National Law School Business Law Review

Volume 1 | Issue 1 Article 8

2015

The Depository Receipts Scheme, 2014: Lessons in Policy Implementation

Pratik Datta

The Depository Receipts Scheme, 2014: Lessons in Policy Implementation

Pratik Datta[*]

Contemporary financial policy making in India is undergoing a sea-change. Hitherto opaque processes are becoming more transparent. More lawyers are involved at the policy formulation stage and in converting them into precise legal drafts. This article illustrates the various factors affecting contemporary financial policy making in India and its implementation, in light of the experience from the recent depository receipt reforms. It analyses the political economy that shaped the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993, and argues that the skewed sectoral preference evident therein was not based on sound economic and regulatory policies. Finally, it concludes that the conceptualisation of the policy behind the Depository Receipts Scheme, 2014 through an expert committee has been extremely transparent and progressive. However, a major challenge in the co-ordination of a multi-pronged implementation strategy remains in the form of a diffused governmental and regulatory set-up, which creates obstacles in the implementation of policies.

* Consultant, National Institute of Public Finance and Policy, New Delhi; B.A., LL.B. (Hons.), West Bengal National University of Juridical Sciences (2010). The author assisted the M.S. Sahoo Committee in its review of the Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993, set up by the Ministry of Finance, Government of India. Views expressed are personal.

Introduction

Capital markets across jurisdictions are segmented from each other by various barriers like capital controls, legal restrictions, information costs, and transaction costs. Finance literature shows that there is much to be gained by overcoming these barriers.[1] The depository receipt is a time-tested tool to overcome these barriers and integrate capital markets internationally.

Originally developed to raise equity funding off-shore, a depository receipt is a security issued in a foreign jurisdiction on the back of domestic securities in the home jurisdiction. Domestic securities are deposited with a domestic custodian on-shore and depository receipts are issued off-shore by a depository bank against such deposited domestic securities. Being foreign securities, depository receipts are traded and settled in the foreign jurisdiction like any other security in that jurisdiction.[2] At the same time, they are but mirror-images of the domestic securities deposited with the domestic custodian. Foreign investors can invest in depository receipts like any other security in their home jurisdiction, while simultaneously reaping the benefit of investing in a security outside their home jurisdiction. Domestic entrepreneurs can use depository receipts to tap these foreign investors and markets.

India's tryst with depository receipts can be traced back to the balance of payments crisis in 1991 and the consequent gradual liberalisation of the capital account.[3] The depository receipt mechanism was one of the earliest areas of post-liberalisation reform.[4] The Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 ("1993 Scheme") focused on off-shore listings – it allowed Indian firms to issue depository receipts off-shore against their domestic

---

[1] The price of stocks of a domestic listed firm may get enhanced if it cross-lists in a completely segmented foreign capital market. *See* R.C. Stapleton & M.G. Subrahmanyam, *Market Imperfections, Capital Market Equilibrium and Corporation Finance*, 32(2) Journal of Finance (1977); the expected return of a pure domestic security with a dual listing may be greater than the expected return of the same security without a dual listing. *See* Cheol S. Eun Gordon, J. Alexander, and S. Janakiramanan, *Asset Pricing and Dual Listing on Foreign Capital Markets: A Note*, 42(1) Journal of Finance (1987).

[2] The Supreme Court has recently held that such depository receipts are "*securities*" as defined under Section 2(h) of Securities Contracts (Regulation) Act, 1956. Therefore, the Securities and Exchange Board of India has adequate powers under the Securities and Exchange Board of India Act, 1992 to investigate and pass orders in suspected cases of market abuse. See *SEBI* v. *Pan Asia Advisors Ltd*., 2015 SCC OnLine SC 626.

[3] For a detailed account, *see* Sumit Ganguly & Rahul Mukherji, India since 1980 (2011).

[4] *See* Report of the Committee to Review the FCCBs and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 (Ministry of Finance, 2013) [hereinafter "Sahoo Committee Report"].

equity shares on-shore.[5] The recent reforms in off-shore depository receipts, leading up to the Depository Receipts Scheme, 2014 ("2014 Scheme"), go beyond equity underlying, thereby greatly expanding the scope and utility of these instruments.[6] From a wider perspective, these ongoing reforms are crucial because they throw light on the financial policy-making process in India and the hardships faced in a multi-pronged policy implementation strategy. The purpose of this article is to analyse these reforms and understand the hurdles faced, at an institutional level, in the implementation of new policies in the Indian financial sector.

Part I of this article examines the political economy that shaped the 1993 Scheme from its inception and across the two decades of its existence. It argues that the skewed sectoral preference evident in the 1993 Scheme was not based on sound economic and regulatory policies. This was a major shortcoming in the scheme, which led to its review and ultimately, the notification of the 2014 Scheme. Part II explains the committee process followed by the Indian government to review the policy framework on off-shore depository receipts and the philosophy that guided these reforms. Part III analyses the 2014 Scheme from this new perspective along with the implementation challenges ahead. The article concludes that the conceptualisation of the policy behind the 2014 Scheme through an expert committee has been extremely transparent and progressive. However, policy implementation in India remains diffused across various government departments and regulators, which renders the coordination of a multi-pronged implementation strategy difficult and time-consuming.

I. The 1993 Scheme

It is no coincidence that the 1993 Scheme, the first post-liberalisation reform in financial law, was itself overtly biased towards equity investment into Indian companies.[7] The Indian political economy at the time preferred equity

5 *See* Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme,1993, GSR 700(E) (Nov. 12, 1993) [hereinafter "1993 Scheme"]; although beyond the scope of this article, it may be worthwhile to note that the on-shore depository receipt reforms began in 1996 when the Finance Minister set up a working group to re-draft company law, culminating in the introduction of the Indian Depository Receipt (IDR) in Section 605A of the Companies Act, 1956 and the Companies (Issue of Indian Depository Receipts) Rules, 2004.

6 *See* Depository Receipts Scheme, 2014 (Oct. 21, 2014).

7 The 1993 Scheme treated investments in depository receipts on underlying Indian equity shares as Foreign Direct Investment (FDI). Such FDI could not exceed 51% of the company's issued and subscribed capital. Investment by Foreign Institutional Investors (FIIs) was excluded from this 51% cap on FDI. *See* Schedule I, Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, Notification No. FEMA 20/2000-RB dated 3rd May 2000 (2000).

market reform.[8] The balance of payments crisis in 1991 led to the devaluation of the rupee coupled with substantial reduction in import controls after 1991. This gave a major boost to the export-oriented services sector, especially information technology and other knowledge-based industries.[9] In the absence of substantial collateral necessary for debt financing, firms in the services sector tend to prefer equity investment. Given the high growth potential of the Indian services sector at that time, it was easier for such firms to raise capital through equity rather than debt. Further, the international capital market was more suitable than the domestic capital market for raising such equity capital since the former was likely to have more sophisticated analysts for new sectors like information technology. Consequently, Indian technology stocks could obtain a better valuation in off-shore equity markets. Moreover, the consumer-commercial market bonding theory would suggest that Indian services sector firms catering to the outsourcing demands of developed western economies would prefer to be listed on their stock exchanges, particularly in the United States.[10]

On the other hand, the Indian manufacturing sector already had well-established firms from the socialist regime, which had the necessary collateral for debt financing, as well as the reputation required to attract equity investors. In contrast, new entrants into the manufacturing sector may have the requisite collateral for debt-financing but would never have the reputation to attract equity investments. Therefore, the crucial players in both the services and manufacturing sector in India stood to benefit from equity market reforms rather than debt market reforms.[11] Consequently, the political economy preferred equity market reforms, with a focus on off-shore listings. The 1993 Scheme was the product of these undercurrents.

This skewed sectoral preference continued to manifest in the form of amendments to the 1993 Scheme. For example, on June 23, 1998, Indian software companies were permitted to issue depository receipt-linked employee stock options. In March 2000, other knowledge-based sectors like pharmaceuticals and biotechnology were also extended similar benefits. On June 16, 2000, the benefit was extended to employees of subsidiary companies. Companies generating 80% of their turnover (for the previous three

---

8 *See* Vikramaditya Khanna & Umakanth Varottil, *Developing the market for corporate bond in India*, (National Stock Exchange, Working Paper, 2012), http://www.nseindia.com/research/content/WP_6_Mar2012.pdf.

9 *See* GANGULY & MUKHERJI, *supra* note 3, at 91.

10 This theory has been recently propounded. *See* Nicholas C. Howson & Vikramaditya Khanna, *Reverse cross-listings – The coming race to list in emerging markets and an enhanced understanding of classical bonding*, (Nov. 19, 2014), http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1219&context=law_econ_current.

11 *See* Khanna & Varottil, *supra* note 8.

financial years) from these sectors were permitted to offer depository receipts to resident or non-resident permanent employees (including directors) of those companies and of subsidiaries incorporated in India or abroad.[12]

Although the 1993 Scheme was the first piece of financial legislation of the liberal Indian economy, it bore clear imprints of the socialist legal drafting style.[13] The scheme allowed the issue of depository receipts by way of either public issue or private placement, subject to the prior approval of the Department of Economic Affairs of the Ministry of Finance. The criteria for such approval closely resembled the philosophy behind merit-based regulation. The government would approve companies which had a track record of good performance (financial or otherwise) – a purely subjective test left to the complete discretion of the government.[14]

As stated earlier, depository receipts help overcome market segmentation by integrating the issuer's capital market with the capital market in which the depository receipts are traded. These markets are said to be perfectly integrated if the 'law of one price' holds across them. Any price differential between similar financial instruments traded in two different geographical locations leads to entry of arbitrageurs who profit out of this differential and ultimately help restore the law of one price and integrate the markets.[15] In fact, this phenomenon actually played out, once depository receipt programs on Indian equity shares were in place, motivating the amendment to the 1993 Scheme in March 2001 to allow two-way fungibility in an effort to remove the impediments to the free play of the law of one price.[16]

On July 29, 2002, Indian companies were permitted to sponsor depository receipt issues against underlying shares at a price determined by a lead manager. However, this required prior or simultaneous listing on a domestic stock exchange and the facility to offer underlying shares against which the depository receipts were to be issued *pari passu* to all categories of shareholders. Unlisted Indian companies were thus prevented from raising capital abroad.[17] Consequently, Indian stock exchanges enjoyed a *de facto* monop-

---

[12] *See* 1993 Scheme, *supra* note 5, at ¶ 3C.

[13] Legal drafting suffers from inertia. *See generally*, Umakanth Varottil, *The Evolution of Corporate Law in Post-Colonial India: From Transplant to Autochthony* (Working Paper, 2015), http://law.nus.edu.sg/wps/pdfs/001_2015_Umakanth_Varottil.pdf.

[14] *See* 1993 Scheme, *supra* note 5, at ¶ 3(2).

[15] *See* Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 VA. J. INT'L L563, 590 (1998).

[16] *See* 1993 Scheme, *supra* note 5, at ¶ 7(1A).

[17] This position is in stark contrast with Israel, where unlisted companies took full advantage of the opportunity to list on United States exchanges. Ultimately, with the intent of promoting dual listing on the Tel Aviv Stock Exchange (TASE), the Israeli Securities Authority (ISA) amended its securities law to exempt domestic firms already traded in the United

oly on account of the 1993 Scheme, at the cost of promoting healthy competition. Some relaxations were made to the simultaneous listing requirement on September 14, 2005, and unlisted companies were permitted to issue depository receipts, if they took verifiable and effective steps to list domestically. On October 11, 2013, unlisted companies were allowed to raise capital abroad without prior or subsequent listing for a period of two years, subject to certain conditions.[18]

On August 31, 2005, the 1993 Scheme was amended to prevent companies, which were otherwise ineligible to access Indian capital markets, from accessing the depository receipt route. Moreover, pricing norms were introduced – the issue price could not be less than the higher of (*a*) the average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the six months preceding the relevant date, and (*b*) the average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date. On November 27, 2008, the pricing formula was aligned with the formula applicable to Qualified Institutional Placements (QIPs).

A. Need for review

Reliance Industries was the first Indian corporation to avail the 1993 Scheme by setting up a depository receipts program in 1992.[19] Since then, over 330 Indian companies have created depository receipt programs, of which 13 are listed either on the New York Stock Exchange(NYSE) or NASDAQ stock market, 24 are listed on the London Stock Exchange (LSE), and the vast majority have approached the Luxembourg Stock Exchange or the Singapore Exchange to raise capital.[20]

Nevertheless, the volume of FDI through the depository receipt route did not increase substantially during this time, compared to the increase in the

States from the burden of reporting to the ISA in addition to the US reporting requirements. *See* Shmuel Hauser, Rita Yankilevitz, and Rami Yosef, *The effects of dual listing on share prices and liquidity in the absence of registration costs*, 4 Journal of Service Science and Management 15, 21 (2011).

[18] *See* Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Mechanism) (Amendment) Scheme, Ministry of Finance, Notification No. GSR 684(EF. No.4/13/2012-ECB) (Oct. 11, 2013).

[19] It is interesting to note that the 1993 Scheme came into effect retrospectively from April 1, 1992. *See* 1993 Scheme, *supra* note 5, at ¶ 1(2).

[20] This was the position in 2013. *See* BNY Mellon, *India: Easing Conditions for investors, Non Capital-Raising Depository Receipts for Indian Corporates are a Strategic Opportunity*, http://www.adrbnymellon.com/files/PB37020.pdf (Last visited May 23, 2015).

volume of FDI in Indian equity during 2000-2014.[21] This disparity may have resulted due to additional eligibility criteria for issuers of depository receipts over and above capital controls on foreign investment in domestic securities.[22]

Beside the economic implications, two decades of legal development in financial and corporate laws also required a relook at the 1993 Scheme.[23] For example, the Companies Act, 2013for the first time gave statutory recognition to depository receipts by defining 'global depository receipt' (GDR),[24] albeit in language different from that of the 1993 Scheme. Moreover, the same depository receipt was treated differently under two different regulatory regimes. While depository receipt holders having the right to give voting instructions have obligations under the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("Takeover Regulations, 2011"), such depository receipts themselves were not calculated as part of the public shareholding under the 1993 Scheme.[25]

The policy thinking in Indian finance has also undergone a sea change in the last two decades. State intervention in financial markets is now focussed solely on addressing market failures.[26] The next section will elaborate on the influence of this approach on the recent reform in off-shore depository receipts.

II. The Reforms Process

The Indian Government set up a committee in September 2013, under the chairmanship of Mr. M.S. Sahoo, to comprehensively review the 1993 Scheme, keeping in view the 'needs of the Indian companies and foreign investors' as well as the 'need for simplification and legal clarity.'[27] The Committee consulted stakeholders including some Indian issuers, depository banks, exchanges and trading platforms, and the financial market regulators, to delineate the relevant policy issues which were subsequently debated and deliberated upon by Committee members internally. Based on

---

21 *See* Sahoo Committee Report, *supra* note 4, at 17.

22 *See* 1993 Scheme, *supra* note 5, at cl. 3.

23 *See* Sahoo Committee Report, *supra* note 4, at 14-16.

24 *See* S. 2(44), Companies Act, 2013.

25 *See* Reg, 2(1)(v), SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, (2011); *see also* Sahoo Committee Report, *supra* note 4, at 42.

26 *See generally*, Report of the Financial Sector Legislative Reforms Commission (Government of India, 2013) http://finmin.nic.in/fslrc/fslrc_index.asp.

27 *See* Constitution of a Committee to Review the FCCBs and Ordinary Shares (Through Depository Receipt Mechanism) Scheme 1993 (Ministry of Finance F.No.9/1/2013- ECB, Sept. 23, 2013).

these deliberations, the Committee prepared a report with its policy recommendations ("Sahoo Committee Report (Phase I)") along with a draft legal scheme, and submitted it to the Government of India. The Government accepted the recommendations, and based on the draft scheme provided by the Committee, notified the 2014 Scheme.[28]

The 2014 Scheme is a reflection of the broad economic and regulatory philosophy behind the Sahoo Committee Report (Phase I). This philosophy is well-reflected in the following passage:

> "Some markets left to themselves may fail to produce efficient allocation of resources. Such an event is referred to as 'market failure.' Regulations exist in order to address such market failures. This framework for thinking about market failures, when translated into the field of finance, induces a clear categorisation of the tasks of the government, as has been clarified by the Financial Sector Legislative Reforms Commission. (sic)"[29]

The Financial Sector Legislative Reforms Commission (FSLRC) had identified four potential areas of market failure in the field of finance: *(a)* consumer protection; *(b)* micro-prudential regulation; *(c)* systemic risk; and,*(d)* resolution.[30] After discussing these four areas in the context of depository receipts, the Sahoo Committee Report (Phase I) concluded:

> "DRs [(depository receipts)] are foreign securities. They are purchased and traded by foreign investors in a foreign jurisdiction. When underlying Indian securities are bundled into DRs or the DRs are cancelled and converted into the underlying Indian securities, the Indian investor or the securities market in India may be affected. Regulations should be framed accordingly."[31]

In other words, state intervention (regulation) should only ensure that depository receipts issued abroad on the back of underlying Indian securities do not in any way compromise the interests of Indian investors investing in

---

28 *See* Sahoo Committee Report, *supra* note 4.

29 *See* Sahoo Committee Report, *supra* note 4, at 29.

30 The FSLRC was set up by the Indian Government to comprehensively review the entire Indian financial legislative framework. The FSLRC report made major policy recommendations for the Indian financial sector and also provided a draft Indian Financial Code (IFC) to replace the archaic legislative framework. In his 2015 Budget speech, the Indian Finance Minister has categorically stated the intention of the Government to table the IFC in Parliament soon. For the report, *see generally*, *supra* note 26; for the 2015 Budget Speech, *see Full text of Budget 2015-16 speech*, The Hindu 2015, http://www.thehindu.com/news/resources/full-text-of-budget-201516-speech/article6945026.ece.

31 *See* Sahoo Committee Report, *supra* note 4, at 30.

those underlying domestic Indian securities in India.[32] This clear economic and regulatory rationale forms the backbone of the 2014 Scheme.

III. The 2014 Scheme

The Sahoo Committee Report (Phase I) observed that "*the law should be neutral to a foreign investor's choice of the mode of purchasing Indian securities and to the Indian issuer's choice of mode of raising capital as long as the basic capital controls are complied with.* (sic)"[33] It recommended that if, under the capital controls regime, a foreign investor can invest in "*securities as defined in the Securities Contracts (Regulation) Act, 1956 whether issued by a company, mutual fund, government or any other issuer and the similar instruments issued by private companies*," depository receipts should be allowed to be issued against them.[34] Accordingly, the 2014 Scheme defines a 'depository receipt' only with reference to 'permissible securities'.[35] The definition avoids any reference to the issuer of such 'permissible securities'. This allows depository receipts to be issued on the back of any domestic Indian security in which a foreign investor can invest. Unlike the 1993 Scheme, the 2014 Scheme does not restrict the potential underlying securities to domestic equity shares alone.[36] For example, Indian debt instruments can now be used as underlying to the extent that foreign investors can invest in them under the FDI route. Moreover, this approach allows the possibility of unsponsored depository receipts being issued on the back of Indian shares without the involvement of the company whose shares are being used for the program. Any person holding 'permissible securities' can transfer the same to a depository bank for issuance of depository receipts.[37] This would enhance the liquidity of the underlying domestic Indian securities by further integrating the Indian and foreign capital markets.[38]

---

[32] In the past, Global Depository Receipts (GDRs) have been misused for committing market abuse in India. However, precedents show that this kind of market abuse requires presence of a colluding party in India and cannot be done solely by investors in GDRs abroad. See *Securities Exchange Board of India* v. *Pan Asia Advisors* , 2015 SCC OnLine SC 626, order dated 06/07/2015.

[33] *See* Sahoo Committee Report, *supra* note 4, at 35.

[34] *See* Sahoo Committee Report, *supra* note 4, at 35.

[35] *See* 2014 Scheme, *supra* note 6, at cl. 2(1)(a).

[36] *See* 2014 Scheme, *supra* note 6, at cl. 2(1)(h).

[37] *See* 2014 Scheme, *supra* note 6, at cl. 3(1)(c).

[38] Recent research across India, Australia, and Israel shows that listing of American Depository Receipts (ADRs) has helped improve liquidity of the underlying securities in the domestic capital market. *See* Sahoo Committee Report, *supra* note 4, at 42-43; also *see generally*, Alex Frino, Elisa Di Marco and Andrew Lepone, *The impact of ADR listing on liquidity*, Market Insights: Australian Securities Exchange 28 (2009), https://otcquote.com/content/doc/asx-adr-whitepaper.pdf; Hauser, Yankilevitz, & Yosef, *supra* note 17.

The Sahoo Committee Report (Phase I) was of the view that "*businesses should be free to structure financial products as per their business needs.*" Business prudence may demand depository receipts "*with the right to instruct voting or with a right to the underlying cash flows without voting rights.*" Accordingly, it recommended that "*the law should not prescribe anything about voting rights or exercise of such rights*" in respect of depository receipts as long as the Takeover Regulations, 2011 are complied with.[39] However, minimum public float is a unique requirement under Indian securities law, aimed at maintaining reasonable liquidity of listed shares in the domestic market. This ensures that the shares are widely held, resulting in better price discovery and reduced possibility of manipulation. Listed shares used for the issue of depository receipts were originally excluded from the calculation of this public float.[40] The rationale was that such underlying listed shares, being deposited with the domestic custodian, go out of circulation, thereby reducing the liquidity in the domestic market. However, the Sahoo Committee Report (Phase I) showed that this assumption was incorrect. It used an event study to show that an issue of depository receipts did not have any impact on domestic trading volume of the Indian securities in the short run.[41] Moreover, the Sahoo Committee Report (Phase I) observed that there was a mismatch in the treatment of the same depository receipt under two different regulations. While depository receipt holders having right to give voting instructions have obligations under the Takeover Regulations, 2011, such depository receipts themselves were not calculated as part of the public shareholding.[42] Based on these observations, the Securities Contracts (Regulation) Rules, 1957 was amended on February 25, 2015, to include listed shares underlying depository receipts within the ambit of 'public shareholding.'[43]

However, this measure alone was not sufficient; three issues persisted. *First*, the board of an Indian listed company could issue depository receipts without any voting instruction rights, instead retaining the voting rights for

---

39 *See* Sahoo Committee Report, *supra* note 4, at 43-44.

40 *See* rr. 19(2) and 19A, Securities Contracts (Regulation) Rules, 1957 (as they stood before February 25, 2015).

41 *See* Sahoo Committee Report, *supra* note 4, at 42-43. This position is also supported by recent research in this field. *See* Frino, Di Marco, & Lepone, *supra* note 38; Hauser, Yankilevitz, & Yosef, *supra* note 17.

42 *See* Reg. 2(1)(v), Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, (2011) (see n. 24).

43 Currently, this benefit is available only if the holder of such depository receipts has the right to issue voting instruction and such depository receipts are listed on an international exchange. *See* Securities Contracts (Regulation) (Amendment) Rules, (2015).

themselves.[44] This could go against the spirit of the minimum public float norm, and yet the company could continue to enjoy the status of a public listed company.[45] To avoid such abuse, the law was amended on February 25, 2015, such that, holders of depository receipts are required to have the right to issue voting instructions, for such depository receipts to form part of public shareholding.[46]

Second, minimum public float raised another unique challenge for unsponsored depository receipts on listed shares of Indian companies. Since the company would not be involved in the issue of depository receipts, it would be unfair to let its shares be used for depository receipts leading to a breach of the minimum public shareholding. Therefore, it was essential to mandate that holders of unsponsored depository receipts on listed securities be given the right to issue voting instructions so as to ensure that all such unsponsored depository receipts form part of the public shareholding.[47]

Third, the Committee was divided in its opinion on whether depository receipts on listed shares should be permitted to be traded in Over-The-Counter (OTC) markets abroad that may include dark pools *inter alia*. Although the majority of the members took the view that depository receipts issued on the back of any Indian securities, listed or unlisted, may be listed on international exchanges as well as traded on OTC systems abroad, they agreed that the listing of depository receipts on international exchanges would carry certain privileges.[48] Accordingly, it was recommended that depository receipts issued on the back of listed Indian equity shares form part of the minimum public shareholding only if the depository receipts entitle the holders to give voting instruction to the foreign depository, and if such depository receipts are listed on an international exchange. Further, it was clarified that 'international exchange' for this purpose would mean any platform in a foreign jurisdiction for the trading of depository receipts which is accessible to the public and which provides pre-trade and post-trade transparency.[49] This position is reflected in the 2014 Scheme as well as the amended Securities Contracts (Regulation) Rules, 1957.[50]

---

[44] *See* Securities and Exchange Board of India, *Agenda and decision of the SEBI Board on Voting Rights of GDR / ADR holders*, ¶¶ 12-16 (May 19, 2010).

[45] *See* Sahoo Committee Report, *supra* note 4, at 42-43.

[46] *See* R. 2, Securities Contracts (Regulation) Rules, 1957 (*see* n. 42).

[47] *See* 2014 Scheme, *supra* note 6, at cl. 3(2)(a).

[48] *See* Sahoo Committee Report, *supra* note 4, at 40.

[49] *See* Sahoo Committee Report, *supra* note 4, at 43.

[50] *See* 2014 Scheme, *supra* note 6, at cl. 2(1)(f); R. 2, Securities Contracts (Regulation) Rules, 1957.

A. Implementation challenges

The implementation of any new policy measure is fraught with challenges,[51] and the 2014 Scheme is no exception. It was notified in the official gazette on October 21, 2014 but came into force on December 15, 2014. This time-lag was intended to give the various other agencies like the Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI) adequate time to make the necessary legal changes before the 2014 Scheme came into effect.[52]Nevertheless, implementation challenges persist. This part will focus on the implementation challenges specifically with respect to capital controls and taxation.

a. Capital controls

Pursuant to the 2014 Scheme, the RBI amended the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ("FEMA 20") with effect from December 15, 2014. The terms 'domestic custodian' and 'depository receipt' have now been specifically defined.[53] Major changes have also been made to Schedule I of FEMA 20. It now clarifies that the foreign investment limit in companies engaged in activities in which FDI is permitted include depository receipts issued on the back of equity shares, compulsorily and mandatorily convertible preference shares, compulsory and mandatorily convertible debentures, warrants, or any other security in which FDI can be made in terms of Schedule I.[54] A new schedule, Schedule X, has also been added to FEMA20.

However, some aspects of the amendments to FEMA 20 have caused much confusion in the market. For example, Schedule I previously permitted a registered broker in India to purchase shares of an Indian company on behalf of a person resident outside India for the purpose of converting the shares into depository receipts.[55] This provision has been deleted from Schedule I, and instead Schedule X allows only a domestic custodian to purchase eligible securities for the same purpose.[56] This is clearly an inadvertent error since

---

[51] Most statutes provide powers to the Government to remove difficulties during implementation. *See* Pratik Datta, *Amendments by Stealth: MCA resurrects Henry VIII's legacy*, Economic and Political Weekly (Dec. 27, 2014), http://www.epw.in/commentary/amendments-stealth.html.

[52] *See* 2014 Scheme, *supra* note 6, at cl. 1(2).

[53] *See* Reg. 2, Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) (Seventeenth Amendment) Regulations, (Notification No. FEMA 330/2014-RB, Dec. 15, 2014) [hereinafter "FEMA 20 Amendment"].

[54] *See* FEMA 20 Amendment, *id*, reg. 3(c).

[55] *See* FEMA 20, *supra* note 7, cl. 4A of Schedule 1 (as it stood before Dec. 15, 2014).

[56] *See* FEMA 20 Amendment, *supra* note 54, cl. I(c) of Schedule 10.

custodians are not in the business of purchasing securities. Further, Schedule X states that the domestic custodian must report to the RBI regarding the issue of any depository receipts in such manner as may be prescribed.[57]

Accordingly, on January 22, 2015, the RBI prescribed Form DRR which must be filed by the domestic custodian who has arranged the issue or transfer of depository receipts.[58] Curiously, although the Form DRR clearly envisages the possibility of 'unsponsored' depository receipts, it still requires certification from the 'company' that all conditions laid down by the Government of India and the RBI have been complied with. Some custodian banks have been interpreting this to mean that even in 'unsponsored' programs, the consent of the issuer company is required, effectively going against the very notion of 'unsponsored' depository receipts.[59] Moreover, for depository receipt issues resulting in an increase of equity capital of a company or a sponsored issue, Form DRR requires details of the equity capital.[60] It is submitted that not all sponsored issues involve a fresh capital raising exercise. Therefore, for sponsored non-capital raising depository receipts, these details required by Form DRR are superfluous. Moreover, this may actually amount to duplication of work over and above the filing of Form FC-GPR.[61]

b. Taxation

Another major challenge in the implementation of the 2014 Scheme is taxation. The Sahoo Committee Report (Phase I) made some far reaching recommendations in respect of the taxation of depository receipts.[62] It noted that depository receipts are foreign securities that are traded beyond the territorial jurisdiction of India. Therefore, there is no reason to tax capital gains from such transactions. Moreover, on cancellation of depository receipts, the foreign investor who was holding the depository receipt becomes the owner of the underlying domestic Indian security. The records show a change in ownership of the underlying domestic Indian security from the depository bank to the foreign investor. However, there is no actual transaction in the underlying security. A similar situation arises in the case of re-conversion of domestic Indian securities into depository receipts. Therefore, the Sahoo

---

57 *See* FEMA 20 Amendment, *supra* note 54, cl. III of Schedule X.

58 *See* Reserve Bank of India, Depository Receipts Scheme (A.P. DIR Series Circular No. 61, Jan. 22, 2015), http://rbidocs.rbi.org.in/rdocs/notification/PDFs/AP61DIR220115DRR.pdf [hereinafter "Circular 61"].

59 *See* Circular 61, *supra* note 58, cl. 6 of Form DRR.

60 *See* Circular 61, *supra* note 58, cl. 12 of Form DRR.

61 *See* Annex–I, Reserve Bank of India, Foreign Direct Investment – Reporting under FDI Scheme: Amendments in form FC-GPR (A.P. DIR Series Circular No. 102, Feb. 11, 2014), http://rbidocs.rbi.org.in/rdocs/notification/PDFs/102APD110214.pdf.

62 *See* Sahoo Committee Report, *supra* note 4, at 46.

Committee Report (Phase I) recommended that such transactions ought not to be treated as a taxable event.[63] Further, a shareholder selling listed shares on a recognised exchange is exempt from long-term capital gains tax and need only pay Securities Transaction Tax (STT). However, if the same shareholder intends to make an off-market tendering of the shares for the purpose of issuing depository receipts, the benefit of long-term capital gains tax exemption is not available.[64] This differential tax treatment results in a limited appetite for transferring shares to a foreign depository towards the issue of depository receipts.[65]

The Finance Bill, 2015 not only fails to implement these recommendations but lags behind contemporary financial reform. Clause 28 proposes some cosmetic amendments to Section 115 ACA of the Income Tax Act, 1961. It replaces the words 'non-resident investors' with 'investors' recognising that resident Indians may also invest in depository receipts under the Liberalised Remittance Scheme.[66] However, it fails to recognise the concept of 'unsponsored' depository receipts, sponsored non-capital raising depository receipts, as well as the economic advantages of allowing unlisted Indian companies to access international capital markets. Consequently, it only envisages the possibility of issuing depository receipts against 'ordinary shares of issuing company, being a company listed on a recognised stock exchange in India.'[67] Further, when a foreign investor cancels a depository receipt and transfers the underlying domestic Indian securities, he has to pay capital gains tax in India. To compute the same, the cost of acquisition of the underlying domestic Indian securities must be ascertained. The Finance Bill, 2015 fails to provide any guidance on this aspect as well.

Conclusion

Expert committee reports have played an important role in the evolution of financial economic policy in India.[68] However, most of these policy recommendations need to be implemented through precise legal instruments. If the drafter of these legal instruments is not involved in the committee process, there is a risk of divergence between the intended policy and the subsequent

---

63 Essentially, this should not be regarded as a 'transfer' for the purposes of computing capital gains. *See* S. 47, Income Tax Act, 1961.

64 *See* S. 10(38), Income Tax Act, 1961.

65 *See* Sahoo Committee Report, *supra* note 4, at 46.

66 *See* Reserve Bank of India, *Liberalised Remittance Scheme*, 2014, http://www.rbi.org.in/scripts/FAQView.aspx?Id=66

67 *See* Cl. 28, Finance Bill, 2015.

68 *See* Ajay Shah, *Expert Committee Reports in Indian Finance* (Feb. 5, 2015),http://ajayshahblog.blogspot.in/2015/02/expert-committee-reports-in-indian.html

draft law. To overcome this risk, recent expert committees set up by the Ministry of Finance have started involving lawyers who can draft the necessary legal instruments. This helps the committee submit a comprehensive policy report along with a draft legal instrument that the government or regulator can implement.[69] The Sahoo Committee Report (Phase I) is one such example. Its recommendations on off-shore depository receipts were shaped by economics, finance, and law. The final recommendations were collated and translated into a precise legal instrument to reduce the risk of ambiguity to the maximum extent possible.

However, implementation remains a bottleneck. Policies once accepted by the government may need to be implemented by different departments and regulators. Co-ordination among them is difficult. Moreover, policy recommendations that are not aligned with the incentives of an agency may not find favour with it, and consequently, implementation suffers. For example, if meeting the revenue target is the sole criterion for measuring the performance of the tax department, it is difficult to see how that department will be inclined to implement a policy that apparently reduces tax collection.[70] Similarly, a securities regulator will not be keen to let domestic companies directly list abroad. This would clearly show its failure in developing the domestic market for capital raising, and increase competition for the intermediaries in the domestic market from which the regulator earns its fees. Therefore, the interests of the securities regulator are also misaligned with these reforms.[71]

The ongoing off-shore depository receipt reforms stand testimony to these various factors influencing the formulation and implementation of financial policies in India. On one hand, it shows how the involvement of stakeholders and lawyers at the policy formulation stage can help in drafting an actionable

---

[69] In Indian finance, the FSLRC was probably the first expert committee to comprehensively review the entire financial legal framework and submit a policy report along with a draft law based on the proposed policy recommendations. *See generally* Financial Sector Legislative Reforms Commission, Indian Financial Code (Mar. 2013), http://finmin.nic.in/fslrc/fslrc_report_vol2.pdf%E2%80%8E.

[70] *See* Tax Administration Reform Commission, First Report of the Tax Administration Reform Commission, tech. rep., 12-13 (Ministry of Finance, May 30, 2014).

[71] From early 2015, SEBI has taken various initiatives to facilitate listing of Indian start-ups on domestic Institutional Trading Platforms (ITPs). The idea is to ease capital raising by Indian start-ups in the knowledge-based sectors like information technology, pharmaceuticals *inter alia*. Moreover, after being listed on the ITP, the companies can move on to the main board as and when they mature. These initiatives by SEBI are in the right direction and, if implemented, would be a worthwhile reform in the Indian capital markets. However, these reforms seem to be a direct consequence of the Depository Receipts Scheme, 2014 – a last ditch effort by the securities regulator to lure Indian start-ups in the knowledge based sectors to list in India rather than venture abroad in search of greener pastures.

policy report along with the necessary legal instruments. On the other hand, it illustrates how a diffused governmental set-up, with multiple departments and regulators with misaligned incentives, can delay the implementation of even the most precisely drafted policy recommendations. Although the institutions may not be broken, evidently, the institutional structures have become obsolete and incapable of smoothly implementing necessary policy changes. It is time to rethink the entire institutional architecture to streamline the financial policy implementation process,[72] acknowledge the present institutional weaknesses and muster the political will necessary to initiate institutional reform.

---

[72] The FSLRC report recommended overhauling the present financial regulatory architecture and replacing it with a modern one. For the report, *see generally*, Financial Sector Legislative Reforms Commission, Justice B.N. Srikrishna Report (see n. 25).

Revisiting the Dual Class Share Structure Debate in India Post the Alibaba IPO: Attempting to Tread the Middle Ground

Arka Saha[*] *& Deekshitha Srikant*[**]

In December 2014, Chinese e-commerce giant Alibaba listed dual classes of shares on the New York Stock Exchange in the largest initial public offering in history. The Hong Kong Stock Exchange's refusal to grant Alibaba an exemption from its prohibition on dual class share listing resulted in the revival of the long standing debate on multiple class share structures with differential voting rights. This paper attempts to locate this debate within the context of the Indian regulatory framework, and discusses the viability of a hands-off approach by contrasting the Indian experience with those of the United States, Hong Kong and Singapore. The paper concludes in favour of a stricter regulatory regime in order to adequately protect shareholder interests, thereby achieving a middle ground by allowing companies to benefit from the advantages of dual class share structures.

[*] B.A. LL.B.(Hons). Candidate 2017, National Law University Odisha.
[**] B.A. LL.B.(Hons.) Candidate 2017, NALSAR University of Law.

Introduction

The Hong Kong Stock Exchange ("HKSE") was moved to an uncomfortable frenzy, when Jack Ma's Alibaba Group Holding Ltd. ("Alibaba") chose to shun the native securities market in favour of the New York Stock Exchange ("NYSE") for what turned out to be the largest initial public offering in history, generating funds worth $25 billion.[1] The paramount consideration for Alibaba in making the offering of dual classes of shares was the HKSE's stricter listing norms which disallow weighted shares, in keeping with the golden 'one vote for one share' rule of corporate democracy. The NYSE on the other hand, allows for shares with differential voting rights to be listed, making it inherently attractive to companies which have different classes of shares with different rights attached thereto. The governance structure adopted by Alibaba, as evident from its prospectus,[2] confers on its 'partnership', which comprises twenty-eight members including its chairman and various other promoters, the right to nominate the majority of its Board of Directors[3]– a right seen as essential to "*set the company's strategic course without being influenced by the fluctuating attitudes of the capital markets so as to protect the long-term interests of Alibaba's customers, the company itself and all shareholders.*"[4]

The popularity of dual class capitalisation has been on the rise with companies such as Google Inc. (traded on NASDAQ) and Facebook, Inc.(traded on NASDAQ) choosing to adopt the same method of capitalisation. Prior to these technology companies, media houses such as The New York Times, The Washington Post and News Corp adopted a similar capital structure as they claimed it helped them in maintaining journalistic integrity. In India, Section 43(a) of the Companies Act, 2013 allows for equity share capital with voting rights[5] or with differential rights as to dividend, voting and any other right subject to prescribed rules in that regard.[6]

---

1 After an initial accumulation of about $21.8 billion, the underwriters to the online marketing giant are reported to have exercised a green-shoe option in the underwriting agreement that allowed for over-allotment of 48 million shares, in light of increased demand, thereby taking the total funds raised to $25 billion.

2 Securities Exchange Commission, *Registration Statement under Securities Act, 1933 of Alibaba Group Holding Limited* (May 6, 2014), http://www.sec.gov/Archives/edgar/data/1577552/000119312514184994/d709111df1.htm.

3 *Id.*

4 Joe Tsai, *Alibaba Offers an Alternative View of Good Corporate Governance*, Alizila, September 26, 2013, http://www.alizila.com/alibaba-offers-alternative-view-good-corporate-governance.

5 Sec. 43(a)(i), Companies Act, 2013, (Act No. 18 of 2013).

6 Sec. 43(a)(ii), Companies Act, 2013.

In light of these recent developments in global capital financing, the merits and demerits of dual class capitalization must be revisited. This article seeks to outline the advantages and disadvantages of dual class share structures and examine their feasibility in the Indian market. Part I of the article elucidates the history and mechanics of dual-class share structures in India. Part II deals with the benefits of dual class share structures and its utilityas a pre-bid takeover defense, while Part III enumerates the risks involved in such capitalization and the corporate governance issues arising from the same. Part IV contrasts the experiences of the United States, Hong Kong and Singapore with dual class capitalisation, and drawing lessons from their experience, Part V recommends strengthening the existing regime regulating such structures in order to ensure better protection of shareholder interests.

I. History of Dual Class Capitalisation in India

The effect of dual class capitalization is the separation of cash flow-rights from voting rights by means of creation of two or more classes of shares with different sets of rights attached. This phenomenon was discovered for the first time in 1926, in a study which traced the increasing tendency of common stock offerings to restrict voting rights of certain classes of shareholders.[7] Legal devices to maintain control in companies where the management owns a minority shareholding, such as non-voting stock, 'pyramiding' non-voting preferred stock and vote-trusts became so popular[8] that they were employed by as many as 42 of the 200 largest companies to maintain control.[9]

In 1991, an expert study on the establishment of new stock exchanges recommended that corporations which had a track record of declaring legitimate dividend be permitted to issue shares without the right to vote.[10] The Companies Bills of 1993 and 1997 further proposed to legitimise shares with differential voting rights (DVRs) in India, positing that such issues be limited to 25% of the total issued share capital[11] – a notion that was actualized vide the Companies (Amendment) Act, 2000, which amended Section 86 of the Companies Act, 1956 (with effect from December 13, 2000). The

---

7 Stevens, *Stockholders' Voting Rights and the Centralization of Voting Control*,40Q.J. Econ. 353, 355 (1926).

8 A. Berle & G. Means, The Modern Corporation and Private Property, 69-75 (rev. ed. 1968).

9 *Id* at 88-89.

10 Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 Geo. Wash. L. Rev. 687 (1985-1986) (hereinafter 'Seligman').

11 *See generally*, Souvik Roy and Kumar Akarshan, *Differential Voting Rights: A Necessity or a Burden*, Taxmann, http://www.taxmann.com/datafolder/Flash/flashart6-8-09_5.pdf (hereinafter 'Roy and Akarshan').

amendment to Section 86 had the effect of dividing equity shares into equity with voting rights and equity with differential rights to dividend, voting or otherwise.[12] Section 2(46A) was also inserted to define 'shares with differential rights' in terms of Section 86.[13] Section 88 of the Companies Act, 1956, which restricted the issue of shares with differential rights as to voting, dividend, capital or otherwise, by public companies, was simultaneously repealed.

In order to enable companies to issue shares with DVRs, the Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001 were promulgated by the Department of Corporate Affairs. The rules set down conditions for an issue of shares with differential voting rights,[14] and allow for the issue equity shares with both higher and lower voting rights. Section 43(1)(a) of the Companies Act, 2013 recognises and allows for shares with differential voting rights in respect of voting, dividend or 'otherwise' *i.e.* other rights which can be contractually attached to shares.

---

[12] *Id.*

[13] Sec. 2(46A), Companies Act, 1956 (Act 1 of 1956).

[14] A few important conditions laid down include the following:

1. The company must have had distributable profits for a minimum of three financial years prior to the year in which shares with differential voting rights are to be issued.
2. The company, for three financial years preceding the year in which shares with differential rights are to be issued, must not have defaulted in filing annual accounts and annual returns.
3. The company must not have failed to repay its deposits or the interests thereon and further, must not have failed to redeem debentures on the due date.
4. The company must not have been convicted under any offence under the Securities Exchange Board of India Act, 1992, the Securities Contracts (Regulation) Act, 1956 and the Foreign Exchange Management Act, 1999.
5. The company must not have defaulted in meeting investor grievances.
6. A listed public company must have obtained approval of extant shareholders by the means of postal ballot.
7. The company must have obtained approval of the shareholders in its general meeting by passing a resolution as required under Sections 94(1)(a) and 94(1)(b).
8. The notice of such meeting must have accompanying it, an explanatory statement consisting of
   a) The proposed rate of voting rights that the equity share capital with differential rights will carry.
   b) The scale or proportion to which such voting rights will vary.
   c) A declaration that the company shall not convert its equity capital with voting rights to equity capital with differential voting rights and vice-versa.
   d) A declaration that the shares with differential voting rights shall not exceed 25% of the total share capital issued.
   e) A declaration that a member holding any equity share with a differential right shall be entitled to bonus shares and right shares of the same class.
   f) A declaration that the holder of equity shares with differential voting rights shall enjoy all other rights to which the holder is entitled, for the differential right accorded to the equity share with regards to voting.

Tata Motors issued shares with differential rights to fund their acquisition of Jaguar Land Rover in 2008, becoming the first company in India to raise capital by means of such an issue.[15] The company issued 6.4 crore shares with differential rights, carrying one-tenth of the voting rights attached to ordinary shares, while commanding a higher dividend. Subsequently, Pantaloons Retail India issued shares with DVRs with one-tenth the voting rights attached, offering a 5% additional dividend as opposed to normal equity shares. Subsequently, the legality of shares with DVRs was upheld by the Company Law Board ("CLB") in *Anand Pershad Jaiswal* v. *Jagatjit Industries Ltd*.[16] The case was centered on a petition to declare a resolution passed at an Extraordinary General Meeting void, by means of which preference shares (each containing 20 votes) had been allocated to K.P. Jaiswal & Sons. This action was upheld by the Company Law Board in light of the enabling framework under Section 86 and the 2001 Rules. Consequently an order was passed to purchase the stake of Anand and Jagajit Jaiswal on the company's behalf as buyback of shares in cash, resulting in a reduction of the equity share capital to that extent.[17]

The Securities and Exchange Board of India ("SEBI") has also attempted reforms with respect to shares with DVRs from time to time – by relaxing the requirements for listing shares with DVRs under the Securities Contracts (Regulation) Act, 1956 by amending the Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000. In 2009, the SEBI Board Meeting on Primary Market Reforms' proposal that no listed company be permitted to issue shares with superior voting rights, culminated in SEBI transforming the concept of DVRs by introducing Clause 28-A of the Listing Agreement.[18]

Dual class shares can be created either at the time of the initial public offer (capitalisation) or by subsequent disenfranchisement through the recapitalization method.[19] Some of the means of recapitalization available are: (*a*) exchange mechanisms (where shares with greater voting rights would lose these rights if transferred beyond a specified group), (*b*) exchange

---

15 Rahul Oberoi, *How to Benefit from Shares with Differential Voting Rights*,Mirror Image, Money Today, March 2013, http://businesstoday.intoday.in/story/how-to-benefit-from-shares-with-differential-voting-rights/1/192706.html.

16 *Anand Pershad Jaiswal* v. *Jagatjit Industries Ltd*., (2010) 1 Comp LJ 509.

17 *Supra* note 15.

18 Clause 28-A of the Listing Agreement states that the listing company must agree to not issue shares in any manner which may confer on any person, superior rights as to voting or dividend vis-à-vis the rights on equity shares that are already listed.

19 *See*, Peter N. Flocos, *Towarda Liability Rule Approach to the "One Share, One Vote" Controversy: An Epitaph For The SEC's Rule 19c-4*, 138 U. Pa. L. Rev., 1761, 1762 (1990) (hereinafter 'Flocos').

offers (where shareholders are given the option to give up voting rights for increased dividend or maintain the existing voting and dividend rights), and (*c*) limited phased voting (limiting the voting rights of a shareholder who has acquired a certain threshold of shares). Other mechanisms include (*d*) leveraged buy-outs (where the company's shareholders themselves buy the stock with increased voting rights), and (*e*) super-voting stock (where after an amendment to the articles of association, new stock with decreased dividend and increased voting rights is issued, curbing transferability of shares).[20]

II. Justifications for Dual Class Share Structures

A. Berle and Means' Separation of Ownership and Control

The management of large public corporations is based on a wide hierarchical structure vested with the ultimate objective of maximising the value of the company, and in effect, shareholder wealth. Such a system is typically characterised by a vast information asymmetry between the managers and the share holders, owing to the former's inside knowledge of business plans and tactics, as well as the wide resources available to them for studying capital markets and other information regarding the sector in which the company operates.

One fear prevalent among corporate management is that shareholders, owing to misinformation or the lack of information, may sell control of the firm to a hostile bidder.[21] Such a situation may prevent management from taking decisions and framing policy which is difficult to reveal to shareholders, though it may potentially result in wealth maximization. The management is thus constantly burdened with short-term profit maximisation, often compromising the long term aspirations of the company.[22] Further, corporate decisions relating to financing and dividend payouts are increasingly being considered indicative of management's intentions,[23] and affect share prices – presumably on account of the increasing relevance of the 'irrelevancy' theorem',[24] which states that the value of a firm is independent

---

[20] *See generally*, Weston, Takeovers, Restructuring and Corporate Governance 365-380 (7th ed., 2009); Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice* 76 Cal. L. Rev. (1988) (hereinafter 'Gordon').

[21] Allen Franklin and Michaely Roni, *Payout Policy*, North-Holland Handbook of Economics and Finance (Wharton Financial Institutions Center Working Paper No. 01-21-B, April 2002).

[22] DeAngelo & De Angelo, *Managerial Ownership of Voting Rights*, 14 J. Fin. Econ.35 (1985).

[23] Gonedes, *Corporate Signaling, External Accounting, and Capital Market Equilibrium: Evidence on Dividends, Income, and Extraordinary Items*, 16 J. Acct. Res. 26 (1978).

[24] Modigliani & Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*,Am. Econ. Rev., (June 1958).

of its capital structure. Thus, corporate management may hesitate to take wealth-maximising decisions based on the signals given by such decisions.[25]

Profit-oriented investors welcome increases and reject cuts in dividend. As a result, the management typically maintains a constant rate of dividend even when performance declines in order to avoid shareholder dissatisfaction. Due to these behavioral tendencies, an increase in dividend causes shareholders to assume that such rate will be maintained over a long duration, providing a causal impetus for a rise in share price.[26] However, a decline in the rate of dividend declared results in speculation that the earnings of the company will decline in the future, thus bringing down share prices. Proviso (1) to Section 123 of the Companies Act, 2013 allows for a company to transfer such percentage of its profits that it deems necessary to its reserves before the declaration of dividend.[27] However, in light of the above findings, the company's management may, view any such proposal as detrimental to share prices, thereby leaving the company vulnerable to hostile takeovers. Dual class share structures, which often vest control in the management by virtue of them possessing shares with greater voting rights, is thus an effective solution to the information asymmetry between the shareholders and the management. Such a structure allows the management to devise and implement financial decisions without being weighed down by aforementioned concerns.

B. Takeover Defense

In a competitive market, companies are often faced with the threat of predatory takeover tactics by competitors or other companies, intended to result in a hostile takeover. Furthermore, a company may face a situation wherein it has to acquire shares at a premium to ward off a 'green-mailer' from taking control. Faced with such hostile situations, a company can adopt a slew of defensive strategies to ward off the raider. Some of these 'kamikaze' defensive strategies intended to make the target company appear less attractive to a raider include the 'fat-man' defense, which involves increasing the target company's debt load by acquiring assets; the 'sale of crown jewels' defense, which involves alienating the company's most prized assets; and the 'macaroni' defense, which involves issuing a vast number of bonds with the condition that they shall be redeemed at a higher rate if the company is taken over. However, the difficulty with these strategies lies in the fact that

---

25 Gordon, *supra* note 20.
26 Gordon, *supra* note 20.
27 Section 123, Companies Act, 2013.

they adversely affect the financial standing of the company, to the detriment of shareholders.

Dual class capitalization is thus an extremely effective means of thwarting off hostile takeovers as most of the voting rights rest with the management.[28] A company with such capital structure may negotiate for an optimum price on behalf of the shareholders in the event of a takeover bid, so as to maximize overall shareholder wealth.[29] Thus, non-controlling shareholders are protected from coercive takeovers, and the possibility of them giving up control is checked.[30]

Dual class capitalization as a pre-bid takeover defense assumes great importance in India, where traditionally promoters hold a small percentage of shares, as the need to maximise monetary returns which can be satiated by the takeover premium offered by a raider, can make promoters vulnerable to shareholder opportunism.[31]

III. The Downsides to Dual Class Share Structures

First, one of the strongest arguments against dual class capitalization is that it is completely antithetical to the golden 'one share, one vote' rule of corporate democracy by allowing insiders to take control without investing in a significant amount of equity. A company is a creature of contract, and authorisation for any delegation is to be done by the shareholders voting at a general meeting.[32] Abrogation from this principle results in a disconnect between the residual income rights of a shareholder[33] and control rights. A shareholder who holds disproportionate voting rights is more likely to pursue self-interest to the detriment of the company's interests, as he is able to transfer his risk to the company, and thereby to the rest of the shareholders, without bearing the full repercussions of corporate decisions.[34]

The degree of variation from the existing shareholder-manager relationship is determined by whether dual class capitalization happens during the company's initial public offering (where the right to vote never existed in the

---

28 Gordon, *supra* note 20.

29 Gordon, *supra* note 20.

30 Abhishek Nath Tripathi and Uttam Maheshwari, *Shares with Differential Voting Rights: A Legal and Economic Analysis*, 15 Student B. Rev. 74, 76(2003) (hereinafter "Tripathi and Maheshwari").

31 *Id.*

32 Section 96 of the Companies Act, 2013 stipulates that every company (other than a one person company) is to hold an annual general meeting of its shareholders.

33 A shareholder has a right only to the "*residual income*" of the company.

34 Tripathi and Maheshwari, *supra* note 30, at 76.

first place due to the company making an IPO with a disproportionate share structure)[35] or recapitalisation (where shareholders are disenfranchised due to a change in the company's share structure). The latter has been the subject of greater scrutiny.

Second, crafting a shareholder voting policy should strive to promote maximum corporate efficiency, capital raising, flexibility, and equity. Perhaps the strongest argument for dual class stock is enabling the management to more easily set and achieve long-term goals, without diluting control of the firm. However, what this concomitantly does is remove all checks on managerial conduct, as the largest shareholder (usually, the Chief Executive Officer) effectively elects the board of directors.[36] In the context of the Alibaba IPO, this danger is especially highlighted as certain members of the company's management formed a partnership, which retains the exclusive right to nominate majority members of the board of directors.[37]

The sphere of decision-making and allocation of power between the shareholders in the general meeting and the board of directors are separate, and the former cannot encroach upon the latter unless specifically empowered by the articles of association, or remove/refrain from re-electing a director if unsatisfied with his/her work. Dual class stock would allow directors to re-elect themselves with the support of the controlling shareholders, thus upsetting the balance of power and removing the only check upon the director.[38] For example, the board of directors of Google unanimously approved the issuance of non-voting stock further focusing control on its founders, in order to avoid resignation or failure to be nominated to the board the following year.[39]

Third, dual class stock also curtails the independence of executive directors, making them susceptible to the decisions of those who possess the support of shareholders with greater voting rights.[40] This would be particularly problematic in India in light of the new corporate governance regime, post the enactment of the Companies Act, 2013 and revised Clause 49 of SEBI's Listing Agreement. In fact, the introduction of the concept of independent director (in Section 149(5) of the Companies Act, 2013 and Clause 49(IIB) of

---

35 *See*, Flocos, *supra* note 19.
36 Tian Wen, *supra* note 37.
37 *Supra* note 2.
38 Tripathi and Maheshwari, *supra* note 30, at 80.
39 Andrew Ross Sorkin, *Stock Split for Google that Cements Control at the Top*, N.Y. Times Dealbook (Apr. 16, 2012), http://dealbook.nytimes.com/2012/04/16/stock-split-for-google-thatcements-control-at-the-top.
40 George W Dent, Jr., *Dual Class Capitalization: A Reply to Professor Seligman* 54 Geo. Wash. L. Rev 725, 739 (1986).

the Listing Agreement) to ensure unbiased decisions and check managerial conduct is diluted in the case of dual class structures.[41] Such concentration of ownership also increases the likelihood of related party transactions.[42]

Fourth, managerial entrenchment is another consequence, due to lack of pressure from non-controlling shareholders. Rupert and Jane Murdoch, for example, retained their positions even after being embroiled in criminal charges as their own respective voting rights were sufficient to ensure their positions.[43] Oversight by institutional investors also dwindles, as they usually depart from companies with dual class structures – see for instance, Morgan Stanley's exit from The New York Times.[44]

Fifth, although one of the justifications of dual class stock is its utility as a takeover defense, it could in fact prove to be the opposite. Inefficiently managed companies are the target of takeovers by efficiently managed companies, and the efficiency of a company is usually reflected in the price of its stock. Dual class stock, in turn, fosters poor standards of management by allowing greater control to holders of lesser equity, ultimately leaving the company vulnerable to takeover bids.[45] Stock price is a reflection of the success of the firm, and success can often be directly related to managerial action.[46]

Sixth, a fall in the price of common stock is also another usual consequence, due to the amount an investor would be willing to pay to gain control over the company. Since there exists a class of stock equal to the remaining stock in all aspects except for the fact that it carries additional voting rights, this stock trades at a higher price, devaluing the remaining.[47]

---

41 KPMG, *SEBI's Amendments to Corporate Governance norms* (Apr. 22, 2014), https://www.in.kpmg.com/SecureData/aci/Files/SEBI%60samendmentstocorporategovernancenorms.pdf.

42 Organisation for Economic and Co-operative Development, *Guide on Fighting Abusive Related Party Transactions in Asia*, September 2009, Asian Corporate Governance Association, ACGA White Paper on Corporate Governance in India (January 2010).

43 *See*, Richard Blackden, *Rupert Murdoch's Iron Grip on News Corp Dealt a Blow*, Telegraph (Oct. 17, 2012), http://www.telegraph.co.uk/finance/newsbysector/mediatechnologyandtelecoms/media/9613863/Rupert-Murdochs-iron-grip-on-News-Corp-dealt-a-blow.html.

44 Press Release, *Morgan Stanley Investment Management. Ltd., Calls for Elimination of Dual-Class Capital Structure to Enable All Shareholders to Hold Board of Directors and Management Accountable for Company's Performance* (Apr. 18, 2006), http://www.businesswire.com/news/home/20060418005896/en/MSIMs-Global-Franchise-Investment-Program-Announces-Withhold.

45 Icahn, *The Case for Takeovers,* N.Y. Times 34 (29 Jan. 1989); Karen D. Bayley, *Rule 19c-4: The Death Knell for Dual-Class Capitalizations* 15 J. Corp. L. 1, 12(1989-1990).

46 *Id.*

47 Gordon, *supra* note 20.

The other oft-cited argument is efficiency, and allocation of such rights to those who most value them.[48] However, since votes are tied to the residual rights of a company, unless each element of residual interest has equal voting rights, optimal decision-making will remain out of reach.[49]

Seventh, the jurisprudential justification for dual class shares is grounded in the freedom of contract, and autonomy of the shareholder – *i.e.*, that the shareholder should be entitled to purchase dual class of shares, if he so desires, knowing fully the consequences of the same during an IPO. However, this premise does not consider the 'freeness' of this choice, which is often manufactured as a result of seemingly massive, irresistible deals, such as the Facebook IPO in 2012.[50] Improper discounting of stocks at the stage of initial public offer or failure on the part of merchant banks working with issuers to furnish adequate information are also unaccounted for, as in the case of Facebook when it realized that its revenues were not as high as initially estimated.[51] Hence, dual class share structures have a fair share of complexities and complications as the media has begun to point out in the context of the Alibaba IPO.[52]

IV. Comparison with Other Jurisdictions

Alibaba is not the first company to take refuge in the United States to launch their IPO as a different jurisdiction did not allow their dual class structure. In 2012, Manchester United listed themselves in the United States, as the London Stock Exchange did not permit their structure and the Hong Kong Stock Exchange refused a waiver on similar grounds.[53] This Part, therefore, attempts to delineate this decision-making by studying the position on dual class structures in the United States, Hong Kong, and Singapore, before

---

48 *See*, the usage of the Coase theorem in Douglas C. Ashton, *Revisiting Dual Class Stock* 68 St. John's L. Rev. 863 1994 ('Ashton'); Tripathi and Maheshwari, *supra* note 30, which envisage allocation of a right to those who most value it for maximum efficiency.

49 Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 5 (1st ed. 1996).

50 ISS, *The Tragedy of Dual Class Commons* (Feb. 13, 2012), http://online.wsj.com/public/resources/documents/facebook0214.pdf.

51 Khadeeja Safdar, *Facebook, One Year Later: What Really Happened in the Biggest IPO Flop Ever,* Atlantic (May 20, 2013), http://www.theatlantic.com/business/archive/2013/05/facebookone-year-later-what-really-happened-in-the-biggest-ipo-flop-ever/275987.

52 *See*, for example, David Reidel, *Four Reasons To Avoid The Alibaba IPO*, Forbes (Sept. 15, 2014) http://www.forbes.com/sites/investor/2014/09/15/four-reasons-to-avoid-the-alibaba-ipo/.

53 Steven M. Davidoff, *In Manchester United's I.P.O., a Preference for American Rules*, N.Y. Times Dealbook (Jul. 10, 2012), http://dealbook.nytimes.com/2012/07/10/in-manchester-unitedsi-p-o-a-preference-for-u-s-rules.

attempting to draw a conclusion on what the ideal position on dual class stock should be.

Some jurisdictions, such as the United States, permit dual class stock both in their company law and listing rules, whereas others such as Germany, Spain and China do not allow such stock in either the legislation or the listing rules. Other countries such as Hong Kong and Singapore only allow them in their respective company law regimes.[54]

A. United States of America

The United States, initially in favour of the 'one share, one vote' principle, has had a fluctuating attitude towards dual class stock. In 1925, the listing of non-voting shares by two well reputed corporations, namely Dodge Brothers, Inc. and Industrial Rayon Corporation, was severely criticised as being opposed to public policy– the same was being utilised for the recovery of purchase prices of businesses by banking houses by the sale of new shares, bereft of voting rights.[55] Subsequent to this, various listings of non-voting stock were rejected by the NYSE on the ground that it was against public policy. Competition from the National Association of Securities Dealers' (NASD) NASDAQ and American Exchange ("AMEX") however lead to the appointment of a sub-committee on Shareholder Participation and Qualitative Listing Standards by NYSE to review listing norms. This inquiry became necessary as a multitude of corporations began exploring such governance structures as an effective pre-bid defense to hostile takeovers. This led to the adoption of a proposal allowing dual class stock in 1986,[56] when the dual class debate resurfaced due to the General Motors' acquisition of Ross Perot's Electronic Data Systems Corporation.[57] Thus, NYSE now allows the listing of companies with dual class share structures, subject to the conditions of approval by a majority of shareholders and a majority of independent directors, failing which the company runs the risk of delisting.[58]

---

[54] Hong Kong Stock Exchanges and Clearing Limited, *Concept Paper: Weighted Voting Rights* 43 (Aug. 2014).

[55] Seligman, *supra* note 10.

[56] Seligman, *supra* note 10, at 688.

[57] M.G. Warren III, *One Share, One Vote: A Perception of Legitimacy*89J. Corp. L 92–3 (1988).

[58] This was a significant relaxation of the earlier conditions framed by the subcommittee formed:

a) Two-thirds of all shareholders eligible to vote must approve the creation of another class of shares;

b) Approval by a majority of independent directors if the Board is contains a majority of independent directors, or consent of all such directors if they comprise of a minority;

c) A ratio of differential rights of not more than ten to one;

Non-voting stock is also permitted, provided that such class of shares meets all the original listing requirements, that all classes of stock carry the same rights in all aspects except voting and holders of such shares receive all communication sent to all shareholders.[59] State law now governs the regulation of voting rights, and NYSE and AMEX are granted exemptions from prohibitions by most states, after the notorious *Business Round table* decision[60] and the Security Exchange Commission's ("SEC") Rule 19c-4 which was introduced to deal with the inconsistencies in the listing standards applicable to dual class stock.[61] However, the degree of SEC opposition has since waned, thus making the United States one of the few jurisdictions that allow dual class stock subject to minimal preconditions.[62]

B. Hong Kong

Although the concept of dual class stock is not alien to this jurisdiction, the Hong Kong Stock Exchange has historically been apprehensive about it, as seen from its refusal to grant a waiver in this regard to Manchester United's IPO, as well as the rejection of Jardine Matheson Holding Limited's application to change its share structure in 1987.[63] As a result, Jardine Matheson shifted its Asian listing to Singapore from Hong Kong in 1994, causing unease amongst Hong Kong's business circles[64] – the last ripple caused by dual class shares in Hong Kong until the Alibaba episode.

Alibaba, after entering Hong Kong in a partnership in 2005 with Yahoo China, grew to become one of China's biggest e-commerce platforms, and

d) All stock must carry equal rights in all other respects except voting. *See*, New York Stock Exchange, *Dual Class Capitalization: Initial Report of the Subcommitteeon Shareholder Participation and Qualitative Listing Standards* (NewYork Stock Exchange: New York, NY, 1985) 3.

59 *See*, NYSE Listed Company Manual, §313(B).

60 *Business Roundtable* v. *Securities and Exchange Commission*, 905 F 2d 406 (DC Cir 1990).

61 Ashton, *supra* note 49.

62 This is further facilitated by certain legislations such the Jump start Our Business Startups Act ('JOBS Act'. Pub. L. No. 112-106, 126 Stat. 306 (2012)), which relaxes regulatory requirements of internal control audits and disclosure of executive compensation among others for IPOs of emerging growth companies. Rule 405 of the Securities Act, 1933 further loosens requirements for foreign private issuers. It is no wonder, therefore, that along with Alibaba, other companies such as Weibo, China's version of Twitter, are also moving to the US; *See*, Wen, *supra* n. 44.

63 Kana Nishizawa and Richard Frost, *Hong Kong Seeks Debate on Dual-Class Shares After Losing Alibaba*, The Washington Post (Aug. 29, 2014), http://washpost.bloomberg.com/Story?docId=1376-NB1ZGC6TTDS501-1C5IS8NEPO864NHIMQE8SLT1F6.

64 *Jardine Matheson Holdings Limited History,* Funding Universe, http://www.fundinguniverse.com/company-histories/jardine-matheson-holdingslimited-history/.

was privatised in 2011 after a scam involving sale of fake products.[65] CEO Jack Ma sought to re-enter Hong Kong markets in 2013, while retaining control via a dual class share structure. Hong Kong's Companies Ordinance states that each member of the company has a single vote per share in a general meeting, subject to the company' articles of association. However, dual class shares are permissible, if provided for in the articles, thereby showing that unlisted companies are permitted to possess such a capital structure.[66] However, the Hong Kong Stock Exchange's Main Board Listing Rule 8.11, which prohibits shares with differential voting rights (with exceptions only for existing companies with dual class shares, or where the Exchange agrees to make an exception),[67] stood in his way. Alibaba's request for such an exemption on grounds of its partnership model was rejected, and till date, the Exchange has never listed a company under this exception.[68]

Although there have been whispers of a revamp of this prohibition in light of the Alibaba episode,[69] some scholars argue that the United States can afford to entertain such structures in its environment which affords strong protections to minority shareholders, its factious culture (allowing for securities collective action,[70] prohibited in Hong Kong), and a deeper professional investor base, all of which are absent in Hong Kong due to the stronghold of family-controlled companies.[71]

C. Singapore

The SGX-ST Listing Manual of the Singapore Exchange ("SGX"), does not permit the listing of companies with dual class share structures. However, in 2012, Singapore amended its company law regime to allow for non-voting shares and shares with multiple votes (subject to the company's articles and other safeguards), in order to maintain its position as a leading

---

[65] *Alibaba Chiefs Quit After Probe into Sales Fraud*, South China Morning Post (Feb. 22, 2011).

[66] *See*, Hong Kong Companies Ordinance, Cap 622, §588(3)(a) and (4).

[67] Hong Kong Stock Exchange's Main Board Listing Rule 8.11(1) and (2), respectively.

[68] E. Yiu, *Alibaba Open to IPO Concessions*, South China Morning Post (Sept. 25, 2013).

[69] Greger Stuart Hunter, *Hong Kong Exchange Considers Rule Change After Losing Alibaba IPO*, Wall Street Journal (Aug. 29, 2014), http://www.wsj.com/articles/hong-kong-exchange-considers-rule-change-after-losing-alibaba-ipo-1409311411('HKEX').

[70] The Private Securities Litigation Reform Act 1995 read with Rule 10-b of the Exchange Act allows for this.

[71] *See generally*, Raymong Siu Yeung Chan and John Kang Shan Ho, *Should Listed Companies be Allowed to Adopt Dual-Class Share Structure in Hong Kong?* Comm. L. World. Rev. 43, 155–182 (2014); *see generally*, HKEX, *supra* n. 81.

financial centre.[72] In October 2014, the Singapore Companies Act was amended to extend the same permission to public companies,[73] and SGX and the Monetary Authority of Singapore are currently reviewing the possibility of lifting the prohibition on listed companies.[74] Singapore has clarified that such permission shall be subject to certain safeguards to ensure that investors are well informed and the rights of shareholders are protected, for example:

a. Conversion of shares from one class to another is made possible provided the company's constitution permits it and lays down the rights attached to these classes;[75]

b. A higher threshold for approval (by special resolutions) is required for issuance of such shares;[76]

c. The holder of a non-voting share must have one vote in resolutions proposing a change in any of the rights attached to that share or winding up;[77]

d. Where more than one class of shares exist, the notice of a meeting where such resolution is to be passed must also carry an explanatory statement explaining the voting rights attached to each class.[78]

The legal position in respect of dual class shares in public listed companies remains unclear till date. Nevertheless, Singapore appears to be embracing dual class stock while bearing in mind the risks that they carry especially for public companies, thereby attempting to strike a balance.

Conclusion

The OECD Steering Group on Corporate Governance in 2007 released a report that did not make any *prima facie* findings against the concept of dual class structures. Nevertheless, the report identified certain essential

---

72 Reuters, *Singapore to allow dual-class shares to attract listings* (Oct. 3, 2013), http://www.reuters.com/article/2012/10/03/singapore-listings-rules-idUSL3E8L35UI20121003.

73 Baker & Mckenzie, *Corporate and Securities Client Alert* (Jun. 2013), http://www.bakermckenzie.com/files/Uploads/Documents/Asia%20Pacific/ASEAN/al_singapore_mofacra-feedback_jun13.pdf.

74 *Fact Sheet on the Companies (Amendment) Bill*, https://www.acra.gov.sg/uploadedFiles/Content/Legislation/Companies_Act_Reform/Companies%20(Amendment)%20Bill%20-%20factsheet.pdf('Singapore Companies Fact Sheet').

75 Herbert Smith Freehills, *South East Asia Dispute Resolution Update* (Oct. 28, 2014).

76 Singapore Companies Fact Sheet, *supra* note 75.

77 Ministry of Finance, *Consultation Paper: Report of the Steering Committee for Review of the Companies Act*,137-138 (Jun. 2011).

78 *Id.*

prerequisites such as liquid and well-informed capital markets and recommended the introduction of shareholder grievance redressal mechanism so as to ensure that private advantage extraction does not reach intolerable levels.[79] In this regard, India still needs to focus on the underlying liquidity of its capital markets,[80] and on corporate governance reforms. However, the fact that India shares many of the same concerns as Hong Kong, including a stronghold of family-run businesses, and scarce collective action by shareholders, cannot be ignored or denied.[81]

The regulatory framework in India governing dual class shares is centered on Section 43 of the Companies Act, 2013 (*i.e.* Section 86 of the erstwhile Companies Act, 1956), the Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001 and the SEBI (Disclosure and Investor) Protection Guidelines, 2000 (as amended in 2009).[82] While the issuance of shares with superior voting rights is prohibited in India,[83] the only pre-requisites set out in the 2001 Rules are availability of distributable profits, no defaults in filing annual returns, resolving investor grievances or repayment of deposits, and no convictions for offences under the Securities Contract (Regulation) Act, 1956, Foreign Exchange Management Act, 1999 and Securities Exchange Board of India Act, 1992. In addition to authorization under the articles of association, shareholder consent must be obtained at a general meeting by means of a resolution. In the case of a public listed company, this can be by means of a postal ballot. An explanatory statement is to be issued detailing the rate of voting rights, degree of variation, and prohibition on conversion of shares with voting rights to shares with differential voting rights, inter alia. Significantly, the explanatory statement should clarify that holders of such shares are entitled to bonus or rights issues, and will possess all the same rights as all other classes of shares other than voting.[84]

---

79 OECD, *Lack of Proportionality Between Ownership and Control: Overview and Issues for Discussion* (Dec. 2007).

80 Mobis Philipose, *India has a lot to do in building liquidity in equity trading*,Mint (Nov. 18, 2013) http://www.livemint.com/Money/BnQOHxGA7upjd9wES24KqN/India-has-alot-to-do-in-building-liquidity-in-equity-trading.html?utm_source=copy.

81 Although the same is not prohibited, its lack of popularity in India has led to SEBI having made attempts to create incentives for class action in India through the SEBI (Investor Protection and Education Fund) Guidelines, 2009; *see generally*, SEBI (Investor Protection and Education Fund) Guidelines, 2009; Umakanth Varottil, *Shareholder Activism and Class Action*, IndiaCorpLaw (Jun. 22, 2009), http://indiacorplaw.blogspot.in/2009/06/shareholder-activism-and-class-action.html.

82 Roy and Akarshan, *supra* note 11.

83 *See*, SEBI, *Amendments to the Listing Agreement* (Circular SEBI/CFD/DIL/LA/2/2009/21/7 dated July 21, 2009).

84 Rule 3, Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001.

It is surprising that the legislators chose to amend the Listing Agreement itself to prohibit the issue of shares with superior voting rights (vide Clause 28-A), instead of simply amending the SEBI (Disclosure and Investor Protection) Guidelines, 2009 or the 2001 Rules. The language of Clause 28-A gives rise to further ambiguity: "*the company agrees that it shall not issue shares in any manner which may confer on any person, superior rights as to voting or dividend vis-à-vis the rights on equity shares that are already listed*."[85] The usage of the term 'superior rights' in imposing the prohibition creates several anomalies and raises complex questions for consideration. Shares with lower or inferior voting rights are allowed to be listed, but will this become the new benchmark and prevent the issuance of the standard equity that companies have consistently been issuing? Will the amendment affect, for instance, the issuance of preference shares with differential rights as to dividend or special rights (such as affirmative vote) to investors under the articles of association?[86]

The inclusion of additional safeguards such as obtaining consent of shareholders through special resolution, preferably by means of a super-majority, as in the United Kingdom, would be a step in the right direction. In addition, in order to prevent managerial entrenchment, holders of subordinate shares should be allowed to directly elect a part of the board of directors,[87] and equal treatment of all shareholders in the face of a takeover bid must be ensured.[88] The Toronto Stock Exchange, for instance, has a mandatory 'coat-tail' provision that allows minority shareholders to tag along at the same price as the holders of superior shares in a takeover bid, ensuring that the control premium is equally distributed between different classes of shares.[89] Indeed, a minimalist regulatory framework as followed in the United States, cannot work in a country where control is so concentrated in the hands of a few family-controlled businesses.

Further, the authors suggest that several concerns surrounding dual class shares can be addressed by the mandatory incorporation of a sunset clause in the company's governance structure. Such a clause would specify that when a certain growth or strategic landmark is reached, the shares carrying

---

85 Clause 28-A, SEBI Listing Agreement.

86 Jayant Thakur, *SEBI Prohibits Issue of Shares with 'Superior' Voting Rights*, IndiaCorpLaw (Jul. 22, 2009), http://indiacorplaw.blogspot.in/2009/07/sebi-prohibits-issue-of-shares-with.html.

87 Barry J. Reiter, *Dual-Class Shares: Not the Enemy*, Lexpert, http://www.bennettjones.com/Images/Guides/external9759.pdf..

88 Robert A.G. Monks, and Nell Minow, Corporate Governance 373 (4th ed., Wiley).

89 Barry J. Reiter et al., *Dual Class Shares – Good or Bad or Both?*Bennett Jones, *available at* http://www.bennettjones.com/uploadedFiles/Publications/Articles/DUAL%20CLASS%20SHARES(2).pdf.

superior voting rights will automatically lapse or convert to ordinary shares, mitigating some of the long-term consequences of a dual class share structure.[90] Since investors can then make informed decisions knowing the expiry date of the control mechanism, it gives the promoters of the company sufficient time post-IPO for the development of the company, paving a middle ground between shareholder rights and competitiveness.[91]

---

[90] Deliotte Insights, *Dual-class Share Structure: Weighing the Risks and Rewards* (Apr. 9, 2014), http://deloitte.wsj.com/riskandcompliance/2014/04/09/dual-class-share-structure-weighing-the-risks-and-rewards/; Simon C.Y Wong, *Rethinking One Share, One Vote*, Harvard Business Review (Jan. 29, 2013), https://hbr.org/2013/01/rethinking-one-share-one-vote.

[91] Peter L. Simmons, *Dual Class Recapitalization and Shareholder Voting Rights*, 87 Colum. L. Rev. 106, 114 (1987).