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Snap judgment – S&P Dow Jones and FTSE Russell indices ensure that investors retain voting rights

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BY

Daniel E. Barenbaum and A. Chowning Poppler

Berman Tabacco

Silicon Valley is known for disrupting industries, and some of its most storied residents seem ready to upend the IPO world, not with technology, but with moxie. The parent company of the popular mobile messaging app Snapchat, Snap, Inc., made headlines this spring with its novel initial public offering (IPO) selling Class A common shares without voting rights. Of the 200 million shares sold at $17 apiece, none came with a right to vote on directors, executive compensation, mergers or acquisitions or other corporate matters. Instead, Snap's two co-founders retained 88.5 percent of the company's voting power, with the remainder left to executives of the company and some early investors. This was a remarkable shift away from the standard practice of taking an investor's capital in exchange for the right to hold the company's management accountable for its use.

Creating multiple classes of stock with differing voting rights is a trend that US technology companies have embraced. Indeed, Google and Facebook created dual-class structures to retain corporate control in the hands of their founders, the rationale being that these visionaries know what is best for the companies they innovated into existence. However, when Google and Facebook went public, each

did so with a dual-class structure that at least afforded public shareholders one vote per share. Subsequently, each company requested shareholder approval before the issuance of a third class of non-voting shares. So while Snap is not the first company to create different classes of stock, it is the first to offer only non-voting shares to the public.

Concerned that Snap was taking this trend too far and disenfranchising shareholders, advocates for investors spoke out against dual-class share structures prior to Snap's IPO. In February 2017, top US fund managers including BlackRock, Inc., Vanguard Group, Inc. and T. Rowe Price called on companies to give shareholders voting rights "in proportion to their economic interest". Similarly, the Council of Institutional Investors (CII), a non-profit association that advocates for pension funds and other institutional investors, sent a letter of objection urging Snap's co-founders to reconsider its contemplated dual-class structure, emphasising the value of investors' input, where "[s]ome companies lacking effective accountability to owners soar for a time but others crash and burn, and still others pursue mistaken strategies for far too long".

Unpersuaded, Snap went public as planned, raising $3.4bn for the company without relinquishing any decision-making power to investors. Since the Snap IPO, industry leaders, stakeholders and academics have considered the implications of such a sea change, and whether non-voting stock is an indication of future market trends for interested buyers or an affront to robust corporate governance. Proponents argue that consolidated voting power in the hands of founders allows them to build long-term value rather than worrying about short-term share price pressures. Opponents argue that even if the structure is efficient at the time of the IPO, the potential advantages are short-lived and potential costs tend to rise as time passes from the IPO. Specifically, dual-class structures remove investors from oversight roles, eliminate management's incentives to perform or face ouster, and result in higher pay for CEOs without comparable payoffs for shareholders. Regarding Snap, its non-voting shares do not have a sunset provision creating an obligation for the structure to expire after a fixed period of time, making these long-term issues more likely to occur.

These considerations led investor advocacy groups to turn their attention to index providers, because many institutional investors hold some portion of their portfolios in one or more established indices that track various industries. While institutional investors want to avoid owning non-voting shares, if companies like Snap were added to a popularly tracked index, these investors would inevitably end up holding non-voting shares. The CII discouraged index providers Standard & Poor's (S&P) Dow Jones and MSCI from permitting Snap and companies that sell non-voting shares from being included in their indices. In addition, a lobby group that represents the largest UK investment managers, the Investment Association, urged British index provider FTSE Russell, as well as MSCI

Global and S&P Dow Jones indices to only include companies that allocate "control of a company in direct proportion to total economic interest and the level of exposure to investment risk".

After months of consultation with market participants, two prominent indices banned companies with non-voting stock. On 31 July 2017, S&P Dow Jones announced that the S&P Composite 1500, which includes the S&P 500, MidCap 400 and SmallCap 600, would no longer add companies with unequal voting rights (i.e., companies with a multiple share class structure). Companies such as Snap are therefore precluded from joining. This change became effective immediately. Existing companies in the indices with multiple classes are grandfathered in. As a result, Facebook, Google and similar companies will not be impacted by the change, even though both have classes of non-voting stock.

S&P's announcement came on the heels of British index provider FTSE Russell proposing new rules on 27 July 2017, requiring companies to ensure that 5 percent of available voting rights are in the hands of unrestricted shareholders of a company in order to be included in their indices. Although it is a modest (and, arguably, a token) percentage, the rule was proposed to address index users' and other stakeholders' concern "that the Snap, Inc. IPO set a dangerous precedent for companies to come to the market with few, if any, voting rights attached to their securities". The rules were published on 25 August 2017, and the limit goes into effect for new IPOs in September. Companies with stock already in their indices have five years – until September 2022 – to make the change. The percentage will be reviewed on an annual basis to determine if a more restrictive threshold would be appropriate, in which case the grace period would be extended one additional year.

A third index, MSCI, may soon be joining these exchanges. In June 2017, MSCI proposed excluding new index constituents, like Snap, from its MSCI GIMI and MSCI US Equity indices when the company-level voting power of listed shares is less than 25 percent. MSCI solicited input from stakeholders through the end of August 2017.

Time will tell whether these index rules will have an impact on whether tech wunderkinds will push for classes of non-voting shares when their companies go public in order to protect their interests and level of control, or whether institutional investors in pressuring indices to ban such companies will somehow be able to shame companies such as Snap from shunning shareholder oversight. Regardless of whether such structures would allow companies to be included in an index, buyer demand for the stock – and not inclusion on an index – will likely drive an IPO's success, no doubt a dynamic that is not lost on the company creators seeking to maintain their control and relative autonomy. In that vein, sceptics question whether index providers are the appropriate entities to toe a line against these multi-class share structures, as opposed to regulators.

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Kara Stein, Commissioner of the US Securities and Exchange Commission (SEC), acknowledged "unequal voting rights present complex and new issues that need to be understood and addressed". However, the SEC has yet to take any steps to regulate the practice.

Nonetheless, by tightening standards to foreclose companies from including non-voting stock, the S&P Dow Jones and FTSE Russell have effectively blocked Snap from being included in their indices. More importantly, these exchanges have taken a meaningful step to preserve the fundamental principle of "one share, one vote" and protect investors' rights. The question now is whether company founders, like those from Snap, will blink.

Daniel E. Barenbaum is a partner and A. Chowning Poppler is an associate at Berman Tabacco. Mr Barenbaum can be contacted on +1 (415) 433 3200 ext. 2325 or by email: dbarenbaum@bermantabacco.com. Ms Poppler can be contacted on +1 (415) 433 3200 ext. 2348 or by email: cpoppler@bermantabacco.com.

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