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Major Stock Index Providers to Limit Inclusion of Multi-Class Companies: What it Means and Why it Matters



CONTRIBUTORS


Larry W. Sonsini


David J. Berger


Katharine A. Martin


Steven E. Bochner


Douglas K. Schnell


Robert G. Day

ALERTS

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Major index providers S&P Dow Jones, FTSE Russell, and MSCI recently adopted, or are in the process of considering, changes to their index eligibility rules that could significantly impact companies that have, or that are contemplating, multi-class capital structures. This action, that may impose costs on retail investors that can be avoided by larger investors, should end calls by institutional investors for the stock exchanges and the U.S. Securities and Exchange Commission (SEC) to prohibit the listing of companies with multiple classes of stock and/or disparate voting rights.

What Happened?

S&P Dow Jones

Effective on July 31, 2017, companies with multiple share classes will no longer be eligible for inclusion in the indices comprising the S&P Composite 1500, including the S&P 500, S&P MidCap 400, and S&P SmallCap 600. This change does not affect existing S&P Composite 1500 index constituents, who will be grandfathered. In addition, the S&P Global BMI Indices, S&P Total Market Index, and other S&P and Dow Jones-branded indices will not be affected.

For existing S&P Composite 1500 companies that issue another publicly traded share class to holders of a share class that is already included in the index, the newly issued share class will be considered for inclusion if the event is mandatory and the market capitalization of the distributed class is not considered to be de minimis. If an existing S&P Composite 1500 company reorganizes into a multiple share class structure, that company will remain in the S&P Composite 1500 at the discretion of the Index Committee in order to minimize turnover.

FTSE Russell

On July 26, 2017, FTSE Russell announced a new eligibility requirement for companies to be included in all standard FTSE Russell indices, including the Russell US indices, that would require companies "to have greater than 5% of the company's voting rights (aggregated across all of its equity securities, including, where identifiable, those that are not listed or trading) in the hands of unrestricted (free-float) shareholders as defined by FTSE Russell." Companies that do not satisfy the voting requirement "will have their securities rendered ineligible for index inclusion. For potential new constituents, including IPOs, the rule will apply with effect from the September semi-annual and quarterly reviews." Existing constituents will have a five-year grace period: the rule will be effective beginning in September 2022. After September 2022, grandfathering will end, and companies that are not in compliance will be removed from the applicable indices. FTSE Russell intends to review the voting rights threshold annually and may adjust requirements in the future.

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"Free float" is defined as the percentage of a company's shares that are considered freely available for public purchase. Determining the free float requires analysis and classification of a company's shareholders but generally excludes: shares held by directors, senior executives and their affiliates; shares held within employee share plans; shares held by governmental authorities (excluding shares held by independently managed pension schemes for governments); and shares subject to lock-up. A company with a ten-to-one dual class structure will need approximately 34 percent of its total outstanding stock to be held by unrestricted shareholders in order to be in compliance with the FTSE Russell requirement.

To meet FTSE Russell's eligibility criteria, newly public companies with dual-class stock would need to either reduce the voting power of high-vote stock or include a formulaic voting provision in their charters guaranteeing their low-vote stock will hold just above five percent of the vote.

MSCI

MSCI is seeking public comment on its proposed rules regarding non-voting shares. As proposed, for new potential MSCI companies, MSCI will not include non-voting shares in the MSCI GIMI and the MSCI US Equity Indexes in cases when the company-level "voting power" (defined as the voting rights of listed shares over total voting rights of the company) of listed shares is less than 25 percent. Existing MSCI companies would remain eligible if their company-listed "voting power" is above 16.67 percent and would have a period of one year to meet the requirement before being removed.

What Does This Mean?

It is important to note that under the rules adopted by S&P Dow Jones and FTSI, the large companies with dual- or multi-class stock already included in these indexes—i.e., Alphabet, Facebook, Berkshire Hathaway, etc.—are grandfathered in and will not be affected by these decisions, at least for several years. Only newly listed companies or companies that would otherwise be eligible to join but have not yet been included are effected by the rule changes.

At the same time the actions by the index providers respond to concerns raised by many of the largest institutional investors, particularly index funds owned by large institutional investors, who argued that they were forced to buy shares of multi-class companies because such shares were included in passive funds designed to mirror the performance of these various indices. The Council of Institutional Investors had also called for the leading index providers to take this action, in part because it (along with many institutional investors) believed that neither the exchanges nor the SEC were likely to prohibit dual-class shares.

The actions by the index providers should end any effort by the institutional investor community to have the exchanges or the SEC take actions to ban or otherwise limit multi-class companies. If multi-class companies are not included in major indexes in the future, institutional investors can make the decision as to whether or not they want to buy the stock issued by these companies. There is no need for further regulatory involvement. Given this action, it is possible that the exchanges or the SEC may be willing to reconsider prior positions on such items as tenure voting or other capital structures designed to encourage longer-term holders.

At the same time, the decision by the index providers is likely to limit the choices available to the retail investor in a way that it does not do to an institutional investor. As SEC Commissioner Stein has previously noted, in 2016, institutional investors owned 70 percent of public shares in the U.S., and just three money managers held the largest stock position in 88 percent of the companies in the S&P 500. The average retail investor does not have the assets of institutional investors, and so has a more limited ability to diversify investments. As has been widely documented in recent years, retail investors have increasingly chosen to invest indirectly in the market, primarily through mutual funds and index funds, especially passive funds that track an index rather than actively managed funds or individual stocks. One reason for this is the growing recognition that retail investors can best maximize returns while mitigating risk by buying lower-cost index funds instead of actively managed funds or individual stocks.

Unfortunately, such investors will no longer be able to have the potential upside represented by the stocks of some of our most dynamic companies, while also getting the protection from the fact that these stocks represent only a small fraction of the larger indexes. Instead, a retail investor will have to pay the additional costs—both direct and indirect, in terms of risk—to owning these companies.[1]

There are at least two even more significant problems with the decision by the index providers to exclude companies with multi-class structures. First, although it is far from clear that all newly public

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companies want to be in the indexes—there are both benefits and drawbacks for a company whose stock is included in a major index—if the goal of this effort is achieved and fewer companies with multi-class structures go public, then it may simply result in fewer companies going public.

As SEC Chairman Jay Clayton has repeatedly emphasized, making it harder for companies to go public in the United States is detrimental to our capital markets. The number of public companies in the U.S. has declined by more than 45 percent since its peak in 1996, while the small, venture-backed company initial public offering (IPO) has virtually disappeared from the market. Even as the SEC is actively looking for ways to encourage more companies to go public, the decision by the index providers has the potential to discourage some of our best private companies from going public.

This leads to the second major problem with the decision by the index providers: it is yet another example of a "one size fits all" view of corporate governance. There has been substantial academic literature demonstrating that there is no single form of corporate governance that inevitably leads to better corporate performance. This research ranges from recent articles showing that the multi-year effort to eliminate classified boards and other defensive measures may have cost the shareholders of these companies hundreds of millions of dollars to questions about the value of the shareholder maximization thesis.[2]

It also must be noted that while the index providers have chosen to exclude companies with multi-classes of stock from the primary indexes in the U.S., they are not making the same decisions with companies in other parts of the world. For example, MSCI just created a new index for China's A shares.

Ultimately, we believe that the decision by the index providers should not be a deciding factor in whether or not a company chooses to go public with multiple classes of stock. At the same time, 2015 and 2016 had just 18 technology IPOs each year, and this year is on track to have about the same number. Many of these companies went public with dual-class or multi-class stock, including most recently Snap and Blue Apron. The decision by the indexes will be a factor considered by companies considering whether or not to go public, as well as whether or not to include a multi-class share structure at the time of an IPO. Given the actions by the index providers and how these actions have been precipitated by some of the largest institutional investors, it should not be surprising why many of the best private companies may continue to try and avoid the public markets.

For more information on stock index provider eligibility rules or multi-class capital structures, contact Larry Sonsini, David Berger, Katherine Martin, Steve Bochner, or any member of the corporate governance or capital markets practices at Wilson Sonsini Goodrich & Rosati.

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[1] Further, it must be noted that many of the largest institutional investors who complained most stridently about the inclusion of companies with multi-class stock in the major indexes routinely invest large sums in so-called "alternative investments" where they have far less protections and involvement in governance decisions than public companies with dual-class structures. In this way, a practical effect of the action taken by the indexes is to further favor the interests of large investors, who already have the ability to both buy more risky investments and better mitigate those risks, while preventing smaller investors from taking the same action in the most economically efficient way for these investors.

[2] *See, e.g.*, K.J. Martijn Cremers, Saura Masconale & Simone M. Sepe, "*Commitment and Entrenchment in Corporate Governance*," *110 NWU.L.Rev.727* (2016) (giving empirical evidence showing the benefits of defensive measures); K.J. Martijn Cremers & Simone M. Sepe, "*The Shareholder Value of Empowered Boards*," *68 Stan.L.Rev.67* (2016). See also William Lazonick, "*How Shareholder Value is Killing Innovation*," *Harv. Corp.Gov.L.Blog*, (August 8, 2017); Joseph L. Bower & Lynn Paine, "*The Error at the Heart of Corporate Leadership*," *Harv. Bus. Rev.* (May/June 2017).

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