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Voting Rights Gone in a Snap – Unequal Voting Rights Back in the Spotlight

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The recent initial public offering of Snap Inc.'s Class A common shares marked the first-ever IPO-related listing of common stock without voting rights on a U.S. stock exchange. While other companies like Google, Facebook and Under Armour have gone public with dual-class equity structures, the public float in these initial offerings typically had voting rights – commonly one vote per share – with founders, senior management and/or pre-IPO investors receiving equity with as many as ten votes per share.[1]

Snap went public with a three-class capital structure: Class A (listed on the New York Stock Exchange, or NYSE, non-voting), Class B (unlisted, held by management and early investors, one vote per share) and Class C (unlisted, held by the two co-founders, 10 votes per share, representing 88.6 % of Snap's total voting power). However, unlike Google, Facebook, Under Armour and other companies that have sunset provisions that would result in a combination of their high-vote and low-vote classes of stock upon the occurrence of certain events, Snap does not have a sunset provision embedded in its capital structure.[2] Nor does Snap otherwise offer investors the opportunity to re-examine the multi-class structure after a set time period, which is another way in which companies with unequal voting rights address the impact of their founders' or senior management's significant equity ownership. To the contrary, as explained in the risk factors section of Snap's IPO prospectus, its two co-founders "have control over all stockholder decisions" and have entered into a proxy agreement pursuant to which "on the death or incapacity of either [of the two founders] the other could individually control nearly all of the voting power of [its] outstanding capital stock."[3]

Some observers are praising the IPO-related combination of listed non-voting public shares and unlisted high-vote founder/top management shares as the innovative, "next big thing" in capital formation. But Snap's IPO construct has also reinvigorated investor calls for reform of stock exchange listing standards that permit IPO-related listings of such shares, amid concerns that other, similarly situated companies might follow suit to the detriment of investors.

Snap IPO Prompts SEC Investor Advisory Committee Panel Discussion

These concerns prompted the SEC's Investor Advisory Committee (IAC), which Congress established in 2010 to advise the SEC on issues relating to investor protection and the integrity of the U.S. securities markets, to convene a public meeting on March 9, 2017.[4] During this meeting, which also addressed investor-related research initiatives, a lively panel discussion highlighted a wide spectrum of viewpoints among panelists and IAC members on the broader governance implications of multi-class capital structures, with a particular emphasis on the issuance of non-voting common stock.

SEC Commissioner Kara Stein, who was present for the panel discussion on multi-class capital structures, offered some words of caution in opening remarks to the meeting: "Voting rights have been a foundational component of sound corporate governance. Unequal voting rights present complex and new issues that need to be understood and addressed. We also must be mindful of the precedent being created. . . . The current structure is premised on taking an investor's capital, while giving that investor the rights that help to hold a company's management accountable in the use of that capital."[5]

At the outset of the panel discussion of multi-class shareholder voting rights, IAC Chair Kurt Schacht, Managing Director of the CFA Institute, expressed the IAC's interest in monitoring whether Snap's capital structure will be replicated by other IPO issuers, then went on to outline the core question for debate by panel members: are multi-class capital structures with non-voting stock a "slap in the face of corporate governance," or are such structures instead harbingers of future "market efficiency?" Panelists David Berger, a partner at Wilson Sonsini Goodrich & Rosati; Ken Bertsch, the Executive Director of the Council of Institutional Investors (CII); Jill Fisch, a professor at the University of Pennsylvania Law School; and Rakhi Kumar, Head of ESG Investments and Asset Stewardship at State Street Global Advisors, presented their respective views on the pros and cons of unequal share voting rights, with a view to assisting the IAC in formulating recommendations to the SEC on whether and how (if at all) the agency should act in this area.

An advocate of multi-class capital structures for public companies, Mr. Berger suggested that the use of non-voting shares could offer a viable solution to the current "corporate governance misalignment" caused by what he characterized as excessive institutional shareholder demands for short-term gains at the expense of longer-term corporate profitability.[6] While recognizing that "no-vote" capital structures ultimately might fail, he cautioned against the hasty imposition of a blanket prohibition (whether through the stock exchange listing standards or otherwise). Mr. Berger also predicted that IPOs of non-voting shares would represent a minority approach to correcting the perceived governance misalignment, stating that other, less restrictive innovations, such as tenure-based voting, were more likely to develop.

Speaking on behalf of institutional investors, Mr. Bertsch and Ms. Kumar maintained that non-voting public equity subverts the "one share, one vote" principle that enables unaffiliated shareholders to hold boards of directors accountable through the corporate electoral process, which they believe is fundamental to safeguarding minority shareholder rights.[7] It is worth noting that CII and other members of the institutional investor community are encouraging the U.S. stock exchanges to tighten their listing standards to foreclose IPO listings of non-voting stock, or, in the absence of such action, for the SEC to revisit existing market rules governing the ability of publicly listed issuers to offer shares with no votes. CII also sent a letter to the Singapore Stock Exchange (SGX) urging it to preserve its existing "one share, one vote" standard for listed companies as SGX seeks public comment on a proposal to permit listed companies to have certain share classes with higher voting rights than others. Further, CII and institutional investors are approaching index fund providers in the United States and the United Kingdom to explore exclusion of non-voting common shares from major market indices.

Professor Fisch presented an academic perspective on the relative costs and benefits of dual class and non-voting shares, placing their evolution in historical context. Pointing out that both the markets and state corporate laws have yet to address this phenomenon, she noted the uncertainty regarding the SEC's authority to regulate shareholder voting rights, which traditionally have been the exclusive province of state corporate law. Professor Fisch warned that the SEC must tread a careful line as it assesses the appropriate balance in this area of at least two of its three key statutory mandates – protecting investors and promoting capital formation (with the third being the maintenance of fair, orderly and efficient securities markets).

The range of views expressed during the March 9 panel discussion has given the IAC much to ponder as it considers possible recommendations to the SEC. Some of the comments and questions posed by IAC members during this discussion offer some insight into the thinking of individual members. For example, Elisse Walter, former SEC Chair and current IAC member, expressed skepticism at the suggestion that the SEC should rely on the U.S. stock exchanges to ensure the protection of investors in light of the multi-class capital structures now permitted. IAC member and Harvard Law School Professor John Coates observed that the Snap IPO should inspire institutional investors to exert market power by promoting the development of alternative indices that distinguish between single-class and multi-class stocks. He

noted that such "self-help" measures could prompt the capital market participants to impose a price discount as the trade-off for the increased investment risks inherent in low-voting and non-voting stock.

Finally, IAC member Anne Simpson, the Investment Director, Sustainability at CalPERS, characterized non-voting public equity as "junk equity," and rejected as absurd the notion that it represents a market innovation that could operate to enhance corporate performance for the benefit of minority common stockholders. Ms. Simpson emphasized that the SEC's disclosure regime relies on fully informed investors to hold boards and management accountable through the exercise of the shareholder franchise. Without proxy voting rights, in her view, non-affiliated investors have no alternatives but to "sell or sue."

How We Got Here – Might History be Repeated?

In the early twentieth century, multi-class capital structures that included non-voting shares were prevalent in the United States. That changed in 1926, when under public pressure in response to the listing of non-voting common stock by the Dodge Brothers Company, the NYSE promised to give more attention to shareholder voting rights when reviewing listing applications. In 1940, the NYSE adopted a "one-share, one-vote" listing standard that applied to new listings of all common equity — whether effected pursuant to an IPO or otherwise (with some exceptions).

Although the American Stock Exchange (AMEX) and Nasdaq permitted multi-class shares, with AMEX, in particular, attracting listings of prominent family-owned media companies,[8] the NYSE retained its "one-share, one-vote" listing standard until 1984. That year, the NYSE imposed a four-year moratorium on this standard, which culminated in the exchange's submission of a proposal to the SEC that would have relaxed existing restrictions on equity listings by companies with multi-class share structures. During the moratorium, 46 NYSE-listed companies either issued voting stock with limited rights or amended their charters to permit the issuance of multiple classes of common stock having different voting rights.

The SEC ultimately rejected the NYSE's proposal and instead promulgated Rule 19c-4 in 1988, which barred national securities exchanges from listing the stock of any issuer that took any action "with the effect of nullifying, restricting or disparately reducing the per share voting rights of existing common stockholders."[9] Almost immediately, new Rule 19c-4 became the subject of intense academic, market and political debate, and its validity was challenged in federal court on the ground that the SEC had exceeded its rulemaking authority under several provisions of the Securities Exchange Act of 1934. In 1990, the U.S. Court of Appeals for the D.C. Circuit struck down the rule as beyond the SEC's delegated authority in its *Business Roundtable* decision. Specifically, the Court of Appeals found that "the Exchange Act [could not] be [understood] to include regulation of an issue that is so far beyond matters of disclosure (such as are regulated under Sec. 14 of the Act), and of the management and practices of self-regulatory organizations, and that is concededly a part of corporate governance traditionally left to states."[10]

In the aftermath of the *Business Roundtable* decision, both the NYSE and Nasdaq decided to adopt their own policies on shareholder voting rights. These policies generally granted companies wide latitude to structure disparate voting rights for multiple classes of common stock at the time of initial listing pursuant to an IPO but, much like former Rule 19c-4, set limitations on subsequent actions that reduced or restricted rights of existing public stockholders.[11]

Beginning with Google, Inc. (now Alphabet, Inc.) in 2004, IPOs with multi-class capital structures have become more commonplace. Many companies, not just in the tech sector, followed suit – including Facebook, Alibaba, Manchester United, LinkedIn, Groupon, Yelp, Zynga, Square, First Data, Zillow, Under Armour and Shake Shack.[12] In each of these offerings, public shareholders were offered low-voting shares that were listed on a U.S. stock exchange, with certain insiders holding unlisted high-voting shares. Either at the time of the IPO, or subsequently, some of these companies adopted "sunset" provisions that limited the lifespan of high-voting shares by setting an expiration date, at which time the multiple share classes would merge into a single class with one vote per share. Other companies have required the holders of low-voting common shares to periodically approve the multi-class structure after the IPO-related listing.

Certain companies have undertaken follow-on issuances of non-voting common stock that have attracted considerable negative publicity and, in some cases, shareholder litigation. For example, Google and Under Armour settled lawsuits in 2013 and 2015, respectively, challenging their non-voting share issuances on the ground that the board of directors

breached its fiduciary duties by authorizing these issuances giving company founders greater control.[13] Litigation involving Facebook is set to go to trial in Delaware Chancery Court later this year, notwithstanding a shareholder vote in 2016 approving the company's proposal to issue a new class of non-voting stock pursuant to a two-for-one dividend to existing shareholders.[14]

Predicting the Post-Snap Future

Only time will tell whether the Snap IPO and accompanying listing of non-voting common stock represents an aberration, or instead is the first in a series of similar capital-raising transactions. Given the agency's experience with former Rule 19c-4 and the current de-regulatory environment, a direct SEC response to investor concerns with respect to non-voting common stock appears unlikely – regardless of what the IAC ultimately recommends. In this connection, SEC Chair nominee Jay Clayton indicated during his recent Senate confirmation hearing that he favored removing unnecessary regulatory costs associated with capital raising in the U.S. securities markets, while declining to express any view on Snap's IPO-related issuance of non-voting stock.[15] Should a similar transaction be launched by another "unicorn" issuer in the foreseeable future, we would expect the SEC to respond much as it did in the context of the Snap IPO – through the Division of Corporation Finance's review and comment on the sufficiency of risk disclosures in the IPO registration statement.

Companies considering the issuance of new non-voting common stock should keep in mind the consequences, in an M&A litigation context, of eliminating the potentially mitigating effect of shareholder approval on the standard of review and burden of proof under state corporate law. Another open question is whether the concept of "materiality" for the purposes of the antifraud provisions of the federal securities laws and/or state corporate law might be affected as applied to disclosure-based shareholder claims by holders of non-voting stock. In light of these and other intriguing questions triggered by the Snap IPO, we recommend monitoring the outcome of the Facebook litigation as well as any significant SEC or market responses to issuances of publicly traded non-voting stock in IPOs or follow-on transactions.

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END NOTES

[1] We note that since their IPOs, Google and Under Armour also have listed non-voting shares that were issued to existing public shareholders in a stock split, while Facebook is attempting to do the same depending upon the outcome of ongoing shareholder litigation. For additional discussion of litigation generated by these actual or proposed transactions, see notes 13 and 14, below, and accompanying text.

[2] Based on our review of each company's publicly available organizational documents. In addition, Under Armour provides for a sunset provision in the terms of its newly issued Class C shares that is triggered by the occurrence of certain events (in addition to liquidation, which is the only event that would cause the combination of the issued classes of Alphabet's shares).

[3] *See* Snap, Inc., Prospectus Filed Pursuant to Rule 424(b)(4), Registration No. 333-215866, filed with the Securities Exchange Commission on March 3, 2017, at p. 19, *available at* https://www.sec.gov/Archives/edgar/data/1564408/000119312517068848/0001193125-17-068848-index.htm.

[4] The video webcast of the SEC's Investor Advisory Committee Meeting on March 9, 2017, is available here: https://www.sec.gov/video/webcast-archive-player.shtml?document_id=030917iac.

[5] *See* Remarks at the SEC's Investor Advisory Committee Meeting, Commissioner Kara M. Stein (Mar. 9, 2017), *available at* https://www.sec.gov/news/public-statement/stein-statement-investor-advisory-committee-meeting-030917.

[6] *See* Multi-Class Stock and the Modern Corporation: A View From the Left (Coast) on Governance Misalignment and the Public Company, David J. Berger (Mar. 9, 2017), available at https://www.sec.gov/spotlight/investor-advisory-committee-2012/berger-remarks-iac-030917.pdf.

[7] *See* Remarks to the SEC Investor Advisory Committee, Ken Bertsch (Mar. 9, 2017), *available at*: https://www.sec.gov/spotlight/investor-advisory-committee-2012/bertsch-remarks-iac-030917.pdf.

[8] NYSE Euronext purchased the American Stock Exchange (AMEX) in 2008, as reported here: Anuj Gangahar, "NYSE Euronext buys rival Amex for $260m," *Financial Times* (Jan. 17, 2008), *available at* https://www.ft.com/content/d8651224-c556-11dc-811a-0000779fd2ac. The AMEX permitted the listing of multi-class share structures.

[9] *See* Exchange Act Release No. 25891 (July 7, 1988), [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH).

[10] *See* The Business Roundtable v. Securities and Exchange Commission, 905 F.2d 406 (D.C. Cir. 1990), *available at* *http://law.justia.com/cases/federal/appellate-courts/F2/905/406/177087/*.

[11] *See* Rule 313.00(A) and (B), NYSE Listing Company Manual, *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?searched=1&selectednode=chp_1_4_13_1&CiRestriction=voting+AND+rights&manual=%2FLCM%2FSections%2Flcm-sections%2F; Rule 5640, Voting Rights, Nasdaq Stock Market Listing Rules, *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_3_8_31&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F.

[12] For a discussion of non-U.S.-companies choosing NYSE or Nasdaq due to the ability to list shares with multi-class structures, see "Shareholder Rights: Out of control," The Economist (Sept. 22, 2014), *available at* http://www.economist.com/news/finance-and-economics/21618889-more-worlds-big-stockmarkets-are-allowing-firms-alibaba-sideline.

[13] Google settled with its shareholders over their claims that Google's founders engineered the stock split in a way that would unfairly benefit the two founders while shortchanging other Google shareholders. *See* Google, Inc., Current Report on Form 8-K (filed Oct. 30, 2013) (reporting that the Delaware Court of Chancery approved the settlement entered into by the company, its board of directors and the plaintiffs in the class action captioned *In Re: Google Inc. Class C Shareholder Litigation*, Civil Action No. 7469-CS). The complex settlement was designed to compensate Class A common shareholders for the difference in value between Class A shares and Class C shares in the first year after the issuance of the Class C shares. Ultimately, the Class C shares had, on average, traded 1.4 percent lower than the Class A shares in their first year of trading and Google paid $522 million to shareholders as a result. Under Armour also settled with its shareholders over their claims that the board of directors breached its fiduciary duties in approving the issuance of non-voting Class C shares through a stock split of current Class A shareholders' shares and amending the company's charter (which had been approved by shareholders). The judicially approved settlement order awarded a $59 million dividend to Class C shareholders, designed to account for losses as a result of the split. *See In re: Under Armour Shareholder Litigation*, Case No. 24-C-15-003240 (Circuit Court, Baltimore County MD).

[14] In complaints filed last year in Delaware Chancery Court*ga*, certain Facebook shareholders alleged that the Facebook board of directors breached its fiduciary duties of loyalty, good faith and candor in approving the issuance of Class C shares that would have the effect of entrenching the CEO and founder, Mark Zuckerberg. *See* In re Facebook, Inc. Class C Reclassification Litig., C.A. No. 12286-VCL (Del. Ch.).

[15] Nominee for SEC Chair Jay Clayton led the team of Sullivan & Cromwell attorneys representing the underwriters in connection with the Alibaba IPO in 2014.