measures as market mechanism optimization, improvement of industry rules and post-event remedies under the dual-class share structure.^[18] The recently modified “Securities Law” has considerably expanded the boundaries of the information disclosure system of Chinese listed companies, but there is still a long way to go to combine theories with practice and improve the supportive systems. First, the internal intellectual guarantee and the protection of investors should be balanced so that the intellectual guarantee will not be used as an excuse for companies to shirk the duty of information disclosure, the false statements and self-dealing transactions will not evade supervision, the abuse of power can be effectively controlled, and the bottom line for intellectual guarantee related to the company’s long-term development will not be crossed. Second, legislation breakthroughs should be made and supportive policies for information disclosure should be constructed to make the information disclosure system a basis for external investors in decision-making.^[19] The contents of information disclosure involve the following three aspects. First, the dual-class share structure of the company should be revealed in the prospectus to specify the weights of voting rights for different share types and limited voting rights of secondary shares; second, the common shareholders should be informed of the risks for short-selling trading, and the public investors should be informed of the potential risks and impacts of the dual-class share structure; third, the key personal information of the founders and executives should be revealed so that the external investors will have full knowledge of the professional capacities and industry levels of the decision-makers, make rational investments, and closely keep track of the disclosed information.^[20]

4 Conclusions

The dual-class share structure meets the needs for differentiation of shareholders, balances the financing supply and demand, resolves conflicts in the control power, and precludes hostile takeovers. Since this structure was adopted, empirical studies have yet to prove whether this structure would effectively cut or reduce values of the company.^[21] Therefore, the dual-class share structure, as a tool to promote economic growth, features non-inferiority, and a framework should be provided for this structure in China as an option for Chinese companies. To remove obstacles in the basis, operation and supervision of the dual-class share structure is important for companies with this structure to achieve sustainable development.

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