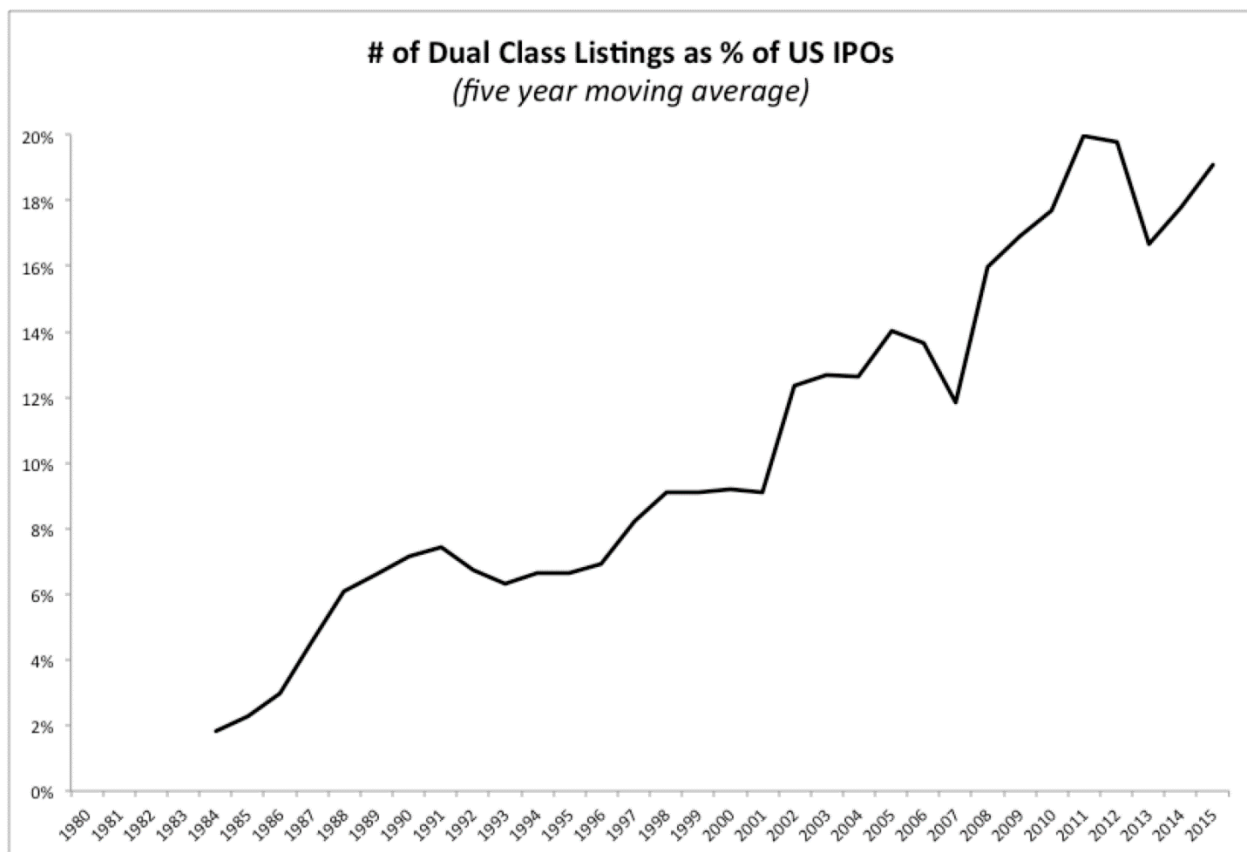


Recommendation of the Investor as Owner Subcommittee Dual Class and Other Entrenching Governance Structures in Public Companies

Preliminary Findings:

- The share of public companies employing dual class or other entrenching governance structures has increased dramatically since 1980, as depicted in Figure 1.¹ Between 2005 and 2015, the number of companies with multi-class stock structures increased by 44%.² The list of public companies with dual-class structures with disparate voting rights includes Google, Facebook, Snap, LinkedIn, Nike, and many others.³

Figure 1.



¹ Figure 1 draws on data from Jay R. Ritter, *Initial Public Offerings with Multiple-Class Share Structures*, <https://site.warrington.ufl.edu/ritter/files/2017/01/IPOs-from-1980-2016-with-Multiple-Share-Classes-Outstanding.pdf>. This figure reflects and this set of recommendations are focused on companies with dual or multi-class structures under which the founder or managers retain high-vote stock, and does not include companies with one-share/one-vote structures, whether or not they have other conventional governance terms, or non-traditional governance structures, such as companies with time-phased voting or benefit corporations, or companies in which high-vote shares are offered for sale to the public.

² The number of companies employing dual-class stock structures increased from 487 in 2005 to 701 in 2015. *See id.*

³ Currently, there are 701 U.S. public companies with dual-class stock structures. *See id.*

- Dual class or other entrenching governance structures allow for a concentration of voting power in the hands of company insiders through a disproportionate allocation of voting rights among shareholders. Under such structures, insiders can control the company while owning a smaller number of shares than would be necessary in a traditional one-share, one-vote structure. As a result, insiders' voting power outstrips their ownership interest, which exacerbates the principal-agent problem and imposes additional risks on investors. The difference or "wedge" between the insiders' voting interests and their ownership interests can be quite large, and can increase over time without further approval or consent of other shareholders. As this "wedge" grows, the interests of the controlling shareholder and the other shareholders diverge further, and the risks that the controlling shareholder will cause the company to take actions that will harm non-controlling shareholders grows.
- Commentary and research on such governance structures is mixed, but recent growth in such structures has prompted shareholder groups, major investors, and advisory groups to express strong opposition to non-traditional governance structures. The Council of Institutional Investors declared that "every share of a public company's common stock should have equal voting rights" and "no-vote shares have no place in public companies."⁴ State Street Corporation has urged the SEC to ban non-voting shares.⁵ Institutional Shareholder Services denounced dual-class structures as "an autocratic model of governance."⁶ BlackRock is a strong proponent of equal rights for all shareholders.⁷ GMI Ratings warned that using a dual-class share structure "can pose a serious risk to a company's public shareholders."⁸
- In 2017, three major index providers opened public consultations on their treatment of non-voting and multi-class structures. The FTSE Russell consultation resulted in a decision to exclude past and future developed market constituents whose free float constitutes less than 5 percent of total voting power.⁹ S&P Dow Jones's consultation resulted in a broader exclusion, which bars the addition of multi-class constituents to the S&P Composite 1500 index and its components, covering the S&P 500, MidCap 400 and SmallCap 600 indexes.¹⁰ MSCI recently announced it was broadening a consultation regarding non-voting shares to address multi-class shares generally, and the consultation remains open.¹¹ Research has consistently established that inclusion of a company's stock in a major index increases the liquidity and value of that stock, a large fraction of

⁴ Council of Institutional Investors, Dual-Class Stock, http://www.cii.org/dualclass_stock.

⁵ Madison Marriage, *State Street Asks SEC to Block Non-Voting Shares*, Financial Times, June 18, 2017, <https://www.ft.com/content/9595e5c4-51db-11e7-bfb8-997009366969>.

⁶ Institutional Shareholder Services, *The Tragedy of the Dual Class Commons*, 1, 3 (Feb. 13, 2012), <http://online.wsj.com/public/resources/documents/facebook0214.pdf>.

⁷ Elzio Barreto and Sumeet Chatterjee, *BlackRock pitches for shareholder protection as Asia bourses weigh dual-class listings*, Reuters (Sep. 26, 2017).

⁸ Kimberly Gladman, *The Dangers of Dual Share Classes*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (May 21, 2012), <https://corpgov.law.harvard.edu/2012/05/21/the-dangers-of-dual-share-classes/>

⁹ FTSE Russell, Voting Rights Consultation, July 2017,

http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf

¹⁰ S&P Dow Jones Indices, Press Release, July 31, 2017, https://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjmulti-classsharesandvotingrulesannouncement7.31.17.pdf?force_download=true

¹¹ <https://www.msci.com/documents/10199/02bacb99-1b53-4c91-b82d-2a1c64dc0825>.

which is not merely temporary but permanent.¹² Through its effect on index eligibility, non-traditional governance is value-relevant for all investors.

- Dual class and other entrenching governance structures create unique risks. Such risks include (1) the inability or greater difficulty of influencing management, (2) the increased risk of divergent views over strategy or business combinations, (3) increased risk of conflict or litigation caused by such divergent views, (4) risks that those who hold relatively small ownership interests can use voting control to approve further changes in governance to the detriment of non-controlling investors,¹³ which can result in delistings under major stock exchange listing requirements,¹⁴ resulting in reduced liquidity and loss of value for investors, and (5) risks that major classes of investors will not be available to purchase shares in the secondary market, either because of policies adopted by specific investors or because shares are excluded from major indices. In addition, holders of non-voting shares may be entitled to less information than holders of voting shares in some situations. Some of these risks exist for investors who do not obtain any or traditional control rights associated with conventional one-share/one-vote common stock, whereas some exist for the company (e.g., litigation) and hence affect all investors.
- The customary role of the SEC in setting and enforcing disclosure requirements for public offerings of multi-class shares is clear. On the one hand, the current disclosure regime under securities laws, and the review of disclosures by the SEC’s staff, does require risk factor disclosures related to a number of the risks posed by non-traditional governance structures. An informal survey of recent SEC filings by major public companies found that companies did disclose risks related to the lack of control rights associated with non-voting shares.
 - For example, Snap Inc. disclosed that one result of a non-traditional structure -- “concentrated control” – would mean that “other stockholders’ ability to influence corporate matters” was “eliminated,” and, as a result, the company’s management “could take actions that ... stockholders do not view as beneficial [and] as a result, the market price of our Class A common stock could be adversely affected.”¹⁵ The company also disclosed that “concentrated control could delay, defer, or prevent a change of control, ... that our other stockholders support,” and “could allow our co-founders to consummate a transaction that our other stockholders do not support [and] ... make long-term strategic investment

¹² E.g., Yen-Cheng Chang, et al., Regression Discontinuity and the Price Effects of Stock Market Indexing, Working paper (June 2, 2014); A. Shleifer, Do Demand Curves for Stocks Slope Down?, 41 J. Fin. 579-590 (1986); L.E. Harris and E. Gurel, Price and Volume Effects Associated with changes in the S&P List: New Evidence for the Existence of Price Pressures, 41 J. Fin. 815-829 (1986); M.D. Beneish and R.E. Whaley, An Anatomy of the “S&P Game”: The Effects of Changing the Rules, 51 J. Fin. 1909-1930 (1996); A.W. Lynch and R.R. Mendenhall, New Evidence on Stock Price Effects Associated with Changes in the S&P 500 Index, 70 J. Bus. 351-83 (1997); J. Wurgler and E. Zhuravskaya, Does Arbitrage Flatten Demand Curves for Stocks?, 75 J. Bus. 583-608 (2002).

¹³ E.g., Jacky Wong, *Sina Shows Its Disregard for Shareholders -- The U.S.-listed Chinese company gives its chairman extra voting rights to fend off activist investors*, Wall St. J. (Nov. 9, 2017).

¹⁴ NASDAQ Stock Market Equity Rule 5640, available at http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_3_8_31&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F (last visited Nov. 12, 2017).

¹⁵ Snap Inc. Form S-1/A (Feb. 24, 2017).

- decisions and take risks that may not be successful and may seriously harm our business.”
- Further, there was evidence that companies revised their disclosures to enhance the salience of the fact and risks associated with non-traditional governance as a result of review and comments by the SEC staff. For example, Snap Inc. revised the first page of its prospectus to include the word “non-voting” in describing the shares being offered.
 - On the other hand, gaps in the current disclosure regime as it relates to dual class governance structures exist.
 - *Wedge Data.* Most basically, current disclosures do not straightforwardly and clearly require investors to be given quantitative information on the “wedge” between ownership and control that dual class and other entrenching structures create. For example, there is no simple line item requiring that an insider with 10% of the equity but 51% of the votes identify and quantify that gap. While Schedule 14A does require ownership information for directors, officers, and 5+% shareholders to be disclosed, the disclosures that are contained in current proxy statements do not allow for investors to quickly identify the size of the “wedge” between ownership and control, as they permit a variety of ways for registrants to disclose ownership information, particularly when one class of shares can be converted into another, where the shares are formally held by trusts or other companies. The resulting disclosures can be difficult to use to derive “wedge” information.¹⁶

For example, Nike discloses its controllers have the right to nominate the majority of the company’s board, but it does not with clarity disclose the total *ownership interest* of the controllers, and without that information, the “wedge” between ownership and control cannot be readily quantified.¹⁷ Thus, while investors can with some effort uncover the fact that Nike is effectively controlled by Travis Knight through his control over Swoosh LLC, which is disclosed as owning the bulk of Nike’s Class A shares. However, the Nike proxy statement does not clearly identify Knight’s effective ownership interest in Nike or Swoosh LLC. Nike does disclose that Swoosh LLC’s equity is owned (through an intermediate holding company) by a trust for which Mr. Knight is a trustee and with respect to which he and unidentified members of his immediate family are beneficiaries. But Nike does not allow an outside investor to understand with any precision the degree to which the trust and holding company arrangement preserves Mr. Knight’s economic interest in Nike. While the fact of a wedge between ownership and control is clear, even diligent analysts would find it daunting to estimate the *degree* to which that wedge may cause the interests of Nike’s controlling shareholders and its non-controlling shareholders to diverge.

¹⁶ See Lucian A. Bebchuk and Kobi Kastiel, *Small-Minority Shareholders in Control*, Working Paper (Oct. 24, 2017) at 37 (“Companies should clearly and coherently disclose in their annual proxy materials the controlling shareholders’ total percentage of equity interest and total percentage of voting rights.”).

¹⁷ Nike, Inc., *Definitive Proxy Statement (Schedule 14A)* 13–14 (July 25, 2016). This example is based on discussion in Bebchuk and Kastiel, *supra* note 16, confirmed by reference to Nike’s proxy statement.

- *Governance Change Risks.* Current disclosures also do not adequately disclose the risk that existing control shareholders can use multi-class control structures to increase the “wedge” between ownership and control over time, either by causing registrants to issue more high-vote stock to the controllers, or by selling low- or no-voting stock.¹⁸ While the fact of control may be disclosed, simple quantification of the size of the potential increase in the wedge between ownership and control under current structures is not.

For instance, while Snap disclosed the major governance provisions it planned to adopt, its IPO registration statement did not clearly disclose that those provisions would enable each of the co-founders to reduce his equity stake to below 1% of total economic ownership without relinquishing control. The fact that the governance structure adopted by Snap could – without further shareholder check – lead over time to such a dramatic divergence between economic and voting interests could be made significantly more salient and clear to investors. A reasonable investor might (wrongly) presume that existing SEC rules, state laws or listing requirements would prevent such a dramatic change over time.

- *Conflict Risk Disclosures.* Offerings do not appear to provide specific details about the kinds of conflicts or disputes that have arisen in the past, at least in part because of the existence of non-traditional governance.¹⁹ Where such disputes result in verdicts for minority or non-voting shareholders, the fact of the disputes and the resulting litigation can nevertheless inform investors about the nature of the risks of such investments; where such disputes result in verdicts for control shareholders, they may highlight gaps in the state law protections for minority investors, and provide more specific examples of how concentrated control can result in harms to minority investors. The very fact of such disputes, moreover, and the fact that they are typically not easily dismissed at the pleading stage, are themselves potential risks that may be worth specifically disclosing to investors before they invest in companies with such structures.
- *Index or Listing Risks.* Prospectuses also do not specifically address the risks of being excluded from major indices, or from being delisted from a stock exchange as a result of the governance change risks mentioned above.²⁰ Indeed, it is not clear that disclosures relating to liquidity or value risks raised by the fact or risk

¹⁸ Id., at 37 (“Currently, annual proxy materials do not readily provide information ... [about the] minimum equity stake [that would allow the controller to maintain control] ... and [the minimum stake] is often affected by multiple governance provisions, including an automatic conversion provision or a sunset clause with a minimum-ownership threshold.”).

¹⁹ Recent examples of such disputes include (1) *In re Ezc Corp Inc. Consulting Agreement Derivative Litigation*, 2016 WL 301245 (Del. Ch. Feb. 23, 2016) (refusing motion to dismiss claim that agreements between control shareholder of a company with non-traditional governance were not entirely fair and permitted controller to extract a non-ratable return from the company); and (2) *Espinoza v. Zuckerberg et al.*, 124 A.3d 47 (Del. Ch. 2015) (dispute involving control shareholder in a non-traditional governance company and whether formalities were followed for shareholder ratification to eliminate dispute).

²⁰ Recent registration statements by Snap, Blue Apron, and Nike did not address index inclusion, nor do the companies appear to have yet disclosed such risks in their filings under the Securities Exchange Act of 1934.

of index inclusion or delisting are currently required for new offerings of such shares. For example, while Snap disclosed generically that it was subject to listing requirements, and in general terms that there could be no guarantee of a continued listing, it did not make any specific disclosures related to listing requirements related to multi-class structures or the potential for control shareholders to use control to cause issuances of supervoting stock or otherwise violate those requirements.

Recommendations:

In line with the SEC's mission,²¹ the Subcommittee recommends that the Division of Corporate Finance respond to the increase in dual class and other entrenching governance structures by continuing to scrutinize disclosure documents filed by companies with such structures, commenting on such documents so as to enhance the salience and detail of disclosures of risks related to such structures, and developing guidance to address a range of issues that such structures raise, as outlined below. We also recommend that the staff commence a pilot program to monitor shareholder disputes arising out of such structures and to determine if enhanced disclosure requirements related to the issues reflected with such disputes are necessary.

Specifically, the Division of Corporate Finance should pursue these actions:

- (1) Require public companies that have dual class or other entrenching governance structures to prominently and clearly disclose the numerical relationship between (a) the amount of common equity or its equivalent economic beneficial ownership interest held by any person entitled to control or direct the voting of five percent or more of shares entitled to voting rights in the election of directors or the equivalent body ("ownership interests"), and (b) the amount of voting rights held or controlled by such a person ("voting rights").
- (2) Require public companies that have dual class or other entrenching governance structures to prominently and clearly disclose (a) any risks that those holding shares with greater voting rights could use those voting rights to approve governance changes that would further increase any disparity between the ownership interests and voting rights held by such persons and (b) the minimum amount of ownership interests that such persons could hold while still retaining control over a majority of voting rights, without the need for approval by other shareholders.
- (3) Require public companies that have dual class or other entrenching governance structures to prominently and clearly disclose potential risks and effects of exclusion or limited inclusion of company shares from major indices as a result of their control rights, and potential effects of exclusion on stock liquidity and value.
- (4) Require public companies that have dual class or other entrenching governance structures to prominently and clearly disclose the risks that stock exchanges could delist such companies' shares if the control persons exercised voting rights they have under state or

²¹ The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. 15 U.S.C. § 78c(f) (2006).

other organizational law to increase their relative voting power or to decrease the relative voting power of other shareholders.

- (5) Monitor shareholder disputes arising out of non-traditional governance structures to identify medium and long-term trends, commonalities, and specific ways in which conflicts of interest that such structures generate can create risks for companies, with a view to a continuous improvement in disclosure requirements through the traditional review and comment process.
- (6) Define “common stock” more specifically for securities law disclosure purposes to distinguish between stock with voting rights under the one-share, one vote system from diminished-rights stock. The Division of Corporate Finance should consider restricting the prominent or salient use of the term “common stock” in registration statements, particularly on the cover page, caption, and other prominent locations in offering documents, to shares that have traditional governance rights, i.e., one-share, one-vote single-class common stock. This is consistent with the Division’s past practice of requiring companies to more prominently include phrases such as “non-voting” on the first page of the prospectus, even when “non-voting” is not formally in the title of the securities (as in the Snap IPO), but would go further to include some constraints on the ability of issuers to choose any title for the securities they are offering, however potentially deceptive the title. While the name of such securities under state or other organizational law could continue to be used in the longer, more complete sections of the disclosure document, we recommend that the prominent and salient portions of the document include specific identifiers that convey the potentially entrenching governance risks such securities create, by using terms such as “non-voting equity,” “variable interests in equity,” or other similar terms.
- (7) For issuers of non-voting stock, consider adding disclosure requirements to Form 10-K that would provide all information equivalent to that ordinarily included in a Schedule 14A, to the extent of the Commission’s authority.

Supporting Rationale:

Corporate disclosures are crucial to the functioning of a market economy. Disclosures reduce the information asymmetry between corporate insiders and current and potential investors and creditors. A rich information environment and low information asymmetry facilitate the efficient allocation of resources, capital market development, market liquidity, and tend to reduce firms’ cost of capital.

The growing importance of indexed investment in the market has increased the need for strong definitions around categories of securities and additional disclosures related to non-traditional governance structures.²² Multi-class stock and non-voting stock structures increase the risk of market confusion and cost of diligence for individual and institutional investors.²³ Defining “common stock” in a standard and customary way, to exclude diminished-rights stock,

²² See Council of Institutional Investors, Remarks to Investor Advisory Committee, March 9, 2017, http://www.cii.org/files/issues_and_advocacy/correspondence/2017/03_09_17_IAC_testimony.pdf.

²³ See *id.*

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will increase transparency on the market and reduce transactional costs, by enhancing the salience of the fact and risks of entrenching governance structures in public offerings.

The change in definition for securities law purposes would not in any way conflict with the conventional division of labor between the states (which, generally speaking, set the corporate law rules by which stock must or may have varied governance attributes) and the SEC (which sets the rules by which such attributes are disclosed in the context of public offerings). Companies could continue to offer securities with non-governance attributes, and could as a matter of corporate law continue to use whatever labels are appropriate for that purpose. However, for purposes of labeling, marketing, offering, and selling shares to the public, the conventional role of the SEC in defining how and what must be disclosed provides ample traditional bases for the SEC to specify (for example) that a security lacking fundamental traditional attributes of common stock (such as the right to vote in the election of directors) should not be called common stock, but instead be given some other identifying name, such as a variable interest security, or a common return security, or other such identifier (up to the issuer in the first instance to choose) that signals prominently that such securities have fundamentally different attributes than conventional common shares.

It is our understanding that the Division of Corporate Finance does not monitor long-term corporate governance trends or look to reported litigation to assess the nature, extent or intensity of conflicts or disputes arising out of non-traditional governance structures. Given the rise in non-traditional governance structures, we believe there is a need to devote more resources to enhance the staff's existing monitoring and review process with additional market monitoring, so as to identify patterns in disputes between company insiders and investors and tailor disclosure requirements to most pressing issues. Such monitoring would allow for more specific comments advising issuers of the need for specific identification of risks related to governance disputes.

- *In re Ezc Corp*, the Delaware Chancery Court highlighted the debilitating effect of non-traditional structures on corporate governance, emphasizing that “[a]s control rights diverge from equity ownership, the controller has heightened incentives to engage in related-party transactions and cause the corporation to make other forms of non-pro rata transfers.”²⁴ The court explained that “as the controller’s equity stake declines, the relative benefit from [self-serving behavior] increase[s].” *In re Ezc Corp*, the company management controlled 100% of voting power with just 5.5% of the outstanding stock. The management entered into a series of allegedly “rubber-stamped” related-party transactions that undermined the company’s financial health. Public shareholders brought suit alleging breach of fiduciary duty and waste of corporate assets, and successfully defended the suit against a motion to dismiss. *In re Ezc Corp* illustrates shareholders’ concern with related-party transactions and management transparency in public companies with non-traditional governance structures. The dispute suggests the kind of specific example of conflict-of-interest transaction that concentrated ownership can facilitate, with attendant risks to the issuer and its investors.
- In *Espinoza v. Zuckerberg*, the Delaware Chancery Court ruled that a disinterested controlling stockholder cannot ratify a self-dealing transaction by an

²⁴ *In re Ezc Corp Inc. Consulting Agreement Derivative Litig.*, No. CV 9962-VCL, 2016 WL 301245, at *2 (Del. Ch. Jan. 25, 2016).

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interested board of directors without a shareholder meeting or written consent.²⁵ In *Espinoza*, shareholders challenged Facebook's directors in their decision to increase non-management director compensation. Plaintiffs claimed that Facebook's directors' compensation is 43% higher than at comparable companies, despite Facebook's lower profits. After the filing of the lawsuit, Mark Zuckerberg, who owned less than 30% of company stock but controlled over 61% of the voting power, expressed his approval of the board's decision in a deposition and an affidavit. The court held that such informal approval does not trigger the business judgement rule to save the board. *Espinoza* highlights the increased risks associated with director self-dealing in companies with non-traditional governance structures.

Finally, as discussed above, major index providers have taken action or are considering taking action to limit or bar inclusion of securities with non-traditional governance attributes, and existing stock exchange listing standards limit the ability of listed companies to take actions that increase or create disparate voting rights without being delisted. Given the consensus view that index-inclusion and listings each can have a material effect on value and liquidity of securities, the risk of exclusion from indexes or delisting from exchanges are attributes that may deserve explicit disclosure requirements, to the extent those risks are known by registrants. Risks of index exclusion, in particular, are likely to increase over time if – as most observers expect – passive, indexed investment continues to be an ever-larger component of the way in which capital is invested.

²⁵ *Espinoza v. Zuckerberg*, 124 A.3d 47 (Del. Ch. 2015).