

Legal Research on the Protection of the Rights and Interests of Small and Medium-sized Shareholders: Based on the Response of Two-Tier Shareholding Structure

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Abstract: The two-tier shareholding structure, which originated in the United States, has become popular around the world. Unlike the traditional model of “equal shares with equal rights”, the core feature of the two-tier shareholding structure is that the company issues two classes of shares with different voting rights. It enables the concentration and stabilization of corporate control, which has a positive effect on the long-term development of the company and resistance to hostile takeovers. Against the background of the rapid development of the capital market and the continuous innovation of corporate governance structure, the two-tier shareholding structure has begun to be adopted by many enterprises. While this structure can improve the efficiency of corporate governance and promote corporate growth, it also raises a number of challenges. In particular, for small and medium-sized shareholders, their shareholdings may face the problem of limited or no voting rights, as well as the lack of an effective internal and external monitoring mechanism for the company. These issues may lead to the impairment of the rights of small and medium-sized shareholders. Currently, challenges in practice include inadequate laws and regulations, insufficient disclosure of information, and inadequate monitoring mechanisms. Therefore, exploring the path to protect the rights and interests of small and medium-sized shareholders and analyzing their current situation has become an important area in the study of two-tier shareholding structures. This paper starts from the actual situation, analyzes the problems exposed in the operation process of two-tier shareholding structure, and then explores the practical and feasible methods to protect the rights and interests of small and medium-sized shareholders on this basis, with a view to putting forward valuable references for the development of China’s securities market.

Keywords: Two-tier shareholding structure, Small and medium-sized shareholders, Rights and interests protection, Securities law, Sunset clause, Information disclosure

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1. Introduction

1.1. Background and significance of the study

In the era of the deep development of global economic integration and the increasing maturity of China's capital market, the original one-share-one-right approach is no longer applicable to companies with complex shareholder relationships. Since entering the 21st century, since mainland China launched the pilot of preferred shares in 2013, the double-layer shareholding structure has gradually ascended to the stage of securities as an innovative model^[1]. In 2018, the Hong Kong Stock Exchange made adjustments to the Main Board Listing Rules, opening up listing and trading for companies with a double-shareholding structure. Immediately following in 2019, the China Securities Regulatory Commission (CSRC) also opened up the use of dual shareholding structures for innovative companies listed on the Shanghai Stock Exchange. In the same year, the Science and Technology Innovation Board (STB) also clarified for the first time the specific rules and measures for dual shareholding structures. By 2021, in the revision discussion of the company law, it was proposed to allow the issuance of shares with different voting rights as stipulated in the company's articles of association in order to meet the diversified investment needs. The above indications suggest that China will fully introduce a two-tier shareholding structure in the future.

While the two-tier shareholding structure has significant advantages in giving more control to specific shareholders, facilitating corporate financing, and maintaining the control of the founders, it also raises problems such as concentration of control and imbalance of decision-making power, and poses a challenge to the protection of the rights and interests of small and medium-sized shareholders. In today's securities market in China, small and medium-sized investors have long taken up more than 90% of the market, and their size has exceeded 200 million people, which is an important part of the securities market. Protecting the interests of small and medium-sized shareholders is of irreplaceable practical significance to the securities market and is crucial to maintaining the stability and development of the securities market.

Under the guidance of socialist rule of law, the protection of the rights and interests of small and medium-sized shareholders is not only an important embodiment of maintaining the principles of fairness, justice, and openness in the capital market, but also an inevitable requirement for promoting the healthy and stable development of the economy. Therefore, the legal research on the protection of the rights and interests of small and medium-sized shareholders under the double-layer shareholding structure not only has theoretical value, but also has important practical significance.

1.2. Literature review

With the implementation of the domestic dual shareholding system and since the introduction of the first dual shareholding structure company in the United States, more and more listed companies are adopting dual shareholding structure, and this trend has attracted extensive attention from the academic community^[2].

At the level of its concept and characteristics, Li argues that the dual equity system is specifically characterized by the separation of power and decision-making power^[3]. In the opposite direction, that is, the shortcomings of the dual shareholding structure, Zhang pointed out the shortcomings under the current legal framework by analyzing the current status of legislative protection of the rights and interests of small and medium-sized shareholders under the dual shareholding structure^[4]. Zhang's study also focuses on the protection of small and medium-sized shareholders' rights and interests under the two-tier shareholding structure, and she discusses the dilemmas faced by small and medium-sized shareholders under the two-tier shareholding structure and the possible solutions through case studies^[5]. Wang analyzed the impact of double-layer shareholding structure on the

rights and interests of small and medium-sized shareholders in depth from the legal point of view, and put forward suggestions to improve the legal system for the protection of small and medium-sized shareholders' rights and interests^[6].

2. Conceptual analysis of the two-tier shareholding structure

2.1. Concept of two-tier shareholding structure

A two-tier equity structure means that the shares issued by a company have different voting rights and are usually categorized into high-voting shares and low-voting shares. High-voting shares are generally held by the founder or management of the company and have control over the company; while low-voting shares are issued to the public, and their holders, i.e., small and medium-sized shareholders, although they have the economic rights and interests of the shares (e.g., the right to dividends), have their voting rights in corporate decision-making significantly weakened. Simply put, the essence of a two-tier shareholding structure is to divest control and ownership interests in the company, ultimately reinforcing the control of specific shareholders. Such a structure realizes a paradigm shift in the allocation of corporate power from the "majority of the capital" principle of the previous single-shareholding structure to a "consensus minority" mechanism that is more conducive to decision-making.

2.2. Characteristics of the two-tier shareholding structure

(1) Separation of voting rights and income rights

Under the traditional structure, the majority shareholder is also the controlling shareholder, whose voting rights are closely linked to the cash flow rights, and the proportion of shareholding directly determines the size of decision-making power. However, the emergence of the two-tier shareholding structure signaled a trend of diversification of shareholders' roles and interests. Some shareholders choose to voluntarily give up part of their voting rights in exchange for economic benefits under specific conditions (e.g., low share price). At the same time, shareholders with managerial ability are granted excess voting rights, which is more conducive to the long-term development of the company.

(2) Strict restrictions on special voting shares

Under the current capital market rules, the decision of the shareholders' general meeting and the need for a majority of voting rights is an inevitable requirement for a company to adopt a two-tier shareholding structure to be listed or quoted on the stock exchange. Although there is no requirement for the holders of special voting shares in the current legal design, the rules of KTC, NSE, and NSSB specify that they should be natural persons who have made "significant contributions" to the company, and they are also required to hold specific positions. As the voting rights of these shares are much higher than those of ordinary shares and they have a certain degree of "personal dependency", if they are allowed to circulate freely in the market, it may lead to a sudden transfer of control of the company and turbulence in the corporate governance structure. Therefore, many companies with a two-tier shareholding structure will impose strict restrictions on the transfer of special voting shares through the articles of association or shareholders' agreements. Even, these shares may not be circulated in the open market. And even if they do circulate, they will be converted into common shares as a result of the triggering of the sunset clause, and their share price will revert to that of common shares.

3. Status quo of the protection of the rights and interests of small and medium-sized shareholders under the two-tier shareholding structure and the difficulties it faces

3.1. Current situation

(1) Relevant provisions of existing laws and regulations in China

In December 2023, the revision of the Company Law of the People's Republic of China provided a legal basis for the two-tier shareholding structure, which clearly stipulated that the structure could be different from that of an ordinary shareholding company. Article 144, paragraph 1, subparagraph 2 of the Company Law on class shares provides a legal basis for the implementation of the two-tier shareholding structure, but does not provide for further detailed design. Meanwhile, in terms of the protection of the rights and interests of small and medium-sized shareholders, Article 145 and Article 146 of the Company Law provide general and general provisions, which undeniably play a certain role but lack specificity.

(2) Relevant regulations of China's Science and Innovation Board

As an important testing ground for China's capital market reform, STEM takes the lead in allowing companies that are in line with the positioning of STEM and can prevent and control risks well to be listed by adopting a two-tier shareholding structure. According to the "Rules for the Review and Approval of Listing on the Science and Innovation Board" and the "Rules for Listing on the Science and Innovation Board", there are relevant provisions on the differentiated voting rights system for companies with a double-layer shareholding structure.

Firstly, STEM has set strict eligibility conditions for holders of super-voting shares. Such shares must be in the hands of beneficial owners of 10% or more of the company's issued shares. The setting enables the reduction of shareholder liquidity. Secondly, the rules clarify the limitations on the scope of application of super voting rights; super voting rights shall not be applied to major resolutions such as mergers, demergers, and amendments to the articles of association of the company. Further, the exit mechanism for holders of super-voting shares plays an important role. Once the holder no longer meets the minimum shareholding requirements, loses his/her shareholder status, leaves the company, or passes away, his/her super voting shares will be automatically converted into ordinary shares. In addition, there are strict timeframes for companies to implement a two-tier shareholding structure, which are limited to the initial public offering stage and subject to strict scrutiny by the exchange. Finally, a special disclosure mechanism has been established for listed companies adopting a two-tier shareholding structure.

3.2. Difficulties faced

Despite the fact that China's existing laws and the relevant provisions of the Kechuan Board and the Stock Exchange have regulated the protection of the rights and interests of small and medium-sized shareholders under the two-tier shareholding structure in various aspects, the following difficulties are still faced in actual operation:

(1) Defects of the sunset clause

Sunset clause is a mechanism to automatically terminate special voting rights. According to the provisions of the KTC Listing Rules, the Shanghai Stock Exchange specifies three circumstances that trigger the sunset clause: equity dilution, inability of the special voting rights holder to fulfill his/her duties, and transfer of voting rights. However, from the comprehensive analysis of relevant practices and theories, these three situations are of an unavoidable ex post facto nature, which makes it difficult to predict the damage to the rights and interests of small and medium-sized shareholders in a timely manner^[7].

In addition, due to the enumerative nature of the provision, special voting rights cannot be effectively converted into ordinary equity when the special voter tries to abuse the voting rights or circumvent the general provisions. Therefore, in practice, its triggering conditions and enforcement standards are often difficult to meet, leading to difficulties for small and medium-sized shareholders to seek effective legal remedies in the event of abuse of power by special voting rights shareholders ^[8].

(2) Uncertainty about the definition of “significant contribution” of the holder of super equity.

China’s relevant rules for special equity holders only require “significant contribution” to the development of the company, but does not give specific criteria to determine the definition of “significant contribution”. The ambiguity of the criteria is likely to cause disputes, making it difficult for small and medium-sized shareholders to defend their rights when their interests are jeopardized. In reality, companies with a two-tier shareholding structure often grant special voting rights to founders or management in recognition of their “significant contribution” to the company.

Take the first two-tier shareholding structure company in China as an example ^[9]. In its prospectus, the description of the holder’s qualifications is only manifested in the form of “yes” and “no” answers given by the holders of the special voting shares to prove that they are in compliance with the listing rules. This makes it difficult to determine the exact materiality of their “significant contribution”.

(3) Weak information disclosure system in the securities law

The information disclosure system is a system whereby listed companies report their financial and operational status to the stock exchange to the public in accordance with regulations. In practice, the penalties for violating information disclosure are light, with a maximum fine of less than ten million yuan for listed companies violating the information disclosure rules. This fine amount is low, and it is difficult to play an effective deterrent and punitive role. At the same time, except for the disclosure items and the amount of penalty, the other provisions are mostly principle-based and lack practical operability. Ultimately, this leads to selective disclosure or concealment of important information by some enterprises, further aggravating the information asymmetry problem for small and medium-sized shareholders.

(4) Regulation to be strengthened

Under the two-tier shareholding structure, the internal regulatory mechanism is weak and the external regulatory body is unclear. At present, the regulatory subjects of listed companies in China are divided into exchange, industry regulation, legal regulation, and administrative regulation. There is a lack of a unified and coordinated mechanism among the three types of regulatory bodies, making it difficult to regulate effectively at the same time. In terms of internal supervision, most of the internal supervisory bodies of listed companies in China are independent directors and supervisory boards, but it is difficult for these two bodies to play a supervisory role in practice. Because special voting rights holders often have high voting rights, they can usually decide the appointment and dismissal of independent directors and supervisors, resulting in the independence and effectiveness of independent directors and supervisory boards are insufficient, and it is difficult to give full play to their supervisory role.

(5) Lack of fiduciary duty of controlling shareholders

Under the two-tier shareholding structure, controlling shareholders often have greater voting and control rights, but their fiduciary obligations (i.e., the obligation to be accountable to all shareholders) have not been effectively implemented. Currently, the third paragraph of Article 180 of the newly revised Company Law of China provides that shareholders shall assume fiduciary obligations based on their de facto

directorship under certain circumstances. However, this provision merely stipulates that shareholders shall assume fiduciary obligations based on their status as controlling shareholders. The indirect nature of this provision does not effectively curb situations in which controlling shareholders jeopardize the interests of the company as a whole and the interests of small and medium-sized shareholders for the sake of their personal interests.

4. Suggestions for improving the protection mechanism of the rights and interests of small and medium-sized shareholders under the two-tier shareholding structure

4.1. Improve the connection between the two-tier shareholding structure and the protection of the rights and interests of small and medium-sized shareholders in terms of legislation

Improve the Company Law and the Securities Law to clarify the legality of the double-layer shareholding structure and provide detailed operational rules and regulatory requirements. In the legal liability section of the Company Law, include the abuse of rights by controlling shareholders or other high-voting shareholders under the double-layer shareholding structure against the rights and interests of small and medium-sized shareholders, so as to increase the penalties for shareholders violating the law. At the same time, accurately limit the scope of application of special voting rights holders under the two-tier shareholding structure in the Securities Law. Summarizing the practice of various countries and the reality in China, the restriction that special voting rights holders must be natural persons and must be qualified to be directors at the time of listing of the company is the most reasonable and effective.

4.2. Improvement of sunset clauses

The core feature of a fixed sunset clause is that a company adopting a two-tier shareholding structure must specify in its articles of association the duration of the structure. This pre-set time limit prevents special voting shares from enjoying privileges for a long period of time, thus preventing governance problems caused by excessive concentration of power, while promoting flexible adjustment and improvement of corporate governance mechanisms.

4.3. Strengthening market regulation

The special voting rights holders under the two-tier shareholding structure are likely to abuse their power; therefore, a strict external supervision mechanism must be established. Considering the special characteristics of China's market and legal environment, strengthening the dual supervision of the Securities and Exchange Commission (SEC) and the capital market is a feasible path, which not only helps to optimize corporate governance, but also protects the interests of small and medium-sized shareholders. As the core institution of market regulation, the SEC needs to improve its regulatory rules and increase penalties for non-compliance. For example, the SEC can set up a professional regulatory team to conduct regular inspections of the corporate governance structure and the behavior of special voting rights holders to ensure the legal compliance of their behavior^[10].

5. Conclusion

It is undeniable that double-layer shareholding structure is a double-edged sword. While this special structure can

effectively resist hostile takeovers and maintain the stability of business operations, it may also jeopardize the interests of small and medium-sized investors, which may in turn undermine the performance of the company. In the face of the trend of popularization of double-layer shareholding structure, we should not only face up to its disadvantages, but also make efforts to improve the relevant system design. It is foreseeable that with the soundness of the supporting mechanism of the double-layer shareholding structure, China's capital market will make great progress in enterprise equity trading and corporate governance, laying a solid foundation for future high-quality economic development.

Disclosure statement

The author declares no conflict of interest.

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