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Regulating Dual-Class Share Structures in China: A Comparative Perspective

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During this revision of the Company Law, China[1] has responded at the legal level to diversified shareholding structures and provided basic regulations for dual-class share structures. Compared to other regions with extensive practices in dual-class share structures, China still has much room for improvement in regulating them. Examining the pros and cons of dual-class share structures reveals their efficiency regarding voting rights and other benefits. However, it is crucial to recognize potential issues, such as increased agency costs and the possible misuse of voting rights that these structures may cause. When summarizing international regulatory approaches to dual-class share structures, we can categorize them into autonomous and central regulatory models. China tends to adopt a centralized regulatory model but should learn from the experiences of autonomous regulatory models to enhance its system.

Keywords: dual-class structure, autonomous regulating model, centralized regulatory model, fiduciary duty

Introduction

The dual-class share structure, also known as the multiple voting rights share structure, differs from the traditional corporate law principle of “one share, one vote”. Under this structure, a company issues two or more common shares, typically classified as high-voting shares (Class A) and standard voting shares (Class B). Class A shares offer multiple voting rights per share, while Class B shares generally provide one vote per share. Class A shares are usually held by insiders, such as company founders and management, while Class B shares are issued to public investors.

The dual-class share structure originated in the United States when International Silver issued non-voting shares in 1898. In the new millennium, this structure saw a resurgence in popularity, especially among technology innovation companies. Numerous firms, such as Google, Facebook, Groupon, LinkedIn, and Snap, have adopted this structure to enhance their competitiveness in the fourth industrial revolution. Various regions, including the European Union, the United Kingdom, Singapore, and Hong Kong, have welcomed dual-class shares to lure new economy companies. In 2019, the Shanghai Stock Exchange in China began accepting dual-class share companies on its Science and Technology Innovation Board. This initiative was also mirrored by the Shenzhen and Beijing Stock Exchanges, making flexible voting rights structures appealing to high-tech and innovative

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[1] Unless otherwise specified, references to China in this article refer to the Chinese mainland.

enterprises. In July 2024, the newly revised Company Law of the People's Republic of China came into effect, officially introducing the dual-class share structure at the legal level.

However, the dual-class share structure separates voting rights from dividend rights, allowing shareholders with decision-making rights to maintain comparatively low economic interests. This disparity has become a significant topic in corporate governance, potentially resulting in increased agency costs and the abuse of control rights. This paper explores the benefits and risks of dual-class share structures, comparing regulatory frameworks across jurisdictions to find a suitable model for China. Given China's unique circumstances, it also provides specific recommendations for regulating dual-class share structures.

Evaluation of Dual-Class Share Structures

Benefits of Dual-Class Share Structures

Firstly, meet diverse shareholder demands. Heterogeneous shareholders, who differ in key aspects such as shareholding percentages, investment motives, and risk appetites, create a diverse spectrum of interests and demands within a company (Feng, 2016). Operational shareholders, typically a company's founders or core management, not only hold equity stakes but also deeply integrate their careers with the company's long-term success. These shareholders prioritize strategic planning and market positioning, valuing them more than short-term gains. The dual-class share structure allows them to retain superior voting rights, enabling them to steer the company's decision-making power while safeguarding their economic interests. This arrangement aligns with their commitment to the company's long-term growth and facilitates their ability to attract external capital without relinquishing control. Conversely, investment shareholders generally focus on returns and capital appreciation. They often refrain from participating in the company's daily operations and seek gains through stock market transactions. These shareholders prefer stocks that offer robust liquidity and consistent dividends. The dual-class share structure caters to the diverse investment needs of these shareholders by offering shares with limited or no voting rights. This arrangement allows them to capitalize on the company's growth while mitigating the risks and complexities associated with corporate governance.

The dual-class share structure effectively responds to shareholders' diverse demands and optimizes the allocation of equity, a multifaceted resource. It establishes a flexible framework for interest exchange, facilitating negotiations and balancing the diverse needs of major shareholders, founding members, minority shareholders, and the public. Through this mechanism, the company can align its managerial and financial interests with shareholders with higher expectations, ultimately achieving optimal resource allocation (Shang, 2016).

Secondly, enhance the efficiency of corporate decision-making. Superior voting shareholders frequently hold dual roles as company managers, which allows them to play a more direct role in corporate decision-making. This arrangement effectively reduces the gap between decision-making and execution, minimizing the costs associated with information transmission and coordination during this process. These shareholders tend to be more engaged and committed to the company's operations, often holding their shares for the long term and contributing consistently to corporate governance. Moreover, their extensive experience and involvement in the industry typically equip them with advanced operational decision-making skills, insightful business perspectives, and a strong commitment to professional ethics. This type of intellectual capital is challenging to transfer to others. Therefore, assigning voting rights to these high-voting shareholders allows for an optimal mix of expertise and decision-making at a lower cost, ensuring the professionalism and accuracy of decisions. Their familiarity with the company's operations enables them to make more informed and prudent decisions, enhancing overall decision-making efficiency.

In contrast, low-voting shareholders usually focus on short-term returns, exhibit greater mobility, and often need a deeper understanding of company operations. Their enthusiasm for corporate governance participation may be higher, but they might need to possess the necessary professional knowledge. As a result, it makes more sense for them to delegate their voting rights to high-voting shareholders. This centralized exercise of voting rights improves decision-making efficiency. Establishing non-voting or low-voting shares can help decrease inefficient agency behavior and reduce transaction costs. Allowing "rationally apathetic" shareholders to transfer their voting rights can diminish passive investors' voting influence while enhancing active shareholders' power (Dorothy, 2019). This optimizes the allocation of voting rights within the company.

Risks of Dual-Class Share Structures

In a dual-class share structure, concentrated control rights result in "insider control", where founding shareholders and their management team hold high voting rights but only a small equity stake. This allows them to maintain significant control over the company, leading to potential legal risks from abusing control rights and increased agency costs.

Firstly, there is the issue of the abuse of control rights in dual-class share structures. In these arrangements, shareholders' voting rights are separated from income rights. Shareholders with superior voting rights hold a majority of the voting power, which results in concentrated control in the hands of a few controlling shareholders. By leveraging their voting power and utilizing the company's decision-making mechanisms, these controlling shareholders can elevate their interests to become legitimate company resolutions. While this differentiated arrangement of voting rights can enhance control, it may also lead to situations where the company becomes a vehicle for the controlling shareholders to extract benefits if not strictly regulated. The power disparity between controlling shareholders or management and small and medium-sized shareholders often means that the latter's interests should be considered. Although small and medium-sized shareholders nominally enjoy certain rights, they need to be able to effectively protect their interests by exercising these rights. They lack the influence to counter decisions that may harm the company and their interests, nor can they effectively challenge the arbitrary actions of shareholders with superior voting rights. This imbalance ultimately risks the company and the small and medium-sized shareholders suffering financial losses. It is common for controlling shareholders to misuse their power, engaging in related-party transactions that can harm the company's interests (Alexander & Luigi, 2004). The abuse of voting rights by shareholders with superior power in dual-class share structures manifests in several ways: exploitation of shareholder resolution rights, misuse of appointment rights for senior management during governance crises, unfair related-party transactions, and the perpetuation of control rights. Founding or controlling shareholders can use their superior voting rights to maximize their capital leverage. In contrast, small and medium-sized public shareholders face substantial risks of having their interests abused at any time.

Secondly, there are increased agency costs. Agency costs are an economic concept that arises when the interests and goals of an agent—an individual acting on behalf of another—are not fully aligned with those of the principal. This misalignment is often compounded by information asymmetry and incomplete contracts between the principal and the agent. Such conflicts of interest can lead to inefficiencies, resulting in agency costs (Paul, Joy, & Andrew, 2010). The impact of dual-class share structures on agency costs is a topic of theoretical debate. Most scholars argue that the concentration of control rights creates an entrenchment effect, which increases agency costs and diminishes company value. In companies with dual-class shares, the fundamental agency cost issue stems from the conflicting interests between controlling shareholders—who possess superior voting rights—and capital shareholders, who have inferior voting rights (Lucian & Kobi, 2017). Furthermore, agency costs in dual-class structures are particularly difficult to mitigate because they grow with the increasing separation of control rights from cash flow rights. The costs associated with decision-making are not proportional to the shared economic returns, resulting in reckless decision-making that can harm both public and private interests.

Comparison of Regulatory Models

Autonomous Regulating Model

Due to its flexibility and adaptability, the autonomous regulating model has garnered widespread attention in selecting regulatory models for dual-class share structures. Exemplified by the United States, this model demonstrates the inclusiveness and innovativeness of the American corporate securities legal system.

Under the autonomous legal governance model for dual-class share structures, the three major exchanges—the New York Stock Exchange, NASDAQ, and the American Stock Exchange—do not impose strict restrictions. Instead, they empower shareholders to negotiate tailored agreements catering to each company's unique circumstances. This collaborative process sees external investors actively engaging with internal controllers to delineate the specifics of dual-class share arrangements, encompassing the distribution of voting rights and safeguarding shareholder interests within the corporate charter. The aim is to maintain a balanced approach that minimizes unnecessary legislative intervention. The bargaining power and negotiating positions of investors and company insiders significantly influence the details of the restrictions. These tailored provisions help ensure compliance with regulatory standards and establish robust legal safeguards for investors. This level of flexibility enables companies to craft their equity structures in alignment with their strategic goals and prevailing market dynamics, ultimately driving shareholder value maximization.

However, the absence of specific regulatory rules in the United States does not mean the country relies solely on these provisions to manage dual-class share structures. Instead, the U.S. employs four main methods as follows: (1) a robust and comprehensive mandatory information disclosure system that prevents management self-enrichment in advance; (2) U.S. law has long established fiduciary duties owed by controlling shareholders to the company and minority shareholders, and naturally, major shareholders with high voting rights under dual-class share structures are no exception; (3) establishing an effective group litigation system to quickly and conveniently recover losses for investors (Zhang, 2020).

These legal methods collectively promote fairness and transparency, safeguarding the interests of all stakeholders involved. The self-regulatory model advocates that shareholders should self-determine the direct and specific restrictions on dual-class share structures. At the same time, indirect regulation and management should be conducted through information disclosure, fulfillment of fiduciary duties, and class action lawsuits.

Centralized Regulatory Model

The Centralized Regulatory Model primarily adopts a mode of substantive review by the regulatory authorities, encompassing full-process supervision from the establishment to the operation and eventual dissolution of dual-class share structures. China adopts a similar regulatory model, tending to establish strict pre-emptive restrictions, which largely suppress the positive aspects of dual-class share structures.

This model can be mainly divided into two types: One is the two-way testing type represented by Japan, and the other is the multi-stage type represented by Hong Kong. On the one hand, the Tokyo Stock Exchange of Japan adopts a rigorous and comprehensive evaluation approach for the substantive review of dual-class share structures. The core of this review lies in two key tests: firstly, the necessity test, which delves into the reasonable basis and legitimacy of a company's adoption of a dual-class structure, ensuring that its implementation is based on the practical needs of the company's long-term development and the maximization of shareholder interests; secondly, the proportionality test, which meticulously compares the balance between the necessity of the dual-class structure and the constraints it imposes on controlling shareholders, striving to maintain the fairness of corporate governance structures and shareholder rights while also taking into account corporate operational efficiency and flexibility (Taro, 2017). Through these two tests, the Tokyo Stock Exchange aims to ensure that the implementation of dual-class share structures complies with market rules while effectively preventing potential risks and unfair phenomena, thereby safeguarding the healthy development of capital markets and the legitimate rights and interests of investors (Koji, 2015).

On the other hand, Singapore, the United Kingdom, and other jurisdictions have specific systems similar to those of Hong Kong. Thus, Hong Kong is introduced here as a typical example. Hong Kong's "Main Board Listing Rules" contain stringent and detailed provisions regarding pre-emptive restraint mechanisms. These primarily include, at the establishment level, prohibitions on post-IPO (Initial Public Offering) dual-class share capital restructuring, market capitalization limits for dual-class share companies, and restrictions on the identity of high-voting-right beneficiaries; at the operational level, restrictions on the proportion of eligible voting rights, proportional limits on voting power, proportional limits on economic interests, safeguards for the right of low-voting-right shareholders to convene extraordinary general meetings, voting right revitalization, and an internal oversight system centered on independent directors, corporate governance committees, and compliance advisors; at the rescission level, provisions for the termination of high voting rights in the event of special circumstances; and supplementary restraint rules consisting of a clear warning system, ongoing disclosure requirements, and commitment letter systems. In addition to these pre-emptive rules established in the Hong Kong Stock Exchange's listing rules, judicial means such as initiating civil litigation for market misconduct under Section 213 of the Securities and Futures Ordinance have, to a certain extent, replaced the protective functions of group litigation and contingency fee arrangements, providing post-event protection for ordinary shareholders in companies with different voting rights attached to the same class of shares (Huang, Zhang, & Lee, 2019).

Reform Suggestions

Rethinking China's Regulatory Framework

Compared to the United States, the birthplace of dual-class share structures, China's corporate governance structure exhibits significant differences. In China, the Company Law grants shareholders more rights in voting matters, and the company's major decisions are often made by the shareholders' meeting. Conversely, in the standard corporate model of the United States, shareholders primarily play the role of passive investors, with their rights concentrated in electing and removing directors, initiating derivative suits against directors who breach their fiduciary duties, approving amendments to the company's constitution, mergers, significant asset dispositions, dissolutions, and approving related-party transactions. Notably, two approval rights—amendments to the company's constitution, mergers, and other significant matters, as well as approval of related-party transactions—require the board of directors first to submit a proposal to the shareholders' meeting. Shareholders are generally not permitted to intervene proactively, which limits their direct intervention capabilities to a certain extent.

In the U.S. corporate law system, shareholders indirectly control the company through dual-class share structures by exercising their right to elect directors. Meanwhile, the U.S. corporate law's requirements for directors' fiduciary duties and the differences in voting rights allocation within dual-class share structures form a system of institutional complementarity. This system emphasizes that directors represent the company's interests, using the "company" as a boundary to effectively sever the direct link between directors and shareholders, thereby preventing the abuse of control rights.

However, in the context of China's Company Law, shareholders inherently possess extensive legal rights. They can directly influence the company's major decisions through their voting rights and indirectly control its operational management through directors. In this situation, the potential for abuse of dual-class share structures in China is relatively high. Since shareholders have more direct and indirect control means, it may lead to an imbalance in the corporate governance structure, harming the interests of minority shareholders. Moreover, China still significantly lags behind mature capital markets in information disclosure, industry supervision, and group litigation as supporting measures (Guo & Peng, 2019). These supporting measures must be more robust to investors' ability and avenues for self-protection. For example, inadequate information disclosure may prevent investors from timely understanding the company's true operating situation, making it difficult for them to make informed investment decisions; the lack of self-regulation may allow some violations to go uncorrected promptly; and the absence of a group litigation system makes it challenging for investors to safeguard their rights through legal channels when facing large-scale infringements.

Proposal of Regulating Dual-Class Shares Structure

Firstly, reconstruct disclosure mechanism of dual-class shares structure. Companies must disclose information related to dual-class share structures, such as periodic and temporary reports. Companies should thoroughly explain the framework of dual-class share structures, clarifying the voting rights ratio, conversion rules, and potential risks associated with different categories of shares (Liu, 2022). This transparency will enable investors to fully understand the significant impact such structures can have on corporate governance and the distribution of shareholder equity. Additionally, to protect the rights of minority shareholders, it is essential that in cases where critical information is deliberately concealed or where majority shareholders exert undue influence, such as coercion, during the establishment of dual-class share structures, minority shareholders should have the right to apply to judicial authorities for the invalidation of relevant resolutions. Historically, there have been cases in the United States where shareholders successfully obtained injunctions against issuing shares with differentiated voting rights due to material misstatements or omissions in proxy statements. These instances revealed improper threats made by management during the voting process. Ultimately, in these cases, the court ruled that the relevant amendments to the Articles of Incorporation could be revoked, thus providing strong legal protection for minority shareholders.

Companies must disclose comprehensive details about all transactions with related parties to improve transparency regarding related parties and significant transactions. This includes, but is not limited to, the nature of the transaction, the rationale behind pricing, the purpose of the transaction, and its potential impacts on the company's financial position and operating results. Such transparency will effectively prevent management from exploiting related-party transactions for personal gain, thereby protecting the interests of the company and its minority shareholders. Additionally, companies should clearly outline the decision-making process, the criteria for their decisions, and the associated risks for significant transactions. This ensures that investors receive accurate information promptly, allowing them to make informed investment decisions. Especially for major resolutions such as changes to a company's primary business, based on sufficient information disclosure, the privileges of shareholders with superior voting rights should be excluded, and all shareholders' voting rights should revert to one share, one vote.

Increasing the number of independent directors on the board is vital to maintain their independence from management and effectively fulfill their oversight responsibilities. Independent directors should regularly produce special reports that thoroughly evaluate the effectiveness and potential risks of the company's dual-class share structure. They must fully disclose this information to investors, enhancing the company's credibility and boosting investor confidence.

Secondly, fiduciary duty of superior voting shareholders. The fiduciary duty rules for shareholders with superior voting rights allow for the subsequent judicial review of their exercise of these rights, creating a framework to prevent the abuse of such rights. This mechanism addresses the challenge of controlling and assessing shareholders' performance with superior voting rights. The primary beneficiaries of the fiduciary duties these shareholders owe are the company and the other shareholders. The company directly benefits from these duties, meaning that shareholders with superior voting rights cannot exercise their rights in a way that harms the company's interests. Fiduciary duties are inherently altruistic. While shareholders with superior voting rights have these altruistic responsibilities, their main focus is benefiting the company, with protecting its interests as the primary goal. Protecting other shareholders' interests is indirectly achieved through the company's well-being.

Fiduciary duties encompass two main aspects: loyalty and diligence (Tamer, 1983). The duty of loyalty represents a negative obligation, emphasizing the need to avoid conflicts of interest. This prohibits shareholders with superior voting rights from jeopardizing the company for their benefit and harming the interests of other shareholders. Conversely, the duty of diligence focuses on ensuring that the one does not neglect his or her responsibilities due to apathy or laziness. This duty should be considered alongside the dual role of shareholders with superior voting rights. They have the authority to vote on decisions that affect the company's production and operations and control the company's management and internal structure. Therefore, they are legally justified to be held to the necessary diligence standard.

The two main legal consequences of abusing superior voting rights are the invalidation of resolutions formed through such abuse and the civil liability for damages incurred by shareholders with superior voting rights. Point

1, under current Company Law, any resolutions passed by the shareholders' meeting, shareholders' general meeting, or board of directors that violate laws or administrative regulations are considered invalid by the judiciary. As a result, the company and other shareholders have the right to initiate legal action to invalidate such resolutions. Point 2, suppose the abuse of superior voting rights has caused any losses. In that case, the shareholders with superior voting rights may be held civilly liable for damages, depending on the actual situation regarding the losses incurred.

Thirdly, improve judicial and non-judicial relief mechanism. Compared to the U.S. group litigation system, China's securities representative litigation system, established in the realm of investor protection, serves as an effective legal barrier aimed at restraining and curtailing the actions of corporate insiders that harm company interests. Compared to the U.S. group litigation system, China's securities representative litigation system is designed to protect investors. It serves as an effective legal barrier to restrain and limit the actions of corporate insiders that may harm company interests. While China has significantly simplified and relaxed the pre-procedural requirements for ordinary representatives within this system, the threshold for initiating litigation remains relatively high for investors in companies with dual-class share structures. In a dual-class share structure, voting rights are artificially separated from profit rights, placing investors disadvantaged in corporate governance. To address this issue, the pre-procedural requirements of the securities representative litigation system for shareholders with low voting rights must be further relaxed. This would help reduce the costs associated with protecting their rights.

Additionally, establishing a specialized agency led by securities regulatory authorities to provide relief channels specifically for holders of classified shares, with a dedicated focus on dual-class share structures, should be explored. When establishing dispute resolution mechanisms, it is crucial to ensure that parties have complete autonomy in selecting arbitration institutions and arbitrators. This autonomy is fundamental for guaranteeing the neutrality of awards and their enforceability. To maintain the quality of awards, enhance operational efficiency, and preserve the neutrality of adjudicators, a system for disqualifying adjudicators should be implemented to prevent potential conflicts of interest. This proposed agency should prioritize resolving disputes between shareholders and corporate management, creating a fairer and more efficient platform for addressing these issues. Although China has substantially simplified and relaxed the pre-procedures for ordinary representatives in the securities representative litigation system, the threshold for initiating litigation remains relatively high for investors in companies with dual-class share structures. Under the dual-class share structure, investors' voting rights are artificially separated from their profit rights, resulting in their often disadvantaged position within corporate governance. To address this institutional shortcoming, it is necessary to further relax the pre-procedure requirements of the securities representative litigation system for shareholders with low voting rights, thereby reducing the cost of safeguarding their rights. Meanwhile, there can be an exploration of establishing a specialized agency led by securities regulatory authorities, specifically providing relief channels for holders of classified shares, with a dedicated channel for dual-class share structures. In establishing dispute resolution mechanisms, we must first ensure that parties have full autonomy in selecting arbitration institutions and arbitrators, which is the foundation for guaranteeing the neutrality of awards and their enforcement power. Secondly, to ensure award quality, enhance institutional operational efficiency, and maintain the neutrality of adjudicators, a system of adjudicator disqualification should be implemented to avoid any possible conflicts of interest. This agency should focus on resolving various disputes between shareholders and corporate management, constructing a fairer and efficient platform for resolving issues.

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