7 May 2019

Smt. Yogita Jadhav
Deputy General Manager
Corporation Finance Department
Securities and Exchange Board of India
SEBI Bhavan Plot No. C4-A
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India

Dear Smt. Yogita Jadhav,

Re: Consultation Paper on Issuance of shares with Differential Voting Rights

We welcome the opportunity to provide our comments on this consultation.

The Asian Corporate Governance Association (ACGA) is an independent, not-for-profit association chartered under the laws of Hong Kong. ACGA is dedicated to assisting companies and markets across Asia in their efforts to improve corporate governance practices. In our educational outreach, we are guided by a practical, long-term approach. ACGA's operations are supported by a membership base of institutional investors, such as public pension funds and fund managers, as well as listed Asian companies, international accounting firms, banks and insurers. We now have more than 110 organisations as members, two-thirds of which are institutional investors with more than US$30 trillion in assets under management globally. They are also significant investors in India.

Background

In recent years ACGA has written extensively on the topic of DVR, also called "dual-class shares" (DCS) in many parts of the world or "weighted voting rights" in Hong Kong.[1] As an independent association promoting higher standards of corporate governance in Asia—and convinced that better public and corporate governance promotes the healthy development of capital markets and national economies over the longer term—we believe that the current adoption of DVR into parts of East Asia introduces new systemic risks that are not being properly addressed by governments and regulators. Our key concerns are as follows:

1. **Valuation discounts and enhanced market risk:** Feedback consistently received from institutional investors is that they apply a discount to the valuation of firms with DVR. Not only do institutional investors increasingly value their voting rights, they

[1] See the "Advocacy" section of the ACGA website (www.acga-asia.org) and search under "Statements and Submissions" for Hong Kong for 2014, 2017 and 2018, and for Singapore for 2017. See also our "CG Watch" reports for 2014, 2016 and 2018. In addition, ACGA has given numerous presentations on this topic. See for example, "WVR in Hong Kong – Increasing governance risk in Hong Kong", given to the Hong Kong Society of Financial Analysts on 11 July 2018.

typically associate such capital structures with weaker governance systems and cultures within firms. Accordingly, founder-owners who insist on having voting rights far in excess of their ownership interest tend to generate a degree of distrust among minority shareholders. ACGA's concern is that if DVR became common in a market, this could lead to an entrenched market discount, which in turn would harm pension fund returns. This contradicts national policy in almost every country, namely to build the value of long-term pension assets. If DVR became common, moreover, it would likely deepen and broaden the range of governance risks that investors face in a particular market—something that should be of particular concern to the large and growing passive investment industry.

2. **Weak legal remedies/safeguards:** Most Asian jurisdictions do not provide minority shareholders of publicly listed companies with strong legal remedies, such as class-action lawsuits, that are available in developed markets like Australia and the US. While such lawsuits are best used as a measure of last resort, they provide an additional tool for minority shareholders to protect their interests. Markets in Asia that have introduced DVR to date, namely Hong Kong and Singapore, have instead introduced a range of listing-rule safeguards to shield investors from possible abuse by DVR holders. Most of these safeguards, although well-intentioned, are either flawed or will have limited effect in our view. The one safeguard that investors have some faith in—a time-based sunset clause—is not provided for in Hong Kong or Singapore. While the SEBI proposal does incorporate this idea, we have concerns about how it might be implemented in practice (see below).

3. **Corporate DVR:** While DVR is often initially presented as a limited set of rights available only to key individuals who have founded a firm, the debate can quickly move to whether or not corporations should have multiple voting rights as well. This trend can be observed in Hong Kong, where the Exchange announced in late 2017 that it was considering a consultation on "corporate WVR" even before the introduction of WVR for individuals on 30 April 2018. While the consultation has yet to take place, it is expected. Unlike individual WVR, which should fall away when a founder/director resigns, retires or passes away, corporate WVR would last in perpetuity, thus extending all the risks highlighted above.

4. **Investor stewardship:** The current pressure in Asia for DVR also highlights a contradiction with the policy of "investor stewardship", namely encouraging asset owners (pension funds, sovereign wealth funds, endowments) to take their ownership and governance responsibilities more seriously and to work with their external fund managers to implement a more responsible approach to investment. This typically begins with a more focussed approach to voting at company meetings and moves on to deeper "engagement" (constructive dialogue) with investee companies on a wide range of environmental, social, and governance (ESG) issues. While not a new idea, investor stewardship emerged as a dominant theme following the failures of governance prior to the Global Financial Crisis of 2007/8. Since DVR

directly undermines the ability of minority shareholders to hold boards and managers accountable through the voting process, it clearly contradicts not only the goal of more active and responsible ownership, but broader corporate governance improvement policies as well.

These issues are reflected in our comments on the SEBI DVR proposals.

General concerns

The SEBI consultation on DVR proposes issuance of such shares under two categories:

- Companies which are already listed on stock exchanges;
- Companies which are not listed but propose to be listed to the public.

We appreciate and understand the consultation's premise that, "India is experiencing a high growth phase, which requires companies to raise capital to sustain this growth. For companies with high leverage or asset light models may prefer equity over debt capital". However, we disagree that differential voting rights is the most practical or best solution for such companies.

India has, for the better part of a decade, been promoting better governance across the board: in 2013, the Ministry of Corporate Affairs released the Companies Act, 2013; the Reserve Bank of India has been steadily working on improving public sector bank (PSB) governance, especially finding solutions to the issue of non-performing assets on the books of banks; and SEBI has amended the listing rules, released insider trading regulations, amended the prohibition of fraudulent and unfair trading practices, and accepted most of the recommendations of the Kotak Committee on Corporate Governance.

In the domestic investment industry, it was SEBI's initial push in 2010 for mutual funds to publish voting policies and data on votes exercised at company meetings that brought dramatic changes to the market, including local proxy voting advisory firms that have slowly encouraged institutional investors to start voting against company resolutions. Then in 2017, the Insurance Regulatory and Development Authority published guidelines for stewardship for Indian insurance companies, while the following year the Pension Fund Regulatory and Development Authority adopted a common stewardship code for pension funds managed by asset management companies. All these measures are likely to be adversely affected by the introduction of DVR into the Indian market.

In fact, the introduction of DVR at this time is at odds with almost everything SEBI has been doing to strengthen corporate governance over the past few years. The voting history of local mutual funds over the past nine years is evidence that India does not have the institutional investor base with the breadth and depth needed to counteract the negative effects of DVR that the consultation itself has enumerated, including misalignment of interests among shareholders, excessive compensation of management, and management entrenchment and expropriation. The Kotak Committee on Corporate Governance in its recommendations also stated that, "Today in India, there are a number of ways in which shareholder interests get compromised".

We therefore believe that allowing DVR in the Indian market, given that it has been marred in the past three years by a spate of high-profile corporate scandals, will only sow more distrust in a system that most investors, both institutional and retail, feel is heavily weighted in favour of promoters. This in turn will lead to investors to apply a discount on issuers that offer DVR shares, while a number of investors will begin to apply a discount to the market as a whole.

We suggest that the credibility of SEBI's regulatory system and the positive work it has done in corporate governance over the past decade will be called into question should the government move forward on DVR. A point we would like to stress is that efforts to contain less mature issuers with "safeguards" will only result in heightened pressure for more active enforcement which regulators cannot always deliver.

We elaborate on specific points below.

Specific concerns

Unequal treatment

The consultation puts forth a number of debatable arguments for implementing DVR: that "new technology firms" not only need help to retain control in case of a hostile takeover bid, but founders of such firms also require assistance to maintain control because having them at the helm is "of great value to all shareholders". SEBI's role, regardless of who comes to market, is surely "to protect the interest of investors in securities"?

The emphasis on hostile takeover bids is somewhat odd in the Indian context, given that such events are rare. The first to have been reported in more than a decade was between Larsen & Turbo, an engineering and construction conglomerate, and Mindtree, an IT services company, in 2018. To propose DVR on the back of one hostile takeover is an over-reaction to market forces. A hostile takeover is merely an "uninvited M&A" that, although it may not sit well with founders, could be in the interests of the target company and investors if it produces synergies, growth, and new competitive advantages. Providing permanent roadblocks to such rare transactions is likely to damage market confidence in the wisdom of financial regulators, while helping a particular group of insiders at the expense of minority shareholders, who exert only limited influence on companies, is making an unlevel playing field even more unbalanced.

Much more telling, though, is the fact that even though shares with inferior voting rights have been permitted by SEBI since 2009, the consultation noted that only five companies had issued such shares, which trade at a very high discount of between 35-45%. This suggests that investors are already sceptical of shares with different voting rights and which give founders/promoters excessive control.

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Weak checks and balances
The consultation proposes sunset clauses and coat-tail provisions as safeguards for shares with superior voting rights, but has remained silent on fractional rights shares. While the proposed sunset clause is initially limited to five years, it comes with an option to extend for another five years upon approval by shareholders:

> "The validity of the SR [superior rights] Shares can be extended by another 5 years with the approval of shareholders by way of a special resolution in a general meeting where all members vote on one-share-one vote basis irrespective of the nature of their shareholding."

An extension not only defeats the purpose of a sunset clause, but the consultation leaves open the possibility that the company could continue to ask for five-year extensions indefinitely.

The consultation further contends that the regulatory framework in India protects "the rights of dual class shareholders, as well as the minority shares" because the Companies Act prohibits conversion of existing equity share capital with voting rights into equity share capital carrying differential voting rights. But this does not address the problem of management entrenchment or excessive control in the hands of promoters.

India as a place to invest
While we acknowledge corporate governance rules and regulations in India have been steadily rising over the past decade, a number of our institutional investor members continue to be concerned about a range of issues, including the quality of corporate disclosure, related-party transactions, compensation of promoters, board evaluations, and the independence of board directors. The advent of DVR would likely make investors even more wary about corporate governance in India and concerned about a possible erosion in market quality.

For the above reasons, we strongly urge SEBI to reconsider this proposal.

Yours truly,

Jamie Allen
Secretary General

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