Dual-Class Stock and Private Ordering: A System That Works

Posted by David J. Berger, Wilson Sonsini Goodrich & Rosati, on Wednesday, May 24, 2017

Editor's note: David J. Berger is Partner at Wilson Sonsini Goodrich & Rosati. This post is based on a Wilson Sonsini publication by Mr. Berger, Steven E. Bochner, and Larry Sonsini. Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock by Lucian Bebchuk and Kobi Kastiel (discussed on the Forum here).

Dual-class stock has become the target of heightened attention, particularly in light of Snap's recent IPO. While the structure remains popular for companies trying to respond to the short-term outlook of public markets—including companies in the technology and media sectors, as well as companies in more traditional industries ranging from shipping and transportation to oil and gas, and everything in between—dual-class stock continues to be the subject of considerable attack by various investor groups and some academics. Further, while a majority of dual-class companies are not technology companies, young technology companies continue to be the primary focus of governance activists.[1]

Despite the controversy over dual-class stock, we believe that the present system of private ordering with respect to dual-class stock will—*and should*—continue. Private ordering allows boards, investors, and other corporate stakeholders to determine the most appropriate capital structure for a particular company, given its specific needs. So long as the company makes appropriate disclosure of its capital structure, including the implications of this structure to its investors, we believe there is no need for further regulation on this issue.

The benefits of a system of private ordering have become increasingly apparent in the U.S. and across the globe. For example, both Nasdaq and the NYSE continue to actively solicit and list companies with multi-classes of stock. According to a recent Council of Institutional Investors (CII) study, about 10 percent of publicly listed companies have multi-class structures. This includes not just newly public and/or prominent technology companies such as Alphabet (formerly Google), Facebook, and Snap, or even numerous media companies such as CBS, Liberty Media, Sinclair Broadcast Group, Scripps, and Viacom, but also companies in every industry ranging from financial services (Berkshire Hathaway, Evercore, Houlihan Lokey, etc.) to consumer products (Constellation Brands, Coca-Cola Bottling Co., Nike, Panera Bread, etc.) to transportation and industrial companies (Swift Transportation, TerraForm, Quaker Chemical, Nacco Industries, etc.).

[1] The Council of Institutional Investors recently published a list of dual-class companies in the Russell 3000. The list can be found here: http://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf.

As the companies identified above demonstrate, many of the dual- or multi-class companies listed by the NYSE and Nasdaq continue to be among the most successful in the world—both financially and from a governance perspective. The success and prominence of these companies make it unlikely that there will be a broad effort among the exchanges to require them to change their governance structure.

The success of many dual-class companies has also led both Nasdaq and the NYSE to continue to support dual-class listings. For example, Nasdaq recently released a report (discussed on the Forum here) that included an endorsement of dual-class stock, including laying out the arguments why companies with dual-class stock should continue to be listed.[2] Among the reasons cited by Nasdaq was the recognition that encouraging entrepreneurship and innovation in the U.S. economy is best done by "establishing multiple paths entrepreneurs can take to public markets." Because of this, each "publicly traded company should have flexibility to determine a class structure that is most appropriate and beneficial for them, so long as this structure is transparent and disclosed up front so that investors have complete visibility into the company. Dual-class structures allow investors to invest side-by-side with innovators and high-growth companies, enjoying the financial benefits of these companies' success.[3]" While the NYSE has not recently issued any public statements on multi-class stock, it continues to actively seek to list companies with multi-class stock, including Alibaba, which chose to list on the NYSE after the Hong Kong stock exchange raised significant questions about its governance structure.

The trend towards private ordering on dual-class shares can also be seen globally. For example, less than two years ago, Hong Kong's stock exchange rejected a proposal to allow companies with dual-class stock to list on its exchange. However, the Hong Kong Securities and Futures Commission (SFC) recently announced a new study to determine whether to permit dual-class listings (including possibly creating a separate exchange for companies listing dual-class stock). While the SFC's decision includes consideration of a new trading exchange in Hong Kong for companies with multi-class structures, its actions have been widely interpreted as essentially reversing its prior decision. Additionally, the SFC's chairman recently announced that the SFC "supports the consultation to allow the public to share their views on the dual-shareholding structure," and he made it clear that the SFC was "open minded" about the possibility of listing dual-class companies.

Singapore appears to be going through a similar transition. Singapore also historically did not allow listings of dual-class companies, but in February 2017, the country released a paper titled "Possible Listing Framework for Dual-Class Share Structures." The proposal has been the subject of considerable debate, with many large institutional investors (including those based in the U.S.) opposed to allowing any type of dual-class listing. At the same time, the head of Singapore's Investors Association, which represents more than 70,000 retail investors and is the largest organized investor group in Asia, has become an outspoken advocate of dual-class stock, arguing that "retail investors are not idiots" and that any "capital market that is aspiring to be leading" should offer this alternative.

The trend can also be seen in Europe. In 2007, the EU considered imposing a one-share/one-vote requirement on publicly traded companies, but abandoned the idea at the time of the 2008

[2] A copy of Nasdaq's Blueprint for Market Reform can be found here: http://business.nasdaq.com/media/Nasdaq%20Blueprint%20to%20Revitalize%20Capital%20Markets_tcm5044-43175.pdf, discussed on the Forum here.

[3] *Id*. at 16.

financial crisis. Now many EU countries are adopting some form of "time-based voting" shares, to encourage long-term investors by giving more votes to shareholders who own their shares for longer periods.[4] For example, France has adopted the "Florange Act," which generally provides that shareholders who own their shares for two years will receive two votes per share. Italy has also considered loyalty shares, while in many of the Nordic countries companies with shares with multiple voting rights are common.[5]

At the same time, critics of dual-class stock in the U.S., especially within the institutional investor community, remain quite vocal. For example, the Securities and Exchange Commission's (SEC's) Investor Advisory Committee recently held a hearing on dual-class stock, where its use was sharply criticized by Commissioner Stein (whose term ends in June), as well as a representative from CII.[6] During the meeting, representatives from CII and other institutional investors urged the SEC to use its regulatory authority over the exchanges to limit the ability of companies to have dual-class structures, while also calling upon the companies that create the benchmark indexes to exclude companies with non-voting stock from these indexes (ironically, many of the same companies that create these indexes are CII members and among the world's largest institutional investors).

More recently, two of the country's leading academics, Harvard Law School professors Lucian Bebchuk and Kobi Kastiel, published an article (discussed on the Forum here) calling for a mandatory sunset provision on all dual-class stock for public companies.[7] The Bebchuk and Kastiel piece argues that "public officials and investors cannot rely on private ordering to eliminate dual-class structures that become inefficient with time," and for that reason "[p]ublic officials and institutional investors should consider precluding or discouraging IPOs that set a perpetual dual-class structure." Bebchuk and Kastiel conclude that "[p]erpetual dual-class stock, without any time limitation, should not be part of the menu of options" for public companies.

We disagree with Bebchuk and Kastiel on the need for additional regulation in this area and, further, do not believe that the SEC will adopt the Bebchuk and Kastiel proposal. While the SEC has not recently taken a formal position on dual-class stock, its new leadership is certainly familiar with the issue. For example, while Chairman Clayton was a partner at Sullivan & Cromwell, he represented many companies with dual-class share structures, and William Hinman, the SEC's new Director of Corporate Finance, represented Alibaba in its IPO. Mr. Hinman, who was based in Silicon Valley before taking his new position at the SEC, was also involved in a number of other IPOs where companies have dual-class stock. While it is impossible to predict the future positions of the SEC, Chairman Clayton has emphasized that one of his top priorities is to reverse the decline in U.S. public companies that has occurred over the last 20 years. As Nasdaq recognized, one way to foster increased numbers of IPOs (as well as

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[4] For a lengthier discussion on time-based voting and its possibilities in the U.S., *see* David J. Berger, Steven Davidoff Solomon, and Aaron Jedidiah Benjamin, "Tenure Voting and the U.S. Public Company," 72 *Business Lawyer* 295 (2017).

[5] According to ISS, 64 percent of Swedish companies have two share classes with unequal votes, while 54 percent of French companies have shares entitled to double-voting rights. *See* "ISS Analysis: Differentiated Voting Rights in Europe" (2017), available at https://www.issgovernance.com/analysis-differentiated-voting-rights-in-europe/.

[6] WSGR partner David J. Berger was also a panelist at this forum, and explained why companies and investors may support dual-class shares (or at least allow for private ordering on this issue). A copy of Mr. Berger's remarks can be found here: https://www.sec.gov/spotlight/investor-advisory-committee-2012/berger-remarks-iac-030917.pdf.

[7] *See* Lucian Bebchuk and Kobi Kastiel, "The Untenable Case for Perpetual Dual-Class Stock," available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2954630 (discussed on the Forum here).

companies staying public rather than going private) is by allowing companies (and entrepreneurs) the option of dual-class shares and other alternative capital structures.

We agree with Nasdaq and believe that dual-class stock is an issue that is best left to private ordering. For some companies, dual-class stock is both necessary and appropriate to respond to the corporate governance misalignment that exists in our capital markets today. In particular, many of the rules governing our capital markets have the practical impact of favoring short-term investors. When responding to this governance misalignment it is understandable that some companies may choose dual-class (or multi-class) stock. While multiple classes of stock are obviously not the right model for all companies (and it must be noted that there are many different types of capital structures even within the multi-class framework), there is no single capital structure that is right for all companies. Given the dynamics of our capital markets and the ever-changing needs of entrepreneurs and companies, a company's capital structure is best left to a company's investors and a system of private ordering based upon full disclosure.