Dual-Class Shares

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This is taken from my 17/4/17 response to the UK government's Green Paper on Industrial Strategy. The full response is at http://bit.ly/AlexIndStr.

1.1 p67 of the Green Paper asks whether companies with dual-class shares should qualify for a Premium Listing. I strongly advise against allowing such companies to qualify for a premium listing.

1.2 The evidence is that dual-class shares are associated with significantly lower firm valuations.

1.2.i Gompers, Ishii, and Metrick's (2010) find that "firm value is increasing in insiders' cash-flow rights and decreasing in insider voting rights". The statistical significance becomes smaller, but the economic significance remains as strong, when using instrumental variables to address the endogeneity of the decision to have a dual-class structure.

1.2.ii These results are consistent with cross-country evidence that, when voting rights exceed cash flow rights, firm value is significantly lower. Lins (2003) studies 1,000 firms in 18 emerging markets and finds that firm value is lower when voting rights exceed cash-flow rights. Claessens et al. (2002) study 1,300 firms in eight East Asian countries and find that firm value decreases when the voting rights exceed the cash-flow rights.

1.2.iii These academic findings are backed up by practitioner studies. A 2012 study by the Investor Responsibility Research Centre ("IRRC") showed that controlled companies with multiple share classes exhibited lower long-run stock returns, higher stock price volatility, and a higher likelihood of accounting-related material weaknesses and related-party transactions than non-controlled companies. A 2016 study by the IRRC found that, in controlled companies, there is less gender and ethnic diversity in the boardroom, directors have longer average tenures with less board refreshment, and there are more and larger related-party transactions. CEO pay at controlled companies with multiple share classes is $7.2 million higher than at single-class controlled companies, and $3.3 million higher than in non-controlled firms.

1.3 These results suggest that, far from protecting a firm's entrepreneurial vision and allowing it to invest for the long-term, dual-class shares entrench management and allow it to pursue its own interests. Indeed, Masulis, Wang, and Xie (2009) find that dual-class shares are associated with:

1.3.i A lower valuation of corporate cash holdings. Cash held on the balance sheet is valued less by the market, consistent with entrenched management using free cash to pay themselves excessively or consume perks. It is inconsistent with dual-class shares allowing managers to undertake valuable long-term investments.

1.3.ii Higher CEO pay. This is consistent with evidence that institutional investor monitoring reduces CEO pay, and ties it more to performance (Hartzell and Starks (2003)).

1.3.iii Worse acquisitions, consistent with dual-class shares allowing managers to build empires. Specifically, acquisitions are associated with lower returns and more likely to exhibit *negative* returns. Moreover, firms are less likely to withdraw from acquisitions that the market perceives as value-destroying, again a sign of insulation from external discipline.

1.3.iv A lower valuation of capital expenditure – i.e. capital expenditures contribute less to firm value. This is consistent with entrenchment leading to empire-building or indisciplined investment rather than valuable long-term investment.

1.4 Moreover, the principle behind dual-class shares sits uneasily with the Government's mission to give voice to the voiceless and make Britain a "country that works for everyone". Dual-class shares entrench the elite by making management *less* accountable, which is why management pays themselves excessively and makes bad acquisitions. Retail shareholders who put their hard-earned money into companies are denied votes. Pension funds who invest for the long-term interest of their beneficiaries are denied votes. Dual-class shares send the message that corporations want the public's money, just not their opinions – similar to the famous quote "taxation without representation is tyranny". For some shareholders to have a voice and others – who are also risking their money in the firm – not to goes against the principle of fairness that the Government is trying to promote. Many commentators rightly highlight the problems of the ownerless corporation and shareholder disengagement; dual-class shares will severely hinder shareholders from engaging, worsening the problem of disengagement and the ownerless corporation. Indeed, engaged shareholders with a long track record of stewardship, such as Hermes, have been lobbying against dual-class shares for decades. A February 2017 report by the International Corporate Governance Network contains the findings of a recent survey "which shows that a strong majority of our Members disapprove of differential ownership structures."

1.5 Proponents argue that dual-class shares protect entrepreneurial vision, and that successful companies such as Google, Facebook, and LinkedIn have them. However, it is a huge unsupported leap to claim that dual-class shares caused their success. Very many other factors were behind their success – non-governance-related (the companies' first-mover advantage) and governance-related (the executives having substantial shares in their firm). If anything, causality is likely to be the other way – given investors' scepticism on dual-class shares, it is only the companies with very strong prospects that will be able to get away with dual-class shares upon IPO. In other words, expected good future performance allows dual-class shares to be adopted, rather than dual-class shares leading to good future performance.

1.5.i Moreover, the above cases are anecdotal examples. It is almost always possible to find anecdotes to support a particular viewpoint. The large-scale evidence presented above demonstrates the negative effects of dual-class shares in general. There are many high-profile anecdotes of substantial failures associated with dual-class shares. For example, dual-class shares allowed Hollinger CEO Conrad Black to run the company like a dictator, exacting huge management fees, consulting payments, and personal dividends, and filling the board with his friends – all leading to underperformance. Vic De Zen of Royal Group Technologies diverted large sums of money for personal benefit, and Frank Stronach of Magna and Jim Shaw of Shaw Communications substantially overpaid themselves despite huge losses. Such cases substantially destroy the public's trust in business.

1.5.ii More generally, the idea that entrepreneurial vision should be left unchecked is also not clear. As a high-profile example of unchecked "vision" (although not dual-class shares), Jerry Yang of Yahoo rejected a takeover bid from Microsoft in February 2008 at a 62% premium, because he stubbornly refused to cede control, and has since substantially underperformed. Even the best entrepreneurs benefit from external opinions; indeed, this is why we promote board diversity, rather than allowing CEOs to fill the board with their friends if they were the founders.

1.6 The evidence against dual-class shares is also consistent with the broader evidence on other devices – such as golden parachutes, poison pills, and staggered boards – claimed to protect a firm's entrepreneurial vision, but actually ending up entrenching management. The most-cited governance paper of the millennium, Gompers, Ishii, and Metrick (2003) finds that companies with the most

entrenchment devices underperformed those with the least by 8.5%/year in the 1990s. Giroud and Mueller (2011) find that this continues to hold with more recent data in non-competitive industries, where management has more latitude to destroy value. Masulis, Wang, and Xie (2007), echoing their paper on dual-class shares, find that companies with more entrenchment devices engage in worse M&A.

1.7 The above large-scale evidence suggests that dual-class structures are undesirable for most firms. However, it may be the case that they are beneficial in certain firms. The current regulations still allow such firms to adopt dual-class structures and be listed. The standard listing simply highlights that investors need to scrutinise such firms' governance particularly closely, and that investors without the resources or expertise to do so may be advised not to invest in such firms.

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