

CERF Fellowship Report August 2021

Overview

My research has continued to focus on attracting listings to the UK equity markets and boosting the growth of the British tech-industry. In particular, I have been researching the use of dual-class stock by listed companies. Dual-class stock is a capital structure which enables founders to retain control through holding shares with disproportionately high voting rights, and issuing shares with lower voting rights, but equal cash-flow rights, to the public. Thereby, dual-class stock can allow a founder to divest of its investment in a company that he or she controls, and raise further equity funding on the public markets, while maintaining control.

I am currently writing a book on the subject of dual-class stock – ‘Founders Without Limits: Dual-Class Stock and the Premium Tier of the London Stock Exchange’ – which scrutinises the adoption of dual-class stock around the world and applies the evidence in the context of the premium tier of the London Stock Exchange. My research has additionally led to three articles on dual-class stock. The first relates to the UK’s tech-industry and the existing prohibition of dual-class stock from the premium tier. The second reviews the empirical evidence on dual-class firms in the US, where they have been permitted on the NYSE since the early 1990s (and on NASDAQ even longer), and where, in modern times, tech-companies have been adopting the structure in droves. The third article centres on recently proposed changes to the UK’s listing regime – HM Treasury’s ‘UK Listing Review’ (3 March 2021), followed by a consultation by the Financial Conduct Authority (July 2021) assessing the effectiveness of the UK’s primary markets. The regulatory reviews both recommend that the premium tier should become more open to the use of weighted voting rights structures, and the article critically evaluates the proposed changes as they relate to dual-class stock. The subject of dual-class stock has generated significant publicity in recent months and is front-and-centre of current corporate governance debates in the UK. I have engaged, and will seek to continue to engage, with the regulators on this topic. The three articles are described further below.

I have also completed research, unrelated to dual-class stock, into the UK’s Stewardship Code. The Stewardship Code encourages asset managers and asset owners to, *inter alia*, steward and engage with the firms in which they invest. The Stewardship Code was substantially up-dated in 2020, after the previous version of the Code attracted significant criticism, and my research assesses the propensity for the new version to more effectively encourage the issuer-specific engagement originally envisaged by the Code. The research scrutinises the Code by focusing on the legal, regulatory and commercial incentives, or lack thereof, for asset managers to undertake issuer-specific engagement. The paper also discusses hedge fund activism, and the likelihood for asset managers generally to exercise holistic-risk engagement of portfolio companies, including in relation to ESG factors.

Finding the British Google: Relaxing the Prohibition of Dual-Class Stock From the Premium-Tier of the London Stock Exchange

Abstract: There is a dearth of British tech-companies listing on the London Stock Exchange (LSE), and the LSE lacks a large, innovative tech-company such as Google. The UK Government, concerned as to the loss of UK tech-companies to foreign acquirors, views the encouragement of UK tech-firm listings as a policy priority. Dual-class stock, currently prohibited from the LSE Main Market’s premium-tier, allows founders to list their firms, and retain majority-control, while holding significantly less of the cash-flow rights in the company. This article will broach the potential for dual-class stock to attract UK tech-company listings, and explore the benefits that dual-class stock can engender for UK tech-companies and their public shareholders. The risks of dual-class structures will also be discussed, but

it will be shown that in a UK regulatory context, in relation to high-growth tech-companies, the risks may not be as severe as presumed, and easily moderated through judicious controls.

Progress: I have published my research in the Cambridge Law Journal (B. Reddy, ‘Finding the British Google: Relaxing the Prohibition of Dual-Class Stock from the Premium-Tier of the London Stock Exchange’ (2020) 79 *CLJ* 315), available at: <<https://www.cambridge.org/core/journals/cambridge-law-journal/article/finding-the-british-google-relaxing-the-prohibition-of-dualclass-stock-from-the-premium-tier-of-the-london-stock-exchange/3D2E2F2CCFBF653D3151F7B2AC6E681F>>

I was due to present my research at the Max Planck Institute for Comparative and International Private Law PostDoc Conference in Hamburg, but it was cancelled owing to the coronavirus situation.

I presented the paper in March 2021 at the Faculty of Law’s (Cambridge University) conference on ‘Funding Innovation: Current Issues in Corporate Finance’.

The Emperor’s New Code? Time to Re-Evaluate the Nature of Stewardship Engagement Under the UK’s Stewardship Code

Abstract: John Kingman’s review of the Financial Reporting Council (FRC) doubted the effectiveness of the UK’s Stewardship Code in encouraging informed and engaged stewardship by institutional investors of the companies in which they invest (issuers). Accordingly, the FRC published the Stewardship Code in 2020 in a final opportunity to prove its effectiveness and relevance, and, in particular, enhance issuer-specific engagement by institutional investors. The up-date has enhanced the reach and substance of the code. However, the legal, regulatory, contractual and competitive environment in which institutional investors exist will constantly forestall soft-law attempts to foster greater issuer-specific engagement, a point perhaps tacitly acknowledged by the 2020 Stewardship Code with its wider scope. Instead, in relation to engagement, stewardship disclosure should focus on the types of engagement that institutional investors are motivated to exercise in practice, such as engagement in response to hedge fund activism, and engagement on systemic risks.

Progress: I have published my research in The Modern Law Review (B. Reddy, ‘The Emperor’s New Code? Time to Re-Evaluate the Nature of Stewardship Engagement Under the UK’s Stewardship Code’ (2021) 84 *MLR* 842), available at: <<https://www.modernlawreview.co.uk/july-2021/emperors-new-code-time-re-evaluate-nature-stewardship-engagement-uks-stewardship-code/>>

More Than Meets the Eye: Reassessing the Empirical Evidence on US Dual-Class Stock

Abstract: Some of the largest and most successful publicly traded companies, such as Alphabet and Facebook, have implemented a capital structure known as dual-class stock. Dual-class stock enables a company’s controller to retain voting control of a corporation while holding a disproportionately lower level of the corporation’s cash-flow rights. Dual-class stock has led a tortured life in the US, and is perhaps the most controversial area of corporate governance today. Between institutional investor derision and the exclusion or restriction of dual-class stock from certain indices, one may assume that dual-class structure must be harmful to outside stockholders. However, in this article, the existing empirical evidence on US dual-class stock will be reassessed by contrasting studies that use different measures of performance. It will be shown that although dual-class firms are generally valued less than similar one-share, one-vote firms, they perform as well as, and, in many cases, outperform, such firms from the perspective of operating performance and stock returns. When it comes to dual-class stock, more than meets the eye, and a presumption that dual-class stock is harmful for outside stockholders should not guide policy formulation.

Progress: I have completed a working draft of this paper, available at: <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3554428>

This paper will be published in the University of Pennsylvania Journal of Business Law in the final quarter of 2021.

Up the Hill and Down Again: Dual-Class Stock and the UK Listing Review

Abstract: The final recommendations of Jonathan Hill's UK Listing Review were published on 3 March 2021. The headline recommendation was that dual-class stock should be permitted on the premium-tier of the London Stock Exchange. The aspiration is to encourage more high-quality UK equity listings, particularly of high-growth tech-companies, for which dual-class stock is especially beneficial. Dual-class stock allows founders to list their firms, and retain majority-control, while holding significantly less of the cash-flow rights in the company. However, in an attempt to protect and placate institutional shareholders, who are generally sceptical of dual-class stock, various conditions have been recommended. This article finds that those conditions comprise a curious mix, some of which are too relaxed and do not substantially protect public shareholders, and some of which are too severe and could deter the very firms the proposals are intended to attract, resulting in dual-class stock in name but not in substance.

Progress: I have completed a working draft of this paper, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3812744

I presented this paper in May 2021 at the CERF Cavalcade.

Bobby V. Reddy, August 2021