One share, one vote—or not?

Board perspectives

The concept of "one share, one vote" dominates the public company landscape in the U.S. Yet, at a distinct minority of companies, founders and other insiders hold a class of equity with multiple votes per share—typically 10—while the public holds stock that carries one vote per share, or in a small number of cases, no votes.

The super-voting stock creates a disconnect between economic interest and voting power, and the holders of super-voting stock are typically able to control the board and all major decisions. Proponents maintain that a multi-class structure allows visionary founders to pursue their strategy without having to respond to short-term pressures. They also argue that many founders would elect to keep their companies private if ceding control to the public were the price of being a public company. Critics of multiclass structures argue that they insulate management from accountability and that such structures should not last forever—even after the founder is gone—with some likening such companies to dictatorships.

Many large tech companies have dual (or even triple) class structures, and they are becoming more heavily weighted in stock indices as a result of their increasing valuations. *The Financial Times* reported that businesses with unequal voting rights represented 4 percent of the MSCI World Index, by weight, in 2005, with that percentage rising to 10 percent currently. Moreover, a majority of the companies with unequal voting structures in that index are U.S. companies.[1]

Yet, multi-class structures are not new in the U.S. For example, Dodge Brothers went public in 1925 with two classes of stock, and such structures were often established at media companies, where the high vote stock was viewed as insulating editorial content from outside pressures.

The debate over multi-class share structures has heated up yet again as the result of several factors, including the 2017 IPO of Snap Inc. in which the shares sold to the public have no voting rights, the decision of certain major index providers to exclude or change the weighting of companies where the public holds low (or no) vote stock, and the reaction of institutional investors to changes made or proposed by index providers.

Index providers

In July 2017, FTSE Russell announced that unless the public holds more than 5 percent of a company's voting rights, that company will not be included in its indices. Approximately 35 companies that were already public would have been excluded based on this low threshold, and they have until September 2022 to comply if they wish to remain in FTSE Russell's indices. FTSE Russell has indicated that it may revisit the threshold.[2]

S&P Dow Jones subsequently adopted a policy under which companies with multi-class structures will no longer be added to the S&P Composite 1500 and its component indices (the S&P 500, MidCap 400, and SmallCap 600). Since S&P Dow Jones grandfathered multiclass companies already in the indices, the impact is primarily on companies contemplating an IPO.[3]

1 Attracta Mooney and Robin Wigglesworth, "Google, Facebook and Snap Challenge Governance Standards," Financial Times, May 27, 2018.

2 FTSE Russell, "FTSE Russell Voting Rights Consultation – Next Steps," July 2017.

3 S&P Dow Jones Indices press release, "S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Results," July 31, 2017.

At present, MSCI is seeking input on a proposal that would keep multi-class companies in its indices but reduce their weighting to reflect the voting power of the public float.[4]

The practical impact of excluding a company from an index is that portfolio managers may not be able to buy the company's stock and may purchase less of the stock than would otherwise have been the case if the company is underweighted.

Institutional investors

The top 10 institutional investors, including Blackrock, Vanguard, and State Street, generally oppose multiclass structures.[5] Yet, many investors have not embraced the index providers' initiatives.

For example, Blackrock has been vocal in its opposition to excluding companies from indices based upon a multi-class structure, arguing that "broad market indexes should be as expansive and diverse as the underlying industries and economies whose performance they seek to capture… index providers should make every effort to reflect the investable marketplace…"[6] Vanguard has taken a similar stance on excluding companies from broad indices,[7] as has Norges Bank Investment Management (NBIM), one of the world's largest investors, with assets of more than $1 trillion.[8]

Blackrock also opposes MSCI's proposal to underweight companies with unequal voting rights and has suggested that MSCI offer a range of alternative indices that reflect investor preferences relating to issues such as unequal voting rights. Underlying Blackrock's stance is its view that regulators, and not index providers, should set governance standards. NBIM has similarly suggested that the MSCI methodology would be appropriate for a "parallel set of indices that investors can follow at their discretion."[9]

Notably, while Blackrock believes "one vote for one share" is the preferred structure for public companies, it recognizes "the potential benefits of dual-class shares to newly public companies as they establish themselves; however, we believe that these structures should have a specific and limited duration." The Council of Institutional Investors (CII), which has long argued in favor of one share, one vote, also raised the concept of a "sunset" on dual-class structures when responding to the MSCI proposal. In particular, CII suggested exempting companies "that choose to adopt firm, reasonable, time-based sunset provisions in their governing documents," noting that "the core of our concern is lack of accountability in the long-term, beyond a reasonable time horizon for understanding risks and opportunities."[10]

Valuation

A central question underlying the debate over multi-class structures is whether such structures positively or negatively affect value. While studies have produced mixed results, MSCI recently issued a report finding that "unequal voting stocks in aggregate outperformed the market over the period from November 2007 to August 2017, and that excluding them from market indexes would have reduced the indexes' total returns by approximately 30 basis points per year over our sample period."[11] A subsequent academic paper found that dual-class firms have a valuation life cycle, with higher valuations at IPO that dissipate after six to nine years.[12] The authors concluded that "some sort of a sunset provisions may be useful." Further contributing to the debate, SEC Commissioner Robert Jackson, Jr. recently released the results of his preliminary analysis of 157 dual class IPOs over the past 15 years that found: "Seven or more years out from their IPOs, firms with perpetual dual-class stock trade at a significant discount to those with sunset provisions."[13]

---

4 MSCI press release, "MSCI Reopens the Consultation on the Treatment of Unequal Voting Structures and Releases a Discussion Paper," January 31, 2018.

5 Nick Dawson, "Swimming Against the Current," Harvard Law School Forum on Corporate Governance and Financial Regulation (HLS Forum), August 14, 2017.

6 Barbara Novick, Open Letter Regarding Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes, May 3, 2018, HLS Forum.

7 Dawson, "Swimming Against the Current."

8 Carine Smith Ihenacho and Séverine Neervoort, NBIM letter to MSCI, Inc., May 31, 2018.

9 NBIM letter to MSCI, May 31, 2018.

10 Kenneth A. Bertsch, letter to MSCI Equity Index Committee, HLS Forum, May 9, 2018.

11 Dimitris Melas, "Putting the Spotlight on Spotify: Why Have Stocks with Unequal Voting Rights Outperformed?" MSCI Blog, April 3, 2018.

12 Martijn Cremers, Beni Lauterbach, and Anete Pajuste, "The Life-Cycle of Dual Class Firms," European Corporate Governance Institute, revised May 25, 2018.

13 Speech by SEC Commissioner Robert J. Jackson, Jr., "Perpetual Dual-Class Stock: The Case Against Corporate Royalty," February 15, 2018.

Commissioner Jackson expressed a hope that stock exchanges will consider listing standards that provide for some form of sunset.

Yet, the listing standards of several countries permit multi-class structures, and as competition for listings increases, more exchanges, including Hong Kong and likely Singapore, are allowing these listings, causing some opponents of super-voting stock to lament a race to the bottom.

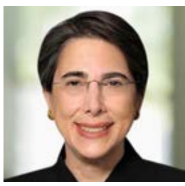
The question remains whether investors will lose their appetite for low (or no) vote shares. To date, that appetite has not waned, although complaints of corporate tyranny have increased.

Directors should consider the following questions:

— If a company is contemplating a multiclass IPO, should the super-voting stock sunset, either after a fixed number of years or after a specified event (such as the founders owning less than a specified percentage of equity)?

— Will the founders/insiders agree to such a trigger, including in the case of companies that are already public?

— Has the board considered the impact of the company being excluded from one or more indices?



This board perspective, originally published in the July 2018 Directors Quarterly, was written by Claudia H. Allen, a Senior Advisor to the KPMG Board Leadership Center. Previously, Claudia was a partner and co-chair of the corporate governance practice at Katten Muchin Rosenman LLP.

About the KPMG Board Leadership Center

The KPMG Board Leadership Center champions outstanding governance to help drive long-term corporate value and enhance investor confidence. Through an array of programs and perspectives—including KPMG's Audit Committee Institute, the WomenCorporateDirectors Foundation, and more—the Center engages with directors and business leaders to help articulate their challenges and promote continuous improvement of public-and private-company governance. Drawing on insights from KPMG professionals and governance experts worldwide, the Center delivers practical thought leadership—on risk and strategy, talent and technology, globalization and compliance, financial reporting and audit quality, and more—all through a board lens. Learn more at kpmg.com/blc.

Contact us

kpmg.com/blc
T: 1-800-808-5764
E: us-kpmgmktblc@kpmg.com

kpmg.com/socialmedia