PLACING LIMITS ON DUAL-CLASS STOCK

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V-CARD

3 MAJOR STOCK INDEX PROVIDERS

HAVE TAKEN STEPS TO REMOVE DUAL-CLASS COMPANIES FROM THEIR INDICES OR REDUCE THEIR WEIGHTING ...

Debate is sharpening over the value of dual-class stock, the controversial governance structure that multiplies the voting power of founders and other insiders—often forever—at the expense of ordinary shareholders.

The number of publicly traded U.S. companies with multi-class stock increased 44% from 2005 to 2015, and nearly one in five IPOs now feature the structure, according to a recent report presented to the Securities and Exchange Commission's Investment Advisory Committee (IAC).

In March, the IAC recommended that the Commission require additional disclosures from dual-class companies. Others want to go further, including one of the SEC's own Commissioners, who suggested U.S. stock exchanges should only allow dual-class shares that automatically convert to ordinary ones over time.

The issue of continuing to allow companies with "perpetual" dual-class stock to list on U.S. markets may be too ripe for the SEC to ignore, despite Chair Jay Clayton's insistence in March that revisiting rules on the topic is "not on my list of near-term priorities."

Since last summer, three major stock index providers have taken steps to remove dual-class companies from their indices or reduce their weighting, potentially leaving legions of index-fund investors without an interest in some of the world's most important companies.

The two Democrats on the SEC, Commissioners Kara Stein and Robert Jackson, jumpstarted the conversation the same week in February with speeches criticizing dual-class companies as "inherently undemocratic" (Stein) and creators of "corporate royalty" (Jackson).

Both spoke at Stanford University, near the Silicon Valley headquarters of dual-class powerhouses Facebook and Alphabet, and down the bay from Dropbox, whose March IPO gave founders 10 times the voting power of ordinary shareholders.

Supporters argue that a dual-class structure allows visionary founders to take their companies public and remain focused on creating lasting value instead of short-term market pressures. They say prohibiting them would put U.S. stock markets at a disadvantage when competing for IPOs of the world's most innovative companies. (Several Asian stock markets are now, paradoxically, considering allowing dual-class companies to list, raising the specter of a "race to the bottom.")

Shareholder advocates say the arrangements inordinately protect corporate insiders from accountability—and can contribute to the collapse of companies like Theranos, where CEO Elizabeth Holmes, accused of fraud by the SEC, exercised almost complete control due to her ownership of all 100-to-1-vote class B shares.

In his February 15 speech at Stanford, SEC Commissioner Jackson sought a middle ground. Setting aside the question of "whether dual-class ownership is always

good or bad," Jackson asked "whether dual-class structures, once adopted, should last forever." His answer: a resounding "no," for reasons of principle and practice.

Perpetual dual-class stock "removes entrenched managers—and their kids, and their kids' kids—from the discipline of the market forever," he said. "Simply put: asking investors to put eternal trust in corporate royalty is antithetical to our values as Americans."

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> SEC COMMISSIONER ROBERT JACKSON

Jackson also presented data that suggested that any performance benefits associated with dual-class structures disappeared over time—as soon as two years after an IPO, according to his study comparing perpetual dual-class companies to those with "sunset" provisions. Seven years after the IPO, companies with perpetual dual-class stock performed worse than those had allowed enhanced voting shares to "sunset" into ordinary shares.

His suggestion, quickly seconded by CII, is that U.S. exchanges consider allowing dual-class companies to list only if they automatically convert to one-share, one-vote after a certain period. "Such standards," he said, "would allow Main Street investors to share in our economy's growth—but avoid asking them to trust corporate management forever." ■

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