FOUNDERS VS. PUBLIC CAPITAL – THE COMPETITION FOR COMPANY CONTROL AT IPO.

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In the last few weeks, Snap Inc. refused to allow new ordinary shareholders a vote. And Spotify is reportedly considering a listing with no offering. Both these actions are in their own way significant rejections of the role of the public equity capital providers, both institutional and retail.

What's the problem?

Becoming a public company requires several fundamental changes to a company's structure and obligations. These requirements have been developed over the past century, to balance the rights and desires of founders and public shareholders. For instance, simplifying the capital structure, addressing shareholder relationships to become arms' length, increasing public disclosure, adding independent directors to the board, putting in place insider dealing procedures, etc. Or in the offering structure itself, requiring adherence to a minimum free float.

Going materially off the consensus, especially for voting, destabilises the careful corporate governance balance, ultimately not a good thing for all investors. For instance, as this Harvard and Wharton study shows, firm value has a negative relationship with voting rights.

While so far there's no indication that Spotify will have dual classes, not having a liquidity event at the time of IPO is another way to belittle the role of the public capital providers. Specifically, due to the lack of liquidity since shares are likely to pass only slowly from private to public hands. it's only too easy to conclude this will impact suitable price discovery for years or decades, until a reasonable amount of the shares are in public hands. And if this major market-facing change is ignored, who know what other aspects of public company governance could also fall by the wayside.

Surely this isn't a new debate

It may be instructive to examine why the dual class restrictions were put in place in the first instance. There are obvious attractions to founders, of course. But it's not hard to understand that dual class structures increase the risk of governance failure, as in this example. Hence the tendency for companies with dual class share structures to underperform, as established in the Harvard and Wharton analysis. Which is why the UK's attitude has for decades been "one share, one vote".

This pushback against public market obligations is also happening elsewhere. Hong Kong and Singapore are losing largecap listings to the US, in particular. And both are considering allowing dual class share structures to be listed, like Snap Inc. Given the dislike of dual share structures was historically driven by investors, it's therefore no surprise that investors such as Aberdeen Asset Management are against these changes.

Continental Europe and Scandinavia isn't blameless, although it's a slightly different situation. Examples such as Porsche AG have both ordinary and preference shares listed, with the ordinary shares held principally by the founding family. In Sweden, this report says a high 64% of analysed Swedish companies have dual voting structures, and it's a feature in other Nordic countries as well as Italy, Germany, Switzerland and Spain. Although, as the report states, the difference lies here:

"Non-voting shares, meanwhile, are often not considered to be a breach of the one-share, one-vote principle as the lack of voting is compensated by a higher dividend. Furthermore non-voting shares are seen more as debt instruments given the comparability of holders of non-voting shares and holders of debt (guaranteed or preferential dividend, no voting rights)."

Compare this to Snap's public share class, with no votes and no preferential dividend.

However even in London, the question of dual class shares has recently been asked by the regulator in the context of international IPOs, as well as for science and technology companies. So is this a losing battle?

So what – who cares if these structures are allowed?

The IFC, a member of the World Bank Group, has this to say on the optimal structure of a capital market - note the investor protection comment:

> "*To reliably extract the benefits of well-functioning markets, adequate regulation for issuers, investors, and intermediaries in addition to robust supervisory arrangements to protect investors, promote deep and liquid markets, and manage systemic risk are critical*."

Seems pretty clear. If investor protection is fundamental to the optimal functioning of a stock market, the obligation falls on the investors to identify and raise issues with the companies and regulators. As we saw, this was the case in the UK in the mid 20th century.

To underline this responsibility, UK Government, listed companies, and institutional investors back the Financial Reporting Council which creates the UK Stewardship Code. Part of a broader package of corporate governance efforts, it makes investors accountable for holding management and shareholders to task in order "*to help improve long-term risk-adjusted returns to shareholders*". Sound familiar?

It's encouraging that many responsible institutional investors are indeed vocal about their opposition to failures of corporate governance. In the UK, just look at the current debate on management compensation.

Will this be enough to persuade companies to think again on dual share structures, or lack of liquidity? Unfortunately, unless prohibited by regulation, I personally think there will always be another Snap Inc using lax regulation, positive market conditions, and the pressure-cooker of an IPO, to take advantage of investors' healthy desires for returns. Investors wanting to prevent this, should perhaps be more vocal in their capital allocation decisions away from such companies.