King & Spalding

Client Alert

Capital Markets Practice Group

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Stock Indices Take Action to Exclude Multi-Class Share Structures

The S&P Dow Jones and FTSE Russell indices recently took actions designed to exclude companies with multi-class share structures from several of the most prominent market indices.

On July 31st, S&P Dow Jones announced that companies with multi-class share structures will no longer be eligible to be added to the S&P 500, the S&P MidCap 400 or the S&P SmallCap 600. Existing companies included in these indices will not be affected by this change. Companies with multiple share classes or with classes having limited or no voting rights will remain eligible for inclusion in the S&P Global BMI Indices and the S&P Total Market Index.

On July 26th, FTSE Russell announced a proposal requiring more than 5% of a company's voting rights be held by unrestricted shareholders in order for the company to be eligible for inclusion on the FTSE Russell indices, including the Russell 3000 and Russell 2000. As proposed, companies currently included in FTSE Russell indices would have until 2022 to change their capital structure to comply with the new rule. FTSE Russell is currently surveying public reaction to the proposal, with a final decision expected to be released later this month.

MSCI is currently engaged in consultations regarding similar changes to their policy, with the consultation period expected to remain open until August 31, 2017.

Multi-Class Share Structures

These actions highlight growing concerns within the investment community regarding the recent trend of public companies implementing multi-class voting structures. The most recent example of this trend occurred earlier this year when Snapchat (Snap) sold non-voting Class A shares in its IPO while certain pre-IPO investors continued to hold Class B shares, which have limited voting rights, and Snap's founders continued to hold voting Class C shares controlling almost 90% of the vote.

Institutional investors and governance commentators have been critical of Snap and other public companies with multi-class share structures, such as Facebook, Google and Zillow. Some of the largest portfolio managers in the world, including BlackRock, Vanguard and State Street, have endorsed a

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"one-share, one-vote" standard, and will support shareholder proposals seeking to implement such standards. In addition, last year Institutional Shareholder Services (ISS) updated its voting guidelines to issue adverse voting recommendations for committee members, and in some cases, the entire board, up for election at IPO companies that impose multi-class share structures having unequal voting rights. Previously, ISS had permitted multi-class share structures when a binding shareholder vote had approved the provision within three years following the IPO, but ISS noted that putting the provision to a binding shareholder vote following the IPO lacks significant meaning if the shareholders have little or no ability to influence the vote. Voting recommendations on companies with existing multi-class structures are considered by ISS on a case-by-case basis.

While multi-class share structures have been widely criticized for diminishing the shareholder voice at public companies, proponents of the structures say that, when used correctly, they can create long-term value for all shareholders by allowing companies to focus on long-term growth, particularly in industries facing disruptive competition or requiring substantial capital expenditures with long investment horizons, by protecting against short-term activist demands. Facebook, for example has maintained a multi-class voting structure since its IPO in 2009 while repeatedly thwarting shareholder proposals seeking a one-share, one-vote standard, and consistently increasing the company's share price.

Talk with Advisors, Engage with Shareholders

As an overarching policy concern, opponents of the S&P Dow Jones and FTSE Russell actions note that the policies may discourage companies from going public. Given the overall decline in the number of recent IPOs, many believe policy decisions should be focused on promoting the overall growth of the public markets rather than specific investor protections. Further, retail investors that invest through index funds will be deprived of these investment opportunities.

These actions by S&P Dow Jones and FTSE Russell may also adversely affect the ability of IPO companies to implement up-C structures, which are implemented primarily for tax planning rather than governance reasons and rely on investors receiving separate classes of stock entitled to separate economic (and sometimes voting) rights. While the up-C structure appears to fall within the literal definition of multi-class share structures covered by the S&P Dow Jones policy, it remains to be seen whether an exception will be made for these structures. To date, S&P Dow Jones has not published any specific interpretive guidance.

When evaluating a company's capital structure, management and the board should consider various methods to reduce the risk of adverse reaction to a multi-class share structure. Meaningful sunset provisions, for example, may afford companies the ability to complete their IPO objectives by allowing use of a multi-class share structure while reducing some of the longer-term issues.

While the changes will have tangible effects on numerous public companies—such as the lost benefit from being included in certain broad-based market indices—it is unlikely these actions will have a uniform impact on every multi-class company. Ultimately, companies interested in implementing or altering a multi-class share structure should speak with their advisors and engage with current and potential investors to solicit feedback on whether and on what terms for such a structure would be acceptable. Companies should also remember that a well-articulated rationale in public disclosures not only enhances transparency regarding a proposed multi-class structure, but can be an effective tool in securing shareholder support for the structure.

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