

# Shares with Differential Voting Rights

Author: Bala N Balasubramanian<sup>\*</sup>

Peer Reviewer: Umakanth Varottil

## Executive Summary

- DVRs have been a controversial issue around the world.
- **Key negatives:** Controller entrenchment, Private benefits, complacency-driven poor performance, denial of higher than market exits benefits on takeover.
- **Key Positives:** Assured control can encourage high risk-taking and longer-term strategies, better performance due to controllers' skills and tight management, chances of superior gains if company successful.
- Rigorous regulation and effective monitoring could minimise disadvantages to non-controlling shareholders and encourage innovative enterprise.

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<sup>\*</sup> Author can be reached at [bala4391@gmail.com](mailto:bala4391@gmail.com). Valuable comments and suggestions from Prof. Umakanth Varottil are gratefully acknowledged.

## I. Introduction

Although the one-share-one-vote principle is the default norm in business corporations in most countries, it is by no means the only norm in practice. Equity shares with differential voting rights (DVR) have always been in vogue to a more or less extent in different countries, including with regard to variations in the terms of differentiation. Seemingly inequitable to the shareholders with less rights than the others, more often than not their pricing and valuations do take into account, and largely compensate for, such erosion of power. While the average retail shareholder, thus, may not be too worried about the implications of such shares with DVRs, there are significant pros and cons that impact promoters and major block investors, favourably or unfavourably; this quarterly briefing reviews some of these perspectives, given the recent regulatory and legislative initiatives on DVRs in India.

## II. Evolution of Voting Rights in Corporations

Before discussing DVRs, it may be instructive to briefly trace how shareholders' voting rights have evolved over time, from the *democratic* (one vote per person, irrespective of the shares held) towards the *plutocratic* (one vote per share held), with numerous variations in between. The East India Company, chartered on the last day of the year 1600, is often cited as an example of democratic voting rights with each member eligible for one vote, irrespective of his equity contribution. Continental Europe seems to have stuck to the democratic system for much longer than the United Kingdom and especially the US, where the discrimination in voting rights among shareholders appears to have been much prevalent and much earlier too than elsewhere in the world. UCLA Professor Bainbridge recapitulates [\(here\)](#) numerous charters granted by the various States reserving more favourable voting rights for the Charter petitioners than the others who may have subscribed later.

With the codification of corporation laws from the mid-eighteenth century onwards, countries appear to have graduated to the plutocratic one-share-one-vote scheme as the *default* option for voting rights, with deviations being permitted at the option of the companies and their shareholders. Although Indian company law had generally followed its British counterpart during the colonial rule, *post-independence* exuberance towards socialism and general apathy towards capitalists in business ensured strict adherence to one vote per share principle until the turn of this century, when DVRs were permitted with some attendant conditions. In case of listed companies, the approach of the market regulator (SEBI) has been to disallow DVRs but more recently this seems to have given way to a more business-friendly orientation that allows DVRs with several safeguards for protection of non-controlling shareholders.

## III. Categories of DVRs

DVRs fall into broadly two categories: Fractional Rights (FR) shares where they carry a fraction of the full voting rights of the standard shares; and Superior Rights (SR) shares where their voting rights are several times of the standard shares. In either case, their cash flow rights remain the same and unaltered (except to the extent of any incentives or (rarely, disincentives that may be introduced in lieu of the erosion suffered or benefits gained, respectively).

The main purpose of DVRs is to support corporate control and promoter entrenchment permanently or (infrequently) for a specified duration even while raising additional funds from others to meet growth needs. To the extent such controller or management entrenchment could likely be injurious to the interests of non-controlling shareholders, DVRs do not deserve to be allowed in publicly traded corporations. On the other hand, it is also true that the mere fact that a transaction likely poses a threat or risk of abuse does not necessarily call for its complete prohibition; it simply highlights the need for stringent policing of such transactions to ensure that management pursues shareholders' best interests rather than its own. That said, the efficacy of such an approach doubtless would be circumscribed by the general tenor of corporate culture and reputation for responsible and transparent behaviour as well as by the effectiveness of the country's institutional and regulatory environment.

#### **IV. The Case for DVRs**

There are at least four reasons why promoter entrenchment may be justified from a public policy as well as a shareholder interest perspective:

- As is the case with most controlled companies, DVR companies are most likely to run a tightly managed operation, leading to better shareholder wealth creation. The promoters could focus on longer term strategies for the good of the company without having to compromise due to likely pressures from non-controlling shareholders (mostly institutional investors with shorter term profit horizons), which would otherwise be the case, like the Damocles' sword of control-loss hanging over their heads.
- Promoters could pursue their idiosyncratic dreams, especially in case of technologically or intellectually driven businesses, without interference from other shareholders. The very format of the incorporated limited liability company has at its roots the idea of risk taking in business without the fear of person ruin in case of failure; DVR concept takes this salutary protection further forward and provides protection to the venturesome promoter not only from the consequences of failure but also the assurance of continuing benefit from success, without someone else snatching it away at fruition after all the hard work had been put in.
- Many out-of-the-box business ideas, especially in the technology-based areas, start with relatively small capital base and when successful require larger infusion of funds. If the promoters cannot proportionately contribute to the additional equity, any issue to outsider investors will be fraught with the risk of control loss.
- If the perceived problems with DVR are entrenchment and its ill-effects, how is it any different from other entrenchment devices already available and apparently acceptable, such as through pyramids, cross-ownerships, and so on.

#### **V. The Case against DVRs**

The arguments disapproving the concept of DVRs are equally strong and cannot be brushed aside without due consideration. The more important of these are summarised as follows:

- Being human, promoters of DVR companies are not beyond putting personal interest ahead, and at the expense, of others' legitimate interests. Unassailable control and entrenchment would be an invitation to all but an exceptional few to rent-seek for themselves through a variety of devices such as exorbitant compensation for themselves, related party transactions, opportunity-grabbing, and so on.
- Entrenchment usually yields to complacency over time and may reflect in sub-optimal performance; shareholders may have no option but to either accept their lot, or exit the company stock.
- While all shareholders may benefit when the DVR company prospers, there is a real danger, of promoters externalising the costs disproportionately largely to outside shareholders, in the event of failure.
- When such takeover attempts are expectedly rejected with the help of superior voting powers conferred by DVRs, outside shareholders stand to lose out on benefiting from possibly higher (than market) value offer of the bidders; or, if staying invested, benefit from the bidders' likely better performance.

#### **VI. DVRs Elsewhere in the World**

Possibly for both economic and emotional reasons, countries around the world seem to be sharply divided on the concept of DVRs, usually labelled as DCS (Dual Class Shares): UK, Germany, Spain, Columbia and Argentina for example have said No to DCSs, while US, Sweden, Canada, and the Netherlands are among countries that endorse DCS. Hong Kong and Singapore have recently allowed DCS. In the internationally competitive market scenario stock exchanges operate (often accused of racing to the bottom in terms of regulatory discipline), it is not surprising countries seek to introduce measures to match competition. Thus, there is a growing trend in the UK to introduce DCS in their stock markets; on the other hand, countries that have experienced the ill effects of the DCS are pushing for some stringent regulation to curb any unbridled license to use DCS. In the US, home to such well known and iconic

brands like Facebook and Google, market regular SEC's Investor Advocate has recently expressed his personal opinion ([here](#)) that DCS was a "Recipe for Disaster" and called for regulatory interventions.

## VII. DVRs at Home<sup>1</sup>

India had abolished DVRs in the 1950s in the wake of independence and consequent euphoria towards socialistic approaches to governance; but with the "liberalisation" of the economy in the 1990s, DVRs were reintroduced; there were very few takers though possibly due to the overly restrictive SEBI regulations and, more importantly, the adverse signalling impact of the concept.

With renewed emphasis in the last few years on ease of doing business in the country and encouragement to technology-based innovation and entrepreneurship, DVRs have re-surfaced as an instrument for accelerated development. Both Company legislation and market regulation have geared up with provisions that encourage DVRs in the Technology space; to address the potential ill-effects of the system, a fairly comprehensive set of restrictions has been introduced in late 2019 (**Exhibit I**).

There are some interesting perspectives that these regulations open up for discussion. For example,

- Should the DVR schemes be restricted to Technology ventures only? Elsewhere, in countries that allow DCS structures, not many are so restricted. Maybe, with its intellectual and technological leadership, both proven and potential, protecting the innovators' control rights would spur this activity to the common benefit of the country and the community; maybe, innovators from the professional class may not have the financial wherewithal to fund these ventures on their own, and this would incentivise them to take the plunge without risking their control over the company.
- The "Sunset" provision of five years extendable to ten years in many ways addresses the diminishing returns proposition of permanent DVRs. However, would it also not lead to a freezing of innovative expansions in the company after ten years? If an enterprising technology promoter has more ideas to experiment with (and is still within the prescribed Rs 5000 crores wealth ceiling), wouldn't he or she rather house them in different DVR entities in sequence so control rights could survive the first ten years? How could these possibilities be addressed in the interests not only of the promoter but also the other shareholders of the original company? Would permitting wholly owned subsidiaries for different innovations or expansions in the same Technology-based areas solve the problem with every shareholders' benefits and rights protected?
- There are many companies in the non-technology-based areas whose promoters may be withholding expansions and diversifications because of their personal financial position. Given the country's urgent imperatives for growth in the economy, would it not be appropriate to remove the prohibition of re-classification of existing capital structure to permit DVRs to the promoters (maybe within the Rs 500 crores wealth limit) with super-majority concurrence of existing shareholders – and promoters not voting- under rigorous court or regulator supervised procedures? To avoid charges of goal [posts being changed, shareholders not in favour of the restructuring need not be squeezed out but allowed to retain their existing shares with rights unimpaired.

Maybe, the regulators have taken cautious first steps in the direction of opening up DVRs in the country, and may follow up in due course on the basis of experience gained. Meantime, it would be interesting times ahead for the capital markets to watch to what extent these DVR reforms succeed in achieving their objectives.

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<sup>1</sup> Section 43 (a) (ii) and Section 47 ((1) (a) and (b) of the Companies Act, 2013; Rule 4 (c) of the Companies (Share Capital and Debentures) Amendment Rules, 2019; Rule 17, 18, 19, 20, 21, and 41 Of the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015; and, Regulation 2, 6, 14,16, 21, 22, 62, 113, 115, 119, 120, 294, Schedules V and VI of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018; contain key provisions relating to DVRs.

**Exhibit I: Equity Shares with Differential Voting Rights (SEBI's Regulatory Framework as of 28 February, 2020)**

<b>Who Can Issue?</b>	For now, only Tech Companies, defined as those in Technology, Information Technology, Intellectual Property, Data Analytics, Bio-Technology, Nano-Technology; to provide products, services, or platforms; with substantial value addition.
<b>What Kind of Rights?</b>	For now, only shares with Superior Rights (SR) in the range of 2 to 10 times those of Ordinary Shares; Shares with Fractional Rights (FR) meaning a fraction of the rights of Ordinary Shares are not permitted in case of all Listed Companies.
<b>Who Needs to Approve?</b>	A Super-Majority (75%+) of the Company's Ordinary Equity Share Votes.
<b>What Quantum?</b>	DVRs votes may not, at any time, exceed 74% of the Company's aggregate post-Issue Equity Votes.
<b>What Duration?</b>	DVRs valid for a period of Five years, extendable to another term of Five years with super-majority approval of ordinary shareholdings, SR shareholders barred from voting on the resolution.
<b>Who can be allotted SRs?</b>	Only Promoters occupying Executive Positions in the Company. Even these may not qualify if they belong to the Promoter group whose Net Worth collectively exceeds Rs 500 Crores, not including the SR shareholder's investment in the shares of the issuing company.
<b>What Happens post-IPO to the SRs</b>	Will be treated as equivalent to ordinary shares in the following situations: <ol style="list-style-type: none"> <li>i. Appointment or removal of independent directors and/or auditor;</li> <li>ii. In case where promoter is willingly transferring control to another entity;</li> <li>iii. Related Party Transactions in terms of SEBI(LODR) Regulations involving SR shareholder;</li> <li>iv. Voluntary winding up of the company;</li> <li>v. Changes in the company's Article of Association or Memorandum-except any changes affecting the SR instrument;</li> <li>vi. Initiation of a voluntary resolution plan under IBC;</li> <li>vii. Utilization of funds for purposes other than business</li> <li>viii. Substantial value transaction based on materiality threshold as prescribed under LODR;</li> <li>ix. passing of special resolution in respect of delisting or buy-back of shares; and</li> <li>x. Any other provisions notified by SEBI in this regard from time to time.</li> </ol>
<b>What Happens in case of certain Events?</b>	SRs get converted automatically into Ordinary Shares in case of: <ol style="list-style-type: none"> <li>i. demise of the promoter(s) holding such shares;</li> <li>i. SR shareholder resigns from the executive position in the Company;</li> <li>ii. merger or acquisition of the Company having SR shareholder where the control would be no longer with SR shareholder;</li> <li>iii. sale of such shares by the SR shareholder after the lock-in period but prior to time based sunset.</li> </ol>
<b>What Happens in case of Subsequent Share-Related Events?</b>	In case of bonus issues or share splits, SR status will apply to the bonus and split shares also In case of Rights Issues, SR status will apply to Rights shares also; but SR

	holders cannot renounce their Rights entitlements.
<b>What Other Governance Requirements concerning the Board of Directors</b>	<p>Where the listed company has outstanding SR shares, Independent Directors should comprise:</p> <ul style="list-style-type: none"> <li>i. At least one half of the Board membership;</li> <li>ii. At least two thirds of the membership of Nomination and Remuneration, Risk Management, and Stakeholder Relationship Committees;</li> <li>iii. Entire membership of the Audit Committee.</li> </ul>
<b>What Other Conditions apply?</b>	<ul style="list-style-type: none"> <li>i. No further issue of any shares with superior or inferior rights as to dividends or voting as compared to such rights applicable to shares already listed.</li> <li>ii. SR shares must have been held at least for six months prior to the filing of the red herring prospectus.</li> <li>iii. There can be only one class of SR equity shares.</li> <li>iv. SR equity shares shall be under lock-in until conversion into ordinary shares.</li> </ul>

**Economic Policy & Research**

Tirthankar Patnaik, PhD	<a href="mailto:tpatnaik@nse.co.in">tpatnaik@nse.co.in</a>	+91-22-26598149
Prerna Singhvi, CFA	<a href="mailto:psinghvi@nse.co.in">psinghvi@nse.co.in</a>	+91-22-26598316
Runu Bhakta, PhD	<a href="mailto:rbhakta@nse.co.in">rbhakta@nse.co.in</a>	+91-22-26598163
Ashiana Salian	<a href="mailto:asalian@nse.co.in">asalian@nse.co.in</a>	+91-22-26598163

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