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DUAL-CLASS INDEX EXCLUSION

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ABSTRACT

One of the most contentious and long-standing debates in corporate governance is whether company founders and other insiders should be permitted to use multi-class stock structures with unequal votes to control their companies while seeking capital through a public listing. Stymied by the permissive attitudes of legislatures and regulators, institutional investors opposed to multi-class arrangements recently turned to a new potential source of regulation: benchmark equity index providers. At the behest of institutional investors, the three largest index providers recently changed the eligibility requirements for their benchmark equity indexes to exclude, limit or underweight companies with multi-class stock structures. Investors expected the prospect of exclusion from such indexes to discourage founders and directors from adopting dual-class stock structures in connection with their initial public offerings.

While there is a voluminous financial literature on the effects of index inclusion and exclusion on stock prices, and legal scholars have recently explored the corporate governance implications of the exponential growth of passive index investing, focusing primarily on the incentives of index fund asset managers, neither the financial nor the legal literature have considered the corporate governance role and influence of the parties who write the rules for index investing: the index providers. We begin to fill this gap in the literature by assessing the efficacy of index providers as corporate governance arbiters through the rubric of their dual-class index exclusion decisions.

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We start with the premise that the index exclusion sanction will not discourage dual-class listings unless it is sufficiently costly to outweigh the perceived benefits of founder control through a multi-class stock structure. We expect the index exclusion sanction will not be sufficiently costly for several reasons. First, it is difficult, if not impossible, to implement a sanction through the public capital markets. Second, the index inclusion effect on which the anticipated sanction is premised has effectively disappeared in recent years and may never have been a long-term source of lower capital costs. Third, despite the explosive growth of index investing in recent years, funds following stock indexes still hold a relatively modest percentage of the market capitalization of U.S. equities—around 12% according to BlackRock. Finally, the proliferation of index investing opportunities has weakened the market-moving influence of any one benchmark index.

To test the efficacy of the sanction, we conduct an event study of the S&P announcement that dual-class companies would henceforth be excluded from the S&P 1500 Composite Index and its components—the S&P 500, S&P 400 mid-cap and S&P 600 small-cap indices. Because S&P grandfathered dual-class companies currently in the index, we are able to compare movements in the stock prices of dual-class companies currently in the index with movements in the stock prices of dual-class companies not yet included in the index at the time of announcement. We do not observe any statistically significant abnormal returns in the stock prices of either included or excluded firms as a result of the S&P announcement, suggesting that exclusion is not expected to have a significant adverse cost of capital effect on firms that elect to list with a dual-class stock structure in the future and that the sanction is ineffective.

In the absence of an effective sanction, the exclusion of dual-class shares from benchmark equity indexes will not affect corporate governance choices. It may, however, have material adverse consequences for index investors and the index providers themselves.

I. INTRODUCTION

"THE key governance debate of the modern market – whether companies should be allowed to raise equity capital without giving their shareholders voting rights – was fought and decided, not at the Securities Exchange Commission or in Congress, and not by investors themselves making independent decisions about what governance protections they needed, but by a couple of for-profit index providers."[1]

One of the most contentious and long-standing debates in corporate governance is whether company founders and other insiders should be permitted to use multi-class stock structures with unequal votes to control their companies while seeking capital through a public listing. Institutional investors have unsuccessfully lobbied Congress, state legislatures and the Securities Exchange Commission for decades seeking to prohibit such stock structures. Following competitive pressure from the American Stock Exchange and NASDAQ, the New York Stock Exchange changed its listing rules to permit such structures in 1986.[2] In the increasingly competitive global environment for listings, other stock exchanges have also started permitting multi-class listings.[3]

Stymied by the permissive attitudes of legislatures, regulators and stock exchanges, and alarmed by Snap Inc.'s decision to offer only non-voting shares to public investors in its initial public offering in 2017, institutional investors sought a new corporate governance regulator as a bulwark against multi-class stock in global capital markets: equity index providers. Index providers choose the stocks included in the benchmark equity indexes, such as the S&P 500, which is in turn followed by passive index funds. Their

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1 Matt Levine, *Index Rules and Analyst Fatigue*, BLOOMBERG (Aug. 1, 2017, 9:32 AM), https://www.bloomberg.com/opinion/articles/2017-08-01/index-rules-and-analyst-fatigue.

2 Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19C-4*, 69 WASH. U. L. REV. 565, 577 (1991); Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 688 (1986).

3 The Singapore Stock Exchange and the Hong Kong Stock Exchange are the most recent converts to dual-class acceptance. *See, e.g.*, John Geddie, *Singapore Lowers Bar for Proposed Dual-Class Share Listings*, REUTERS (Mar. 28, 2018, 5:26 AM), https://www.reuters.com/article/us-sgx-listing/singapore-lowers-bar-for-proposed-dual-class-share-listings-idUSKBN1H416Y; Benjamin Robertson, *Hong Kong Adds Dual-Class Shares, Paving Way for Tech Titans*, BLOOMBERG (Apr. 24, 2018, 4:38 AM), https://www.bloomberg.com/news/articles/2018-04-24/hong-kong-approves-dual-class-shares-paving-way-for-tech-titans.

choices are guided by rules they write—eligibility criteria—to determine which stocks should be included. As passive index investing becomes increasingly popular, billions of dollars follow index inclusion decisions, and index providers have increasing influence over global capital flows.

Institutional investors and their advocates petitioned the largest stock index providers, FTSE Russell, MSCI, and S&P Dow Jones Indices to exclude companies with unequal multi-class voting structures from their benchmark equity indexes, hoping to force corporate founders to accept a one-share-one-vote standard of corporate governance when going public. The index providers, who make their living constructing and licensing indexes to institutional investors and the managers of passive index funds, acceded to their requests and, to one extent or another, limited the access of multi-class companies to their benchmark equity indexes.[4]

While there is a voluminous financial literature on the effects of index inclusion and exclusion on stock prices,[5] the legal literature has yet to consider the power of the parties who write the rules for index investing: index providers.[6] A number of legal scholars have explored the implications of the exponential expansion of passive index investing on corporate governance by considering the role and influence of passive index investors and fund managers. Some have expressed concern about the anti-competitive effects of concentration of ownership among a small number of asset managers,[7] while others have assessed the incentives of passive managers to exercise control over corporate managers through engagement and voting.[8] Neither the financial nor the legal literature have considered the corporate governance role or influence of index providers.

We begin to fill this gap in the literature. The effort to influence corporate governance standards through an index exclusion penalty for multi-class stock structures presents an opportunity to test the regulatory influence

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4 *See infra* Section II.C.

5 *See infra* Sections II.B.2, III.A.2.

6 One scholar has suggested in passing that the index exclusion decisions present a powerful deterrent for companies to list with multi-class stock structures. *See* Dorothy S. Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. (forthcoming 2019).

7 Einar Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1271–72 (2016); Fiona Scott Morton & Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, 127 YALE L.J. 2026, 2027 (2018); Eric A. Posner et al., *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669 (2017); Edward B. Rock & Daniel L. Rubinfeld, *Antitrust for Institutional Investors*, 82 ANTITRUST L.J. 221 (2018).

8 *See* Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017); Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493 (2018).

of index providers. We assess their role and influence through this rubric. In Section I, we explain the background to the institutional investors' efforts to get indexers to exclude multi-class stock structures from their benchmark indexes, describing the increase in dual-class stock listings, the investors' opposition to such structures, their attempts to obtain redress through regulators and stock exchanges and the regulators' unwillingness to change the status quo.

In Section II, we explain the business of indexing and index providers and the reasons institutional investors reached out to index providers to provide a solution to investors' dissatisfaction with multi-class share structures, including, most importantly, the hope that index exclusion would penalize companies adopting such a structure by preventing them from benefiting from the index inclusion effect—the market perception that firms added to benchmark equity indexes enjoy a long-term increase in their stock price due to forced buying by index investors. We then cover the three largest indexer's responses to the investors' petitions—prohibition in the case of S&P Dow Jones Indices, a voting rights hurdle from FTSE Russell, and index weighting by voting power from MSCI, Inc.

In Section III, we consider whether the effort to regulate corporate governance structures through index eligibility rules will succeed. We start with the premise that the index exclusion sanction will not work unless it is sufficiently costly to outweigh the perceived benefits of founder control through a multi-class stock structure. We expect the index exclusion sanction will not be sufficiently costly for several reasons. First, it is difficult, if not impossible to implement a sanction through the public capital markets. Second, the index inclusion effect on which it is premised has effectively disappeared in recent years and may never have been a real source of lower capital costs. Third, despite the explosive growth of index investing in recent years, passive funds following stock indexes still hold a relatively modest percentage of the market capitalization of U.S. equities—around 12% of the S&P 500, for example. Finally, the proliferation of index investing opportunities has weakened the market-moving influence of any one benchmark index.

To test the cost of the index exclusion sanction, we conduct an event study of the S&P announcement that dual-class companies would henceforth be excluded from the S&P 1500 Composite Index and its components—the S&P 500, S&P 400 mid-cap and S&P 600 small-cap indices. Because S&P grandfathered dual-class companies currently in the index, we are able to compare movements in the stock prices of dual-class companies currently in the index with movements in the stock prices of dual-class companies not yet included in the index at the time of announcement. We do not observe any statistically significant abnormal returns in the stock prices of either included or excluded firms as a result of the S&P announcement, suggesting that exclusion is not expected to have a significant adverse cost of capital effect on firms that elect to list with a dual-class stock structure in the future and that the sanction is ineffective.

In Section IV, we explore the consequences of an ineffective index exclusion sanction. While an ineffective sanction will not affect corporate governance choices, it may have unintended adverse consequences. We note that indexers are violating indexing theory in their efforts to please their customers, index investors may be adversely affected if the indexers persist, and the index providers themselves are likely to lose influence over time unless they reverse course.

II. BACKGROUND

A. Rise of Dual-Class Listings

A rapidly increasing number of the nation's most dynamic companies have been adopting dual-class stock structures at the time of their initial public offerings in recent years. In dual-class stock structures, one class of common stock has more votes per share than another class of common stock (most often the ratio is 10:1). Dual-class and other multi-class stock structures are sometimes used by company founders and other insiders to retain control of a company when they do not have sufficient capital to own a controlling block of shares on a one-share, one-vote basis.

Opponents of unequal voting rights structures argue that they protect insiders from outside control and accountability, leading to entrenchment and agency issues.[9] Proponents of unequal voting rights structures argue that such protection is by design and critical to allow founders and other insiders to

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9 *See, e.g.*, Letter from Ash Williams, Chair, Council of Institutional Inv'rs, to Elizabeth King, Chief Regulatory Officer, Intercontinental Exch. Inc. (October 24, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NYSE%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf; Lucian Arye Bebchuk, Reinier Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP 295, 298–301 (Randall K. Morck ed., 2000); Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585 (2017).

invest for long term results without being exposed to outside investor pressure to maximize short term profit.[10]

Historically, only a small fraction of public companies in the United States had dual-class stock structures. In recent years, however, in response to the increasing concentration of public stock ownership among institutional investors and the rise of activist investors, an increasing number of company founders, particularly in the technology sector, have chosen to go public with dual-class stock structures.[11] There were more dual-class IPOs in 2017 than in any prior year—approximately 19% of all IPOs utilized a dual-class stock structure.[12] Moreover, following Google's 2004 example, many of the most high-profile IPO companies in the last ten years, including Dropbox, Facebook, Groupon, LinkedIn, Square, TripAdvisor, Yelp, Zillow and Zynga, have utilized the dual-class stock structure to enable their founders to retain control post-IPO.

Importantly for our purposes, companies with dual-class stock structures have also been representing an increasingly large portion of the aggregate market capitalization of the S&P 500. In 2007, only 5% of the S&P 500 was composed of dual-class shares. In 2017, the weight of dual-class shares in the index had risen to 12%.[13]

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10 *See, e.g.*, Bernard S. Sharfman, *A Private Ordering Defense of a Company's Right to Use Dual Class Share Structures in IPOs*, 63 VILL. L. REV. 1 (2018); Bernard S. Sharfman, *The Undesirability of Mandatory Time-Based Sunsets in Dual Class Share Structures: A Reply to Bebchuk and Kastiel*, 93 S. CAL. L. REV. POSTSCRIPT 1 (2019); *see also* David J. Berger, *Dual-Class Stock and Private Ordering: A System That Works*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 24, 2017), https://corpgov.law.harvard.edu/2017/05-24/dual-class-stock-and-private-ordering-a-system-that-works/.

11 *See* David J. Berger, *What's the Problem with Dual Class Stock? A Brief Response to Professors Bebchuk and Kastiel*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (April 17, 2019), https://corpgov.law.harvard.edu/2019/04/17/whats-the-problem-with-dual-class-stock-a-brief-response-to-professors-bebchuk-and-kastiel/; Ran Ben-Tzur, *New Index Rules Likely to Significantly Impact Tech Companies with Multi-Class Capital Structures*, FENWICK & WEST (Aug. 4, 2017), https://www.fenwick.com/publications/Pages/New-Index-Rules-Likely-to-Significantly-Impact-Tech-Companies-with-Multi-Class-Capital-Structures.aspx.

12 COUNCIL OF INSTITUTIONAL INVESTORS, *Dual-Class IPO Snapshot: 2017–2018 Statistics* (2018), https://www.cii.org/dualclass_stock; *See* SEC Investor Advisory Committee, *Recommendation of the Investor Advisory Committee: Dual Class and Other Entrenching Governance Structures in Public Companies* (Mar. 8, 2018), https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-on-dual-class-shares.pdf.

13 STATE STREET GLOBAL ADVISORS, *Shareholder Rights in the Age of Snap* (Apr. 2017) (on file with author).

B. Institutional Investor Opposition to Dual-Class Stock

1. The One-Share-One-Vote Ideology

Institutional investors generally take the view that all shares should have equal voting rights, adhering to the mantra one-share-one-vote. As a result, they are strongly opposed to multi-class share structures that leave control in the hands of founders and other insiders, claiming they are an inferior form of corporate governance. Following the Snap Inc. initial public offering in 2017, a spokesperson for Vanguard noted that, "We are increasingly troubled by the rise of nonvoting and low-voting shares. These structures contradict our fundamental belief that shareholders' economic interest and voting rights should be aligned."[14] BlackRock, Fidelity, State Street and T. Rowe Price have also stated publicly on numerous occasions that all companies should have a one-share-one-vote capital structure.[15] The Council of Institutional Investors (CII), a nonprofit, nonpartisan association of public, corporate and union employee benefit funds and other employee benefit plans, whose foundations and endowments have a combined assets under management exceeding $3 trillion, has promoted the one-share-one-vote approach to governance for its entire 32-year history.[16] The insistence on one-share-one-vote governance by investors and their advocates has existed for more than a hundred years, and was the formal or informal policy for listings on the New York Stock Exchange from 1926 to the mid-1980s.[17] This underlying ideology informed the institutional investors' appeal to index providers and is reflected in the index exclusion policies.

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14 Richard Teitelbaum, *Index Firms Take Issue with Nonvoting Rights*, WALL ST. J. (Apr. 9, 2017, 8:00 AM), https://www.wsj.com/articles/index-firms-take-issue-with-nonvoting-rights-1491739227.

15 Letter from Barbara Novick, Vice Chairman, BlackRock Inc., to Baer Pettit, President, MSCI, Inc. (April 19, 2018), https://www.blackrock.com/corporate/literature/publication/open-letter-treatment-of-unequal-voting-structures-msci-equity-indexes-041918.pdf; Ross Kerber, *FTSE Russell Turns to Investors on Snap Voting Rights Quandary*, REUTERS (Mar. 8, 2017, 1:38 PM), https://www.reuters.com/article/us-snap-index/ftse-russell-turns-to-investors-on-snap-voting-rights-quandary-idUSKBN16F2FF; Lindsay Frost, *Snap's Multi-Class Structure Sparks Questions*, AGENDA (March 20, 2017).

16 E-mail from Ken Bertsch, Exec. Dir., Council of Institutional Inv'rs, to S&P Dow Jones Indices Inc. (Apr. 27, 2017) [hereinafter E-mail from Bertsch to S&P], http://www.cii.org/files/20170426%20CII%20comment%20S&P%20no%20vote%20share(1).pdf.

17 Bainbridge, *supra* note 2, at 569.

2. The Lack of Consensus on Dual-Class Structures

The 2017–2018 Global Policy Survey by Institutional Shareholder Services highlighted a wide sentiment gap between investors and corporate issuers over the question of dual-class stock listings. The survey incorporated responses from 571 organizations, of which over 400 were based in the United States; 129 of these organizations were institutional investors (asset managers or asset owners) and their advisors, and the remainder were corporations, directors and their advisors.[18] Among investors and their advisors, 43% believed dual-class listings were never appropriate, another 43% stated that dual-class structures would be appropriate if they included a sunset, and 5% responded that dual-class listings are always appropriate.[19] Among corporate issuers, their directors, and their advisors, 50% took the view that any capital structure should be acceptable, 27% believed that dual-class should be acceptable if they include a sunset, and 11% concluded that dual-class listings are never appropriate.[20]

In connection with considering the exclusion of companies with dual-class stock structures from their benchmark equity indexes, the major stock index providers polled their investor clients, and two of them published the results of their consultations. More than two-thirds of the investors responding to FTSE Russell's consultations wanted to exclude dual-class companies with less than a fixed percentage of their votes in public hands, with European investors voting more heavily for higher percentages of public ownership than American investors—consistent with the London Stock Exchange's requirement that votes held by public shareholders must constitute at least 25%.[21]

A majority of respondents to MSCI's consultation on excluding non-voting shares from its benchmark equity indexes supported the proposal. MSCI noted that international institutional investors, in particular, view the

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18 ISS, 2017–2018 ISS GLOBAL POLICY SURVEY: SUMMARY OF RESULTS 2 (2017), https://www.issgovernance.com/file/policy/2017-2018-iss-policy-survey-results-report.pdf.

19 *Id.* at 3.

20 *Id.*

21 Index Announcement, FTSE Russell, FTSE Russell Voting Rights Consultation – Next Steps 2, 4 (July 2017) [hereinafter Voting Rights Consultation - Next Steps], http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf; Index Announcement, FTSE Russell, FTSE Russell Voting Rights Consultation Results 2–3 (July 2017) [hereinafter Voting Rights Consultation Results], http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Results.pdf.

one-share-one-vote principle as a fundamental characteristic for investability and "not just a specific governance consideration."[22]

3. The Prisoner's Dilemma

One might assume that if investors do not like a particular corporate governance structure they can just choose not to invest. There are two problems with this assumption. The first is that investors following or benchmarking off an index generally have to buy the stocks in the index whether they like them or not.[23] The second problem is fear of missing out—if other investors buy a dual-class stock that increases in value and you don't because you don't like the governance structure, your comparative performance will suffer. Some might even say you will look dumb.[24]

Josh Korff, a partner at Kirkland & Ellis, has noted that "[t]he very nature of hot IPOs like Snap and Blue Apron allows issuing companies to effectively do what they please, despite rising levels of shareholder objection."[25] Investors do not want to miss out on the IPO, and a herd mentality develops: "This is something that investors hate," explained Korff, "but Snap can get away with it because of the fear of missing out. Everyone is going to invest in Snap's IPO, whether you like their no voting rights policy or not."[26] Korff suggested that there may exist a tipping point, where investors would object to such share provision if a few of the big investors decline to invest—but, of course, that has not happened.[27]

Investors are stuck in a classic prisoner's dilemma. All investors would be better off, under the one-share-one-vote rule, if they all agreed not to invest in companies with multi-class share structures. However, the incentives to defect are too high—if some investors invest in successful multi-class companies while the majority of the market abstains, the defecting investors

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22 Consultation, MSCI, Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes 4 (Jan. 2018) [hereinafter MSCI Consultation], https://www.msci.com/documents/1296102/8328554/Consultation_Voting+Rights.pdf/15d99336-9346-4e42-9cd3-a4a03ecff339.

23 *See* discussion *infra* Section II.B.1.a.

24 Matt Levine, *ISS Tells Investors How They Want to Vote*, BLOOMBERG (Jan. 30, 2018, 10:05 AM), https://www.bloomberg.com/view/articles/2018-01-30/iss-tells-investors-how-they-want-to-vote.

25 John Crabb, *Blue Apron's No-Vote Shares IPO Concerns Investors*, INT'L FIN. L. REV. (June 28, 2017), http://www.iflr.com/Article/3728513/Blue-Aprons-no-vote-shares-IPO-concerns-investors.html.

26 *Id.*

27 *Id.*

will outperform their peers and burnish their reputations at the others' expense. Since asset managers' incomes are typically directly proportional to assets under management, and assets follow the returns on prior investments, the incentive to shine at others' expense is considerable.

4. *Investors Call for Regulation*

Since, unlike New York's diamond merchants, public market investors are not able to police themselves, they have turned to regulators for help.[28] Concerned about the increase in unequal voting structures, asset managers and institutional investors started actively opposing dual-class listings following Facebook's IPO in 2012.

The Council of Institutional Investors petitioned Nasdaq, the NYSE and the SEC to prohibit such structures and institute a one-share-one-vote policy for public companies. Leading public pension funds, such as CalPERS and CalSTRS, asset managers, such as Fidelity, State Street, T. Rowe Price and Vanguard, and proxy advisory services, such as Institutional Shareholder Services, have stated their opposition to dual-class structures in their proxy voting guidelines, threatening to vote against the directors of companies that have such structures.[29] In January 2017, the Investor Stewardship Group, a new organization of influential institutional investors and asset managers holding an aggregate of $17 trillion in assets under management, announced its Corporate Governance Principles, which state that "[s]hareholders should be entitled to voting rights in proportion to their economic interest," newly public companies should adopt one-share-one-vote structures, and directors of existing dual-class companies should phase out their controlling structures.[30]

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28 *See* Lisa Bernstein, *Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 115 (1992); Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328, 2351 (2004). *But see* Barak D. Richman, *An Autopsy of Cooperation: Diamond Dealers and the Limits of Trust-Based Exchange*, 9 J. LEGAL ANALYSIS 247 (2017) (discussing the breakdown of the self-policing nature of the diamond industry).

29 *See supra*, note 15; *see also 2018 Proxy Season Review*, SULLIVAN & CROMWELL LLP (July 12, 2018), https://www.sullcrom.com/files/upload/SC-Publication-2018-Proxy-Season-Review.pdf.

30 *Leading Investors Launch Historic Initiative Focused on U.S. Institutional Investor Stewardship and Corporate Governance*, BUS. WIRE (Jan. 31, 2017, 11:26 AM), https://www.businesswire.com/news/home/20170131005949/en/Leading-Investors-Launch-Historic-Initiative-Focused-U.S; *Corporate Governance Principles for US Listed Companies*, INV'R. STEWARDSHIP GRP., https://isgframework.org/corporate-governance-principles/.

5. Regulators Demur

Neither the SEC nor the national stock exchanges have indicated any interest in taking up further regulation of dual-class stock structures, although the two Democrats on the Commission have made speeches in the last year criticizing aspects of dual-class stock structures.[31]

a. The SEC

At a meeting of the SEC's Investor Advisory Committee in March 2018, SEC Chairman Jay Clayton stated that the regulation of dual-class stock structures was not on his list of near-term priorities for SEC rulemaking, asking for more analysis of the topic that considers related issues, including concerns about short-termism and about the attractiveness of U.S. public capital markets compared to foreign public markets and global private markets.[32] Chairman Clayton reiterated his position a few days later at CII's annual spring conference, reiterating that regulating dual-class stock structures is not at the top of the SEC's priority list and that governance by index "doesn't sit really well" with him.[33] There are, in any event, significant questions regarding the SEC's discretion to regulate corporate voting structures following the D.C. Circuit's 1990 *Business Roundtable* decision striking down the SEC's Rule 19c-4, which required national stock exchanges to establish listing rules limiting the use of multi-class stock structures.[34] The court concluded that Section 19(c) of the Securities Exchange Act of 1934, which gave the SEC the authority to impose rules on national stock

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31 Speech, Kara M. Stein, Commissioner, SEC, Remarks at Stanford University on Mutualism: Reimagining the Role of Shareholders in Modern Corporate Governance (Feb. 13, 2018), https://www.sec.gov/news/speech/speech-stein-021318; Speech, Robert J. Jackson, Jr., Commissioner, SEC, Remarks at University of California, Berkeley on Perpetual Dual Class Stock: The Case Against Corporate Royalty (Feb. 15, 2018), https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty.

32 Public Statement, Jay Clayton, Chairman, SEC, Remarks to the SEC Investor Advisory Committee (Mar. 8, 2018), https://www.sec.gov/news/public-statement/statement-clayton-2018-3-8.

33 Andrea Vittorio, *FTSE Russell to Revisit Voting Power One Year After Snap IPO*, BLOOMBERG LAW (Mar. 13, 2018), https://www.bna.com/ftse-russell-revisit-n57982089820/.

34 Business Roundtable v. SEC, 905 F.2d 406, 412–13 (D.C. Cir. 1990) (holding that the SEC exceeded its statutory authority in promulgating a rule barring national security exchanges and associations from listing stock of corporations which nullify, restrict or disparately reduce per share voting rights of common shareholders); Bainbridge, *supra* note 2, at 566–67.

exchanges, did not confer authority on the SEC to unilaterally impose a voting rights listing standard on the exchanges, and that the SEC's action to do so impinged on the tradition of state regulation of corporate law.[35] Any SEC effort to regulate multi-class stock structures would have to overcome this established precedent.

b. The Stock Exchanges

Nasdaq has explicitly rejected calls for stricter rules against listing of multi-class stock structures, noting the importance of the structure in encouraging innovators to access public capital markets:

> One of America's greatest strengths is that we are a magnet for entrepreneurship and innovation. Central to cultivating this strength is establishing multiple paths entrepreneurs can take to public markets. Each publicly-traded company should have flexibility to determine a class structure that is most appropriate and beneficial for them, so long as this structure is transparent and disclosed up front so that investors have complete visibility into the company. Dual-class structures allow investors to invest side-by-side with innovators and high-growth companies, enjoying the financial benefits of these companies' success.[36]

The NYSE has not responded to calls for listing rules prohibiting the use of multi-class capital structures. The NYSE abandoned its 1940 policy prohibiting such structures in the face of a listed company revolt in 1986, citing competition from other exchanges. In recent years, it has benefited from adopting a more lenient rule than other international exchanges, wresting Alibaba away from the Hong Kong Stock Exchange, for example. Thus, it is unlikely that the NYSE will change its policy any time soon.

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35 *Business Roundtable*, 905 F.2d at 412–13.

36 NASDAQ, *The Promise of Market Reform: Reigniting America's Economic Engine* 17 (2018), https://business.nasdaq.com/media/Nasdaq_Blueprint_to_Revitalize_Capital_Markets_April_2018_tcm5044-43175.pdf.

III. REGULATION BY INDEXATION

Having failed to persuade capital markets regulators and corporate boards that unequal voting structures should be abolished and alarmed by the prospect of complete disenfranchisement through non-voting stock structures, institutional investors called upon a group that could be expected to be more responsive to their concerns about dual-class stock structures: index providers. As Matt Levine summarized,

> [Investors did] not just individually refuse to buy Snap shares. What they did instead was call up the index providers and ask them to help out. And the index providers did, changing their methodologies to exclude some dual-class shares from some indexes. Because index providers are not disinterested guardians of some pure abstract notion of what the index should be. They are just companies with a business, and the business is licensing indexes to fund managers, and the indexes are the products, and the fund managers are the customers, and the index providers want the product to be fit for the customers' purposes. And when the customers all say "this index doesn't work for our purposes," the index changes, because the abstract purity of the index doesn't matter at all to anyone, but its usefulness to investment managers does.[37]

A. Indexing and Indexers

The basic idea behind benchmark equity index funds is to make it possible for passive investors to obtain returns that reflect market return—holding all of the securities in the market, or a representative selection of such securities, in the same proportions as those securities exist in the market.[38] Index funds seek to mirror, and some active funds seek to benchmark their results against, the results of a market index either through full replication—buying all the securities included as constituents of the index—or through

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37 Levine, *supra* note 24. The institutional investors calling upon the indexers to exclude multi-class shares so they cannot invest in them seems akin to Odysseus calling upon his crew to tie him to the mast so he cannot be seduced by the sirens to jump into the sea. The indexers are the rope and the mast.

38 William Sharpe, *The Arithmetic of Active Management*, 47 FIN. ANALYST J. 7, 7 (1991).

optimization—acquiring only a representative sample of securities in an index based on correlations, exposure and risk.[39]

Index providers create indexes that passive investors can follow to get exposure to particular investment risks and returns. The providers make money by licensing the indexes to institutional investors and asset managers—informing them of the constituents of the index (specific stocks or bonds) so that investors can purchase such constituents and receive investment returns equivalent to the index return. In establishing the eligibility terms for inclusion of stocks in their indexes, index providers consult with their clients—institutional investors and asset managers managing index funds.

Index-provider officers note that clients voiced concerns over the use of dual-stock structures, and it was clear that investors want to exclude companies with very low voting rights from benchmark indexes.[40] As Joti Rana of FTSE Russell stated: "If our client doesn't want non-voting shares in the index, that's something we need to seriously take on board" for consideration.[41]

B. Calling on the Indexers

1. Institutional Investors Seek Indexer Solution

On March 2, 2017, Snap, Inc. upped the ante in the dual-class debate by going public with a multi-class stock structure listing *non*-voting shares—instead of having unequal voting rights, public investors would have *no* voting rights.[42] Snap's decision to go public with non-voting shares generated a fire

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39 GÖKHAN KULA ET AL., BEYOND SMART BETA: INDEX INVESTMENT STRATEGIES FOR ACTIVE PORTFOLIO MANAGEMENT 19, 45, 128 (1997); ANANTH N. MADHAVAN, EXCHANGE-TRADED FUNDS AND THE NEW DYNAMICS OF INVESTING 63 (2017); DSC Quantitative Group LLC, *Index Replication: Principles and Applications*, THOMSON REUTERS (Aug. 12, 2015), http://lipperalpha.financial.thomsonreuters.com/2015/08/index-replication-principles-and-applications/; Edmund Shing, *ETF Investing – The Three Methods of Index Replication*, HARRIMAN INTELLIGENCE (Mar. 24, 2014), http://intel.harriman-house.com/investing/etf-investing-indices-copied/.

40 Benjamin Robinson et al., *Index Chiefs Say Dual-Class Shares Are an 'Issue' for Investors*, BLOOMBERG (July 13, 2017, 10:08 PM), https://www.bloomberg.com/news/articles/2017-07-14/dual-class-shares-a-global-problem-for-msci-chief-fernandez.

41 Kerber, *supra*, note 15.

42 Snap's approach was arguably the next logical step in the effort by founders to obtain insulation from activist investors when going public. Activists can still target dual-class management. *See* Ronald Orol, *Activist Investors Target Snapchat Parent Snap Over Non-Voting IPO Shares*, THESTREET (Feb. 8, 2017, 8:51 PM) [hereinafter Orol, *Activist Investors*],

storm of criticism and protest from institutional investors and the financial press.[43]

In response to the Snap listing, institutional investors called for non-voting shares to be excluded from major equity indexes.[44] "They're tapping public markets but giving public shareholders no say," said Amy Borrus, deputy director of the Council of Institutional Investors (CII).[45] "What we would like to see, at the least," she explained, "is for the indexes to exclude new no-vote companies."[46] CII subsequently wrote letters to each of the FTSE Russell and MSCI, insisting that the Snap offering was an unacceptable departure from corporate governance orthodoxy and that the index providers should exclude non-voting shares from their benchmark equity indexes to prevent the spread of such governance structures.[47]

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https://www.thestreet.com/story/13993165/1/insurgents-rail-against-snap-over-non-voting-ipo-shares.html ("Activist hedge funds can still target dual-class companies with unequal voting structures by nominating director candidates in the hope that a large vote of the noninsider shareholders will back their nominees, sending an embarrassing message to the company that change is needed. However, companies with nonvoting shares will be impervious to activists."). Jeff Ubben of ValueAct Capital has acknowledged this, saying "[i]t is logical that when you do go public, which is required to gain the capital you need for your business, that you would seek non-voting shares to protect yourself against the wise guys . . . . It is related to hedge fund activism and how someone is going to show up on your doorstep." Ronald Orol, *Insurgents Add Their Voices to Criticism of Snap IPO*, THESTREET (Feb. 24, 2017, 9:09 AM), https://www.thestreet.com/story/14015299/1/insurgents-add-their-voices-to-criticism-of-snap-ipo.html. Ubben noted, however, that a class of voting shares should be introduced after seven to ten years, because perpetual non-voting shares "takes the vitality out of the public markets." *Id.*

43 *E.g.*, Steven Foley & Hannah Kuchler, *Snap's Offer of Voteless Shares Angers Big Investors*, FIN. TIMES (Feb. 3, 2017), https://www.ft.com/content/17db65c0-e997-11e6-893c-082c54a7f539; Jack Newsham, *Investors Blast Snap's Plan to Offer Non-Voting Shares*, LAW360 (Feb. 7, 2017, 3:48 PM).

44 *E.g.*, Ronald Orol, *Activists Urge Exchanges to End No-Vote IPOs Like Snap*, THESTREET (Feb. 28, 2017, 3:07 PM) [hereinafter Orol, *Activists Urge Exchanges*], https://www.thestreet.com/story/14019899/1/activists-urge-exchanges-to-end-no-vote-ipos-like-snap.html) ("[I]nstitutional investors have a multi-fold retaliation strategy that includes putting pressure on exchanges to change their listing rules prohibiting companies from listing with non-voting shares. . . . [T]hey are also nudging indexes that they base their investments on, such as the S&P 500 and the Russell 3000, to set up a new index they can follow that only lists corporations with voting share structures.").

45 Ross Kerber, *Investor Group Seeks to Bar Snap from Indexes over Voting Rights,* REUTERS (Mar. 6, 2017, 2:27 PM), https://www.reuters.com/article/us-snap-ipo-indexes-idUSKBN16D2D6.

46 *Id.*

47 E-mail from Kenneth A. Bertsch, Exec. Dir., Council of Institutional Inv'rs, to MSCI Equity Index Committee (Mar. 29, 2017) [hereinafter E-mail from Bertsch to MSCI], https://www.cii.org/files/issues_and_advocacy/correspondence/2017/03_29_17_MSCI_letter_request_for_consultation.pdf; E-mail from Kenneth A. Bertsch, Exec. Dir.,

The International Corporate Governance Network (ICGN), representing institutional investors in 45 countries with US$26 trillion in assets under management, adopted, "[a] strong stance against dual class share structures of any sort."[48] ICGN contends that the best way to address governance risks in indices is to eliminate constituents with differential ownership and control structures and set reasonable free float requirements, to ensure minority shareholders have both rights and opportunity to improve corporate governance of listed issuers if and when problems arise.[49] The institutional investors have two aims: ending forced buying of bad governance and discouraging founders from going public with multi-class stock structures.

a. Ending Forced Buying of Bad Governance

In their letters calling for the exclusion of non-voting or multi-class share structures from benchmark indexes, the Council of Institutional Investors and the passive investors they represent, including large pension funds, generally claim that if a security is in a benchmark index they are following, they must buy it.[50] Technically, indexing theory does not require investors to purchase all the stocks included in an equity index. Investors can replicate the return on an index without holding every security by purchasing a representative group of the constituent stocks—an approach known as optimization.[51] The financial literature suggests, however, that tracking error increases significantly with optimization, so there are significant incentives to replicate rather than optimize.[52] Public funds are often evaluated as much on tracking error as actual results.[53] In any event, while direct passive investors

Council of Institutional Inv'rs, to FTSE Russell Governance Board (Mar. 24, 2017) [hereinafter E-mail from Bertsch to FTSE Russell], https://www.cii.org/files/issues_and_advocacy/correspondence/2017/03_24_17_letter_ftse.pdf.

48 Letter from Kerrie Waring, Exec. Dir., Int'l Corp. Governance Network, to S&P Dow Jones Indices (May 3, 2017) (on file with author).

49 Letter from Kerrie Waring, Exec. Dir., Int'l Corp. Governance Network, to MSCI Equity Index Comm. (Aug. 13, 2017).

50 Orol, *Activist Investors*, *supra* note 42 (quoting Aeisha Mastagni of CalSTRS, which has shares of every company in the Russell 3000, in noting that "[o]nce it is in the index, we will own it, and it is tough for us not to own shares in the index").

51 *See, supra*, note 39 and accompanying text.

52 Marshall E. Blume & Roger M. Edelen, *S&P 500 Indexers, Tracking Errors, and Liquidity*, 30 J. PORTFOLIO MGMT. 37 (2004); STATE STREET GLOBAL ADVISORS, *supra* note 13, at 3 (noting that "actively excluding [dual-class] companies from the S&P 500 Index leads to an annualized expected tracking error of over 0.6%," which is unacceptable for "index investors whose investment objective is to match the index return").

53 Blume & Edelen, *supra* note 52.

have the option to exclude certain index stocks from their portfolio, it is cumbersome.[54]

Passive index investors and active institutional investors benchmarking to indexes often state that they want shares of companies with suboptimal corporate governance structures to be excluded from indexes so that they are not forced to buy them. What they do not discuss, however, is that when multi-class companies excluded from benchmark indexes perform well, the index will underperform. They seem to implicitly assume that exclusion will lead to conversion.

b. Penalizing Companies that Adopt Dual-Class Structures

While it is not often stated in their public statements on the indexing issue, institutional investors clearly hope that excluding dual-class stocks from benchmark equity indexes will discourage entrepreneurs from using such governance structures in their IPOs. In other words, they are hoping to use the index exclusion as a sanctioning mechanism to change corporate choices.[55] Exclusion from benchmark equity indexes would reduce the amount of capital available for investment in excluded companies since index investors would not invest.[56] Since, as explained in the next section, studies have suggested that stock prices increase with inclusion in an index and decrease with exclusion from an index, the cost of capital could theoretically increase with index exclusion. If the cost of capital increase is sufficiently high, directors may conclude that it outweighs the benefits of giving the founder control after the initial public offering. They might even imagine it would be inconsistent with their fiduciary duties to approve such a structure if it imposes a significant long-term drag on the price of the company's common stock as a result of index exclusion.

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54 Orol, *Activists Urge Exchanges*, *supra* note 44 (noting that to optimize, a fund's board would have to instruct external investment managers to continue to invest based on the index, less a particular stock).

55 Rachel Evans, *Thanks to ETFs, S&P 500 Companies Have a New Boss – the S&P 500*, BLOOMBERG (Aug. 2, 2017, 3:05 PM), https://www.bloomberg.com/news/articles/2017-08-02/thanks-to-etfs-s-p-500-companies-have-a-new-boss-the-s-p-500 (quoting Amy Borrus, Deputy Director of the Council of Institutional Investors).

56 *See* Evans, *supra*, note 55; Caitlin Huston, *Snap Backlash, Facebook Capitulation Won't Stop Founder-Friendly Stock Structures*, MARKETWATCH (Sept. 27, 2017, 7:24 AM), https://www.marketwatch.com/story/snap-backlash-facebook-capitulation-wont-stop-multi-class-stock-structures-2017-09-22/print (quoting Borrus).

2. The Index Inclusion Effect

The perception of the market is that inclusion in a benchmark equity index has a materially positive impact on a new constituent's stock price. This can lower the cost of capital for firms included in the index. In seeking to exclude multi-class companies from benchmark equity indexes, institutional investors and index providers presumably believe that index exclusion will act as a sanctioning mechanism to discourage multi-class listings. While the use of indexation as a sanctioning mechanism has not been studied in the U.S., it has been in Germany, where scholars contend that a change to the indexing methodology of a major index, the DAX, to weight index representation by the voting rights of public shareholders, caused some German companies to unify their dual-class capital structures.[57]

a. The S&P 500

Addition to the S&P 500 Index has historically been a significant event for corporations. For instance, "[w]hen Alphabet was added to the S&P 500, it received an immediate 7% bump in its share price."[58] Facebook similarly experienced a 4% increase "upon the news that it would be included in the index."[59] In addition, companies generally want to be included in benchmark indexes because it increases their investor base.[60] Financial journalists perpetuate the conventional wisdom that addition to benchmark equity indexes benefits companies because index portfolio managers and other investors benchmarking against such indexes will have to buy their shares.[61]

The genesis of these expectations around index inclusion was Andrei Shleifer's seminal 1986 study, which determined that between 1976 and 1983

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57 André Betzer et al., *Index Membership vs. Loss of Voting Power: The Unification of Dual-Class Shares*, 49 J. INT'L FIN. MKTS., INSTITUTIONS & MONEY 140, 152 (2017) (concluding that beyond a certain threshold of voting power, the private benefits of control foregone by the large shareholder exceed the shareholder's benefits from unification, in which case unification is not undertaken; in other cases, the danger of dropping out of the index was an important reason for conversion). German companies, of course, have a very different governance structure than U.S. companies, which presumably has an effect on the outcome.

58 Adam Levy, *Why Excluding Snap from the S&P 500 Is a Big Deal*, THE MOTLEY FOOL (Mar. 9, 2017, 8:00 PM), https://www.fool.com/investing/2017/03/09/why-excluding-snap-from-the-sp-500-is-a-big-deal.aspx.

59 *Id.*

60 Richard Teitelbaum, *Nonvoting Rights Questioned*, WALL ST. J., Apr. 10, 2017, at B9 (citing Ben Johnson, director of exchange-traded-fund research at Morningstar).

61 *See, e.g.*, Kerber, *supra* note 15.

stocks added to the S&P 500 experienced abnormal returns of about 3% on the announcement date of the addition—the index inclusion effect.[62] The basic argument is that adding a stock to an index will create increased demand from index-tracking investors, putting upward pressure on the price, despite the fact that fundamentals haven't changed. This is in contrast to the efficient market hypothesis and the Capital Asset Pricing Model, which model stock prices as a function of future expected cash flows discounted by their systematic risk.[63] Later studies found that the S&P 500 inclusion effect increased in the 1990s and early 2000s with the increase in capital invested in S&P 500 index funds rapidly expanded.[64]

b. Other Indices

The index inclusion effect has been widely studied and extended to other indices around the world. Research on other indices in the 1990s and early 2000s show price and volume effects similar to those of additions to the S&P 500, though generally more temporary.[65] As a result, some investors have

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62 Andrei Shleifer, *Do Demand Curves for Stocks Slope Down?*, 41 J. FIN. 579, 582 (1986).

63 Pyemo N. Afego, *Effects of Changes in Stock Index Compositions: A Literature Survey*, 52 INT'L REV. FIN. ANALYSIS 228, 230 (2017) (noting that the systematic nature of observed price and volume effects of index additions is inconsistent with the efficient market hypothesis).

64 Messod D. Beneish & Robert E. Whaley, *An Anatomy of the "S&P Game": The Effects of Changing the Rules*, 51 J. FIN. 1909, 1929 (1996); Honghui Chen et al., *The Price Response to S&P 500 Index Additions and Deletions: Evidence of Asymmetry and a New Explanation*, 59 FIN. ANALYSTS J. 1901, 1908 (2004) (noting 1976–1989 = abnormal returns of 3.17% and 1990–2000 = abnormal returns of 5.45%); William B. Elliott et al., *What Drives the S&P 500 Inclusion Effect? An Analytical Survey*, 35 FIN. MGMT. 31, 32–33 (2006) (noting 1993–2001 = abnormal returns of 5.67%); Anthony W. Lynch & Richard R. Mendenhall, *New Evidence on Stock Price Effects Associated with Changes in the S&P 500 Index*, 70 J. BUS. 351, 352 (1997) (noting 1990–1995 = abnormal returns of 3.80%); Antti Petajisto, *The Index Premium and its Hidden Cost for Index Funds*, 18 J. EMPIRICAL FIN. 271, 275 (2011) (noting 1990–2005 = abnormal returns of 8.8%, while 2001–2005 = abnormal returns of 4.5%).

65 Rajesh Chakrabarti et al., *Price and Volume Effects of Changes in MSCI Indices – Nature and Causes*, 29 J. BANKING & FIN. 1237 (2005) (MSCI Standard Country Indices for twenty-nine countries between 1998 and 2001); Honghui Chen et al., *Index Changes and Losses to Index Fund Investors*, 62 FIN. ANALYSTS J. 31, 33 (2006) (Russell 2000); Khelifa Mazouz & Brahim Saadouni, *The Price Effects of FTSE 100 Index Revision: What Drives the Long-Term Abnormal Return Reversal?*, 17 APPLIED FIN. ECON. 501 (2007) (FTSE 100); Katsuhiko Okada et al., *Addition to the Nikkei 225 Index and Japanese Market Response: Temporary Demand Effect of Index Arbitrageurs*, 14 PAC.-BASIN FIN. J. 395 (2006) (Nikkei 225; finding that run-up in stock price from announcement date to change date is completely canceled out by stock price decline following the exchange date); Petajisto, *supra* note 64 (Russell 2000); Daniel Pullen & Gerard Gannon, *The Index Effect: An Investigation of the Price, Volume and Trading Effects Surrounding Changes to the S&P Australian Indices* (Deakin Univ. Sch. of Acct.,

suggested that they may choose not to invest in a company that will be excluded from an important index if they think such exclusion will impact long-term liquidity and overall valuation as a result of "shrinking [the] buyer universe."[66]

c. Reasons for the Index Inclusion Effect

A number of hypotheses have been offered by scholars to explain the index inclusion effect: price pressure (temporarily downward sloping demand curves), imperfect substitutes (long-term downward sloping demand curves), information (anticipation of improved fundamentals), investor awareness (increased trading following consciousness raising) and liquidity (increased value from improved liquidity).

According to the price pressure hypothesis—which assumes demand curves for equity shares are downward sloping in the short term—prices will revert to their original levels once the short-term buying pressure from index inclusion eases.[67] In other words, short-term imbalances lead to only temporary stock price reactions. Under this hypothesis, the explanation for the price jump on inclusion in an index is simple supply and demand—mechanical indexers must trade a significant percent[68] of the outstanding shares of the added issuer in short order—"and an even higher percentage in

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Econ., & Fin., School Working Paper No. SWP 2007/07, 2007) (ASX 200); Cristina Vespro, *Stock Price and Volume Effects Associated with Compositional Changes in European Stock Indices*, 12 EUR. FIN. MGMT. 103 (2006) (FTSE 100); *see generally* Robin Greenwood, *Short- and Long-Term Demand Curves for Stocks: Theory and Evidence on the Dynamics of Arbitrage*, 75 J. FIN. ECON. 607 (2005) (Nikkei 225).

66 Ronald Orol, *Here Is Another Reason Why Blue Apron Is Facing an Investor Backlash*, THESTREET (July 18, 2017, 4:15 PM) (quoting James Chadwick, Portfolio Manager at Activist Fund Ancora Advisors).

67 Lawrence Harris & Eitan Gurel, *Price and Volume Effects Associated with Changes in the S&P 500 Index: New Evidence for the Existence of Price Pressures*, 41 J. FIN. 815, 828–29 (1986); Lynch & Mendenhall, *supra* note 64, at 372. *But see* Myron S. Scholes, *The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices*, 45 J. BUS. 179, 195 (1972).

68 Harris & Gurel, *supra* note 67, at 817. This percent will be determined by dividing the dollar amount of assets invested in funds indexed to the S&P 500 by the free-float adjusted total market capitalization of the constituent companies included in the index, which as of 12/31/2017 was US$3,411,309 million divided by US$22,900,164.8 million, or 14.8%. *See Annual Survey of Assets as of December 31, 2017,* S&P DOW JONES INDICES (Dec. 31, 2017), https://us.spindices.com/documents/additional-material/spdji-indexed-asset-survey-2017.pdf?force_download=true; *S&P 500 Historical Total Market Cap & Float Adjusted Cap,* SIBLIS RESEARCH (Oct. 11, 2018), http://siblisreasearch.com/data/total-market-cap-sp-500.

terms of the free float (not to mention the significant buying associated with benchmarked active management)."[69]

An alternative theory states that the long-term downward sloping demand curves are caused by imperfect substitutability, causing persistent changes to added or deleted stocks.[70]

The price pressure and imperfect substitute hypotheses arguably contradict the efficient market hypothesis, which assumes the prices of shares reflect only information about their fundamental value—not demand-side factors. Hence, alternative explanations for the index inclusion effect that attempt to marry these two doctrines have emerged. The information hypothesis posits that the inclusion decision is not information neutral—it conveys positive information about the future prospects or investment value of the stock, noting that analysts revise earnings forecasts for newly included stocks.[71] There have been, however, a number of studies refuting the information hypothesis for the index inclusion effect.[72]

A close cousin of the information hypothesis is the investor awareness hypothesis, which argues that inclusion in the index prompts stock analysts to devote more time and resources to produce and analyze information on firms in the benchmark index, raising investor consciousness of the newly added stock and increasing demand for the stock.[73] As a corollary, scholars have

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69 Jeffrey Wurgler, *On the Economic Consequences of Index-Linked Investing*, *in* CHALLENGES TO BUSINESS IN THE TWENTY-FIRST CENTURY 20, 23 (Gerald Rosenfeld et al. eds., 2011).

70 Shleifer, *supra* note 62, at 588–89; *see also* Upinder Dhillon & Herb Johnson, *Changes in the Standard and Poor's 500 List*, 64 J. BUS. 75, 84 (1991).

71 Jie Cai, *What's in the News? Information Content of S&P 500 Additions*, 36 FIN. MGMT. 113, 119 (2007); Diane K. Denis et al., *S&P 500 Index Additions and Earnings Expectations*, 58 J. FIN. 1821, 1823, 1839 (2003); Prem C. Jain, *The Effect on Stock Price of Inclusion or Exclusion from the S&P 500*, 43 FIN. ANALYSTS J. 58, 63 (1987) (discussing that selection identifies firms that are industry leaders and have good management); Petya Platikanova, *Long-Term Price Effect of S&P 500 Addition and Earnings Quality*, 64 FIN. ANALYSTS J. 62, 74 (2008) (discussing that inclusion is associated with subsequent improvements in earnings quality).

72 *See* Eric Belasco et al., *The Impact of Passive Investing on Corporate Valuations*, 38 MANAGERIAL FIN. 1067, 1068 (2012) (asserting that valuations of S&P 500 constituents increased relative to non-constituent stocks based on panel regressions of price-to-earnings ratio on aggregate money flow into S&P 500 index funds); Chakrabarti et al., *supra* note 65 (noting evidence of price-pressure and some liquidity effects but no information effects for additions to MSCI Standard Country Indices for 29 countries between 1998 and 2001); Karel Hrazdil & Thomas Scott, *S&P 500 Index Revisited: Do Index Inclusion Announcements Convey Information About Firms' Future Performance?*, 48 Q.J. FIN. ACCT. 79, 108–09 (2009) (refuting Denis et al., finding no information effect of index inclusion—no positive post-inclusion unexpected earnings among firms in 2000-2004 and higher earnings post-inclusion in 1989-1999 due to earnings manipulation).

73 Chen et al., *supra* note 65, at 1903; Elliott et al., *supra* note 64, at 47 (finding support for investor awareness and price pressure theories of cross-sectional abnormal returns upon

noted that addition effects are greater than deletion effects, so the price changes must be driven by investor awareness of the firms, as deletion would not appear to make investors "unaware" of the stock.[74] Some also argue that increased visibility incentivizes management to deliver superior results.[75]

Another theory consistent with the efficient market hypothesis is the liquidity hypothesis, which holds that addition to an index leads to greater liquidity, followed by a decline in investors' required rate of return, thus promoting higher prices.[76] More recent work has suggested that the increases in the prices of the shares of companies added to the S&P 500 is not about increased demand at all, but rather, is a result of short-term supply shocks when supply is insufficient to meet demand at the time of addition.[77]

d. The Indexplosion and Index Influence

A tectonic shift has taken place in the U.S. investment industry in recent years. According the Investment Company Institute, more than a trillion dollars of equity assets under management have moved from actively managed funds to passive index mutual funds and ETFs in the last ten years. As a result, passive index investors hold more than US$3 trillion in domestic equities, 38% of U.S. equity assets managed by investment funds are managed by index funds, and index funds hold 13% of the shares of the S&P 500 companies and about 12% of all U.S. equities.[78] Based on the rate of transfer from active to passively managed products, Moody's Investors Service predicted in February 2017 that passive funds and ETFs will control more than 50% of all assets under management by investment funds in four to seven years.[79]

If inclusion in a benchmark equity index creates demand and price pressure, then as more money goes into passive index funds, one would

index inclusion and rejecting imperfect substitutes, improved liquidity, improved operating performance explanations for stock price increases).

74 Chen et al., *supra* note 65, at 1917.

75 Denis et al., *supra* note 71, at 1822.

76 Shantaram P. Hegde & John B. McDermott, *The Liquidity Effects of Revisions to the S&P 500 Index: An Empirical Analysis*, 6 J. FIN. MKTS. 413, 418 (2003); Shleifer, *supra* note 62, at 587–88.

77 Jan Schnitzler, *S&P 500 Inclusions and Stock Supply*, 48 J. EMPIRICAL FIN. 341, 341–42 (2018).

78 Calculated by authors based on information available in INV. CO. INST., 2018 INVESTMENT COMPANY FACT BOOK (58th ed. 2018).

79 Justin Fox, *When FTSE Russell, MSCI and S&P Rule the World*, BLOOMBERG (June 23, 2017, 10:00 AM), https://www.bloomberg.com/view/articles/2017-06-23/when-ftse-russell-msci-and-s-p-rule-the-world.

expect the demand and price pressure to increase. As we explain below, however, that does not appear to be what is happening.[80]

C. Indexer Responses

On March 2, 2017, Snap's listing day, MSCI initially announced that Snap met all of the market capitalization requirements for inclusion in its benchmark World and U.S. indexes and would be included in an expedited manner.[81] As the firestorm around Snap's non-voting shares mushroomed, however, MSCI quickly reversed itself. On March 3, 2017, MSCI announced that Snap did not meet all of the requirements for early inclusion and its inclusion would be assessed in MSCI's May 2017 semi-annual review of its benchmark indices.[82] MSCI also sought comment from the investment community on the "continuing eligibility of companies that do not have any listed voting shares for potential inclusion into the MSCI Global Investable Markets Indexes and MSCI US Equity Indexes."[83] That was the first inkling that at least non-voting shares, if not all multi-class companies, would be excluded from benchmark stock indexes going forward. The same day, a Wall Street Journal blog reported that Snap might be excluded from the S&P 500 and other S&P benchmark indexes, citing "a person familiar with the situation."[84] On March 6, 2017, Reuters confirmed that S&P Dow Jones Indices was joining MSCI in considering whether to exclude Snap and any other company selling non-voting shares from their stock benchmarks.[85] Finally, on March 8, 2017, Reuters reported that FTSE Russell would consult investors on whether to include non-voting shares in its benchmark equity indexes shortly after the Snap, Inc. IPO.[86] At this point, however, the

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80 *See infra* Section III.A.2.

81 Index Announcement, MSCI, Eligibility of Companies Without Listed Voting Shares in the MSCI Equity Indexes (Mar. 2, 2017, 9:18 PM), https://app2.msci.com/webapp/index_ann/DocGet?pub_key=83quIOqU4ck%3D&lang=en&format=html.

82 Index Announcement, MSCI, Update on the Treatment of Snap (US) in the MSCI Equity Indexes (Mar. 3, 2017, 9:15 PM), https://app2.msci.com/webapp/index_ann/DocGet?pub_key=LLDu%2BH5J4r0%3D&lang=en&format=html. FTSE Russell did a similar about face. This last-minute change has been blamed on an unusual one-year lock-up of 25% of the shares offered to the public in the IPO, which caused the float-adjusted capitalization to fall below the relevant eligibility thresholds for both indexes.

83 *Id.*

84 Richard Teitelbaum, *Snap Shares May Be Excluded from S&P 500, Other Indexes*, WALL ST. J. (Mar. 3, 2017, 4:15 PM), https://blogs.wsj.com/cfo/2017/03/03/snap-shares-may-be-excluded-from-sp-500-other-indexes/.

85 Kerber, *supra* note 45.

86 Kerber, *supra* note 15 (citing interview with Joti Rana, Americas head of governance and

institutional investors and index providers were still only talking (at least publicly) about excluding non-voting shares.

Subsequently, the three largest index providers, S&P Dow Jones, FTSE Russell and MSCI, announced the commencement of consultations regarding the eligibility of non-voting shares for inclusion in their benchmark equity indexes in April, May, and June of 2017, respectively.[87]

1. S&P Dow Jones Inc.: Prohibition

S&P's consultations were with "members of the investment community—institutional investors and their representatives. In addition to questioning the community about non-voting shares, S&P inquired about whether all shares of a multi-class company with one class of non-voting shares should be ineligible for inclusion.[88] This was the first instance of a member of the investment community making a public statement about the possibility of excluding voting shares of multi-class companies from benchmark indexes.

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policy for FTSE Russell).

87 Index Announcement, FTSE Russell, Eligibility of Securities with Zero Voting Rights (Apr. 3, 2017), http://www.ftse.com/products/index-notices/home/getmethodology/?id=2122858&_ga=2.231445913.723741020.1518917690-1383005857.1518917690 [hereinafter FTSE Zero Voting Eligibility Announcement]; Press Release, S&P Dow Jones Indices, S&P Dow Jones Indices Announces a Consultation on the Eligibility of Non-Voting Share Classes (Apr. 3, 2017), http://us.spindices.com/documents/index-news-and-announcements/20170403-spdji-eligibility-non-voting-share-classes-consultation-reopen.pdf [hereinafter S&P Consultation Press Release]; *see also* Fox, *supra* note 79; Orol, *supra* note 66; Teitelbaum, *supra* note 60.

88 S&P asked for input on the following questions:

1. If the only listed share classes of a company do not have voting rights, should that company be eligible for inclusion in an index?
2. For companies with multiple-class structures where one or more listed share class is non-voting:
   - Should only the non-voting share classes be ineligible?
   - Should all share classes be ineligible?
   - Should all share classes be eligible?
3. If the company does not file information statements regarding shareholder ownership, should the company be ineligible for inclusion?
4. If the methodology were to exclude all share classes so the company is not eligible, should current constituents be "grandfathered" and remain in the index?
5. Should eligibility of non-voting shares differ in benchmark vs investable index families?

S&P Consultation Press Release, *supra* note 87.

Responding to S&P's consultation inquiry, the CFA Institute, which represents investment professionals, took the view that shares with no voting rights should not be included in equity indexes, but for companies with multiple classes of shares, only the non-voting shares should be ineligible, and existing multi-class members of indexes (such as Facebook and Google) should be grandfathered for two years.[89] "Indexed investors would largely be relieved of the requirement to own companies with what would be deemed to be poor governance practices or sub optimal shareowner rights."[90] The CFA Institute suggested that companies with no voting rights could be placed in a new "governance light" index, but not "commingled with issuers who adhere to full governance/shareholder accountability standards."[91]

The CII suggested that S&P exclude companies with multi-class share structures that do not include a time-based sunset of at most five years, extendable only by a vote of a majority of the low-vote shares, stating that "owners [must] have a viable mechanism, outside of litigation, to protect against insider entrenchment and the associated risk to long-term performance."[92] This was the first instance in which a member of the investment community explicitly called for expanding the exclusion from non-voting shares to all shares of all multi-class stock companies. To minimize market disruption from reconstitution of the index, however, CII supported grandfathering of existing index constituents, including high performing multi-class constituents such as Alphabet and Facebook.

On July 31st, 2017, S&P Dow Jones Indices announced that companies with multiple share class structures would henceforth be ineligible for inclusion in its S&P Composite 1500 indexes, including the S&P 500, though existing constituent members would be grandfathered.[93] The S&P Composite 1500 (comprised of the S&P 500, S&P MidCap 400 and S&P SmallCap 600) is designed to reflect the U.S. equity market, and through the market, the U.S. economy. Although the eligibility criteria for inclusion in the S&P 1500

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89 Letter from James Allen, Head, Capital Mkts. Policy & Matt Orsagh, Dir., Capital Mkts. Policy, CFA Inst., to S&P Dow Jones Indices (June 29, 2017), https://www.cfainstitute.org/Comment%20Letters/20170629.pdf.

90 *Id.*

91 *Id.*

92 E-mail from Bertsch to S&P, *supra* note 16.

93 S&P DOW JONES INDICES, *S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rules*, PR NEWSWIRE (July 31, 2017, 6:46 PM), https://www.prnewswire.com/news-releases/sp-dow-jones-indices-announces-decision-on-multi-class-shares-and-voting-rules-300496954.html [hereinafter *Decision on Multi-Class Shares and Voting Rules*].

indices are fairly objective,[94] S&P Dow Jones retains significant discretion since not all companies satisfying the criteria are included in the index. By excluding multi-class stocks from the S&P 500 entirely, S&P took a prohibition approach to regulating the voting issue. This was the most severe sanction, but also, potentially, the most disruptive, and the most likely to lead to problems for the index itself if companies conclude the benefits of dual-class control outweigh the benefits of index membership.

2. FTSE Russell: Voting Rights Hurdle

FTSE Russell also announced a consultation regarding potential changes to the security eligibility and weighting rules of the FTSE Russell indexes on April 3, 2017, later deciding that it would exclude securities issued by companies whose public shareholders hold no voting rights, including Snap.[95]

FTSE Russell issued its consultation paper regarding the exclusion of certain equities from its equity indexes on May 26, 2017,[96] delaying consideration of Snap for inclusion in its Russell 3000 indexes until after the

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94 The eligibility rules for the S&P 500, for example, include:

- Market Capitalization: unadjusted company market capitalization of $5.3 billion or more
- Liquidity: ratio of annual dollar value traded to float-adjusted market cap should be 1.00 or greater
- Domicile: U.S. company
- Public Float: At least 50% of the stock
- Sector Classification: New entrants should contribute to sector balance maintenance, comparing GICS sector index weights and market weights
- Financial viability: the sum of the most recent four consecutive quarters' as-reported earnings should be positive
- Seasoning – IPOs should be seasoned for 6-12 months
- Tracking stocks and companies with multiple share class structures are ineligible

S&P Dow Jones Indices, S&P U.S. Indices Methodology (August 2017), at 5–6.

95 Teitelbaum, *supra* note 14; FTSE Zero Voting Eligibility Announcement, *supra* note 87. FTSE Russell reconstitutes its Russell 3000 equity index annually, objectively choosing the constituents based on market capitalization, nationality and corporate structure characteristics. New IPO companies are considered for inclusion on a quarterly basis. FTSE RUSSELL, *Russell U.S. Equity Indexes Construction and Methodology v3.5* (Aug. 2018), http://www.ftse.com/products/downloads/Russell-US-indexes.pdf.

96 Letter from Petter Johnsen, Chief Inv. Officer Equities, Norges Bank Inv. Mgmt., and Jonas Jølle, Head of Policy Dev., Norges Bank Inv. Mgmt., to FTSE Russell (June 16, 2017) [hereinafter Letter from Johnsen to FTSE Russell], https://www.nbim.no/en/responsibility/standard-setting/consultations/2017/voting-rights-consultation/.

consultation.[97] FTSE Russell consulted index users and other stakeholders on whether FTSE Russell indexes should include a minimum hurdle rate for the percentage of a company's voting rights in the hands of non-restricted shareholders, noting that "[e]nforcing such a minimum threshold for voting rights in the hands of non-restricted shareholders would ensure that minority investors would have some minimum, albeit limited, degree of control over the company."[98] The results of the consultation showed broad support for the introduction of such a hurdle—68% of respondents agreed that a minimum hurdle percentage of voting rights in public hands should be imposed.[99] Opinion was split among respondents as to which securities should be ineligible for inclusion: 31% thought only non-voting shares should be ineligible, 29% felt all securities of companies failing to meet the voting hurdle should be ineligible, and 21% felt the weighting of all securities of companies failing to meet the hurdle should be reduced (rather than declaring securities ineligible).[100] Among respondents seeking a voting rights hurdle, 60% thought existing constituents should be grandfathered.[101]

On June 19th, 2017, the WSJ reported that FTSE Russell was considering excluding some unequal share companies in addition to non-voting share classes—proposing to establish a "minimum threshold for the percentage of voting control attached to company shares in an index."[102] A month later, on July 26, 2017, FTSE Russell announced that companies from developed markets must have at least 5% of their voting rights across all securities held by public investors to be eligible for inclusion in certain FTSE Russell equity indexes, including the popular Russell 1000, 2000, and 3000 indexes.[103] FTSE Russell already imposed a 25% minimum free float requirement on UK incorporated companies for inclusion in its UK Index Series, such as the FTSE 100, so the effects of the new policy will be felt primarily in its US and

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97 Consultation, FTSE Russell, Voting Rights Consultation 2 (May 2017), http://www.ftse.com/products/indices/market-consultations.

98 *Id.*

99 Voting Rights Consultation - Next Steps, *supra* note 21, at 2; Voting Rights Consultation Results, *supra* note 21, at 2.

100 Voting Rights Consultation – Next Steps, *supra* note 21, at 2; Voting Rights Consultation Results, *supra* note 21, at 4.

101 Voting Rights Consultation – Next Steps, *supra* note 21, at 2; Voting Rights Consultation Results, *supra* note 21, at 6.

102 Richard Teitelbaum, *FTSE Russell Index Considers Booting Firms with Lots of Non-Voting Shares*, WALL ST. J. (June 19, 2017, 8:00 AM), https://www.wsj.com/articles/proposal-puts-focus-on-share-class-structure-1497873601.

103 Index Announcement, FTSE Russell, FTSE Russell Voting Rights Consultation – Next Steps (July 26, 2017), https://www.ftse.com/products/index-notices/home/getmethodology/?id=2336290.

global indices.[104] Existing constituents are grandfathered for five years until September 2022.[105] FTSE Russell also reconfirmed that Snap and any other new issuers listing only non-voting shares would be excluded from the Russell 3000.[106]

Thus, FTSE Russell imposed a voting rights hurdle for eligibility to its benchmark equity indexes—a middle path between the S&P prohibition approach and the MSCI weighting approach. Some companies would still be excluded completely from the indexes, unlike the MSCI approach, but not anywhere near as many companies as would be excluded from the S&P indexes. On the other hand, S&P indefinitely grandfathered all existing constituents, while FTSE Russell grandfathered them for only 5 years. To be fair, it was easier for FTSE Russell to limit its grandfathering because all of the high-flying technology companies in the Russell 1000 easily passed over its hurdle without needing to make any capital structure changes, while they all would be caught by the S&P's broader exclusion if not grandfathered indefinitely.

3. MSCI Inc.: Voting Rights Weighting

MSCI has taken more time to complete its consultation and has not issued a conclusion as of this writing. MSCI initially published a consultation paper on June 12, 2017.[107] The initial consultation was limited to only non-voting shares, as MSCI sought feedback on the eligibility of firms with non-voting shares for inclusion in its Global Investable Markets Indexes (GIMI) and US Equity Indexes.[108] MSCI proposed to exclude non-voting shares in its equity indexes in cases where listed shares constitute less than 25% of the total voting rights of the company.[109] MSCI also inquired whether companies with only non-voting shares should be excluded and whether shares with limited voting rights should no longer be considered equity, and therefore excluded, even if the percentage of the issuer's voting rights inherent in other

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104 Voting Rights Consultation – Next Steps, *supra* note 21, at 3; Voting Rights Consultation Results, *supra* note 21, at 3.

105 Voting Rights Consultation – Next Steps, *supra* note 21, at 3.

106 James Rufus Koren & Paresh Dave, *Snap Won't Give Shareholders Voting Rights. For That, It's Being Shunned by a Major Stock Index*, L.A. TIMES (July 28, 2017, 10:40 AM), http://www.latimes.com/business/la-fi-snap-russell-indices-20170727-story.html.

107 Orol, *supra* note 66.

108 Consultation, MSCI, Consultation on the Treatment of Non-Voting Shares in the MSCI Equity Indexes 2 (June 2017), https://www.msci.com/index-consultations.

109 *Id.* at 3.

listed securities is high.[110] MSCI also noted that its broad equity indexes have historically sought to reflect the investable market, while governance criteria were limited to its ESG indexes, asking whether there should be an evolution of broad benchmarks to exclude companies with severe ESG issues such as corporate governance problems, human rights issues, or involvement in controversial weapons production.[111]

In November 2017, following the S&P and FTSE Russell exclusion decisions, which included multi-class shares in addition to non-voting shares, MSCI announced that it would broaden its review of non-voting share index eligibility to include all types of unequal voting structures, focusing on the "theoretical and practical issues of the application of a 'one share, one vote' principle to the investment opportunity set of international institutional investors."[112] MSCI reported that the majority of parties responding to its initial consultation supported the exclusion of non-voting shares, while a minority of participants were strongly opposed to exclusion because it would "result in equity benchmarks that less clearly represent the overall [investment] opportunity set."[113] According to MSCI, "many international institutional investors . . . consider the 'one share, one vote' principle part of their definition of common equity for publicly listed companies, and not a specific governance consideration."[114] While expressing the view that additional and broader public debate about unequal voting structures is necessary before changing its index eligibility methodology, MSCI announced that it would "temporarily treat any securities of companies exhibiting unequal voting structures as ineligible for addition to its MSCI ACWI Investable Market Index (IMI),"[115] MSCI US Investable Market 2500 Index (and sub-indexes thereunder), and certain developing market equity indexes.[116]

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110 *Id.* at 5.

111 *Id.* at 7–8.

112 Press Release, MSCI, MSCI to Broaden the Consultation on the Treatment of Non-Voting Shares in Equity Benchmarks (Nov. 2, 2017), https://www.msci.com/documents/10199/02bacb99-1b53-4c91-b82d-2a1c64dc0825.

113 *Id.*

114 *Id.*

115 *Id.* As of June 30, 2017, there were over $3.2 trillion in assets benchmarked to the MSCI ACWI suite of indexes. MSCI, ACWI (2017), https://www.msci.com/documents/1296102/1362201/MIS-ACWI-brochure-2017.pdf/e23b68bf-5d62-4ac0-8f5b-4ba783789aa5.

116 Press Release, MSCI, MSCI Equity Indexes November 2017 Index Review (Nov. 13, 2017), https://www.msci.com/eqb/pressreleases/archive/MSCI_Nov17_QIRPR.pdf. MSCI explains that companies with unequal voting structures are those that have multiple classes of equity securities where (1) "[s]hareholder voting rights are not proportionate to

In January 2018, MSCI announced that it was reopening its consultation on the treatment of unequal voting structures and released a discussion paper regarding the consultation.[117] In its announcement and discussion paper, MSCI proposes to adjust the weights of stocks with unequal voting rights in its indexes to reflect company level listed voting power in addition to free float.[118] MSCI initially expected to announce the results of its consultation on or before June 21, 2018,[119] but subsequently announced it would postpone its decision to the end of October 2018.[120]

In its discussion paper on the issue, *Should Equity Indexes Include Stocks of Companies with Share Classes Having Unequal Voting Rights?*, MSCI explains that it is reluctant to entirely exclude companies with unequal voting equity classes from its indexes because investors benefit from the growth prospects and diversification potential of those companies and exclusion would violate the basic index principle of offering comprehensive coverage of the listed investable equity market.[121]

In considering the weighting approach, MSCI is seeking to determine how equity indexes can continue to offer comprehensive coverage while recognizing the importance of voting power for certain types of investors, noting that voting rights are an important dimension of investability for passive index investors since, unlike active investors who can sell securities to express dissatisfaction with management, they must retain the shares of

their economic interest," (2) "[a]ny share class has restrictions on voting on agenda items", or (3) "[v]oting rights for any share class are conditional upon certain events" (such as dividend non-payment). Consultation, MSCI, Temporary Treatment of Unequal Voting Structures in the MSCI Equity Indexes 3 (Jan. 2018), https://www.msci.com/documents/1296102/5603800/TemporaryTreatment.

117 Press Release, MSCI, MSCI Reopens the Consultation on the Treatment of Unequal Voting Structures and Releases a Discussion Paper (Jan. 31, 2018) [hereinafter MSCI Press Release on Reopening Consultation], https://www.msci.com/documents/10199/d4d619dd-ec0b-4cb3-8d9a-cef31b5d617b.

118 *Id.*; *see also* MSCI Consultation, *supra* note 22, at 2; Consultation Discussion Paper, MSCI, Should Equity Indexes Include Stocks of Companies with Share Classes Having Unequal Voting Rights? 3 (Jan. 2018), https://www.msci.com/documents/1296102/8328554/Discussion+Paper_Voting+rights.pdf/d3ba68f1-856a-4e76-85b6-af580c5420d7 [hereinafter MSCI Unequal Voting Discussion Paper].

119 MSCI Press Release on Reopening Consultation, *supra* note 117.

120 Lewis Krauskopf & Noel Randewich, *Index Provider MSCI Delays Decision on Unequal Voting Rights Stocks*, REUTERS (June 21, 2018, 5:52 PM), https://www.reuters.com/article/us-funds-msci-rights/index-provider-msci-delays-decision-on-unequal-voting-rights-stocks-idUSKBN1JH3AH.

121 Dimitris Melas, *Summary of the MSCI Consultation Paper on Voting Rights and Index Inclusion*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 22, 2018), https://corpgov.law.harvard.edu/2018/05/22/summary-of-msci-consultation-paper-on-voting-rights-and-index-inclusion/.

indexed companies and can influence corporate policy only through voting.[122] Thus, MSCI proposes to include differential voting rights shares in the index to maintain comprehensive coverage of the equity universe, while appropriately reflecting the reduced voting power characteristics of these securities in index weights.[123]

Traditionally, companies have been included in equity indexes at weights proportional to the free float of the company's listed securities—that is, the amount of a company's securities that should be purchased to replicate the index reflects both the size of the company's market capitalization compared to the capitalization of the other companies in the index and the percentage of the company's capitalization that is actually available for purchase (the free float).[124] MSCI is proposing that in addition to weighting for the free float, the amount of a company's market capitalization included in an index would be weighted according to the percentage of its voting power that is publicly listed and available for purchase. The aim of weighting according to listed voting power is to align economic exposure and listed voting power.[125] MSCI explicitly notes that this is intended to be a kind of sanction. It provides an incentive to companies to reduce the gap between free float and voting power by penalizing companies that offer low voting power (through lower weighting and therefore less representation in the index) and excluding companies that provide zero voting power.[126]

IV. INEFFECTIVE SANCTION

We now turn to an assessment of the effectiveness of the index exclusion sanctions established by the index providers. We start with the premise that the index exclusion sanction will not affect the corporate governance choices of founders and insiders unless it is sufficiently costly to outweigh the perceived benefits of founder control through a multi-class stock structure. We expect the index exclusion sanction will not be sufficiently costly because it is unlikely to materially affect firms' costs of capital. There are four primary factors supporting our view: (1) active investors focused on fundamentals will likely bid up the prices of any firms whose stock prices are artificially depressed by exclusion from an index; (2) recent research in the finance literature suggests that the positive price effects of index inclusion have

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122 MSCI Unequal Voting Discussion Paper, *supra* note 118, at 5.
123 *Id.* at 17.
124 *Id.*
125 *Id.* at 18.
126 *Id.* at 17.

vanished in recent years; (3) active investors still hold much more equity than index investors; and (4) the influence of S&P 500 membership on stock prices has likely diminished in recent years as alternative indexes have proliferated. In addition, other index providers may create new competing indices that include dual-class firms, which generally outperform the market, at least in their first several years post-IPO. To test our hypothesis, we conducted an event study of the S&P 1500 index exclusion decision.

A. No Effective Penalty

1. The Challenge of Public Market Sanctions

In their recent essay, *How Investors Can (and Can't) Create Social Value*, Paul Brest, Ronald Gilson, and Mark Wolfson explain the challenge of creating social value through impact investing in public capital markets.[127] They note that it is virtually impossible to subsidize socially valuable activities or penalize socially adverse activities through public market investments and divestments.[128] If investors seek to lower the cost of capital of socially beneficial corporations by investing in their shares, value-neutral investors will sell the shares at a premium, returning the stock price to its unsubsidized level.[129] Similarly, if investors seek to penalize socially adverse corporate behavior by divesting from the stock of socially harmful companies, value-neutral investors will bid the price back up to its fundamental value-based price, reaping outsized profits in the process.[130] Thus, Brest, Gilson, and Wolfson conclude, "[i]t is virtually impossible for investors to affect the outputs or behavior of firms whose securities trade in public markets through buying and selling securities in the secondary market."[131]

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127 Paul Brest et al., *How Investors Can (and Can't) Create Social Value* (European Corp. Governance Inst., Law Working Paper No. 394/2018, 2018).

128 *Id.* at 13.

129 *Id.* at 13–15.

130 *Id.*

131 *Id.* at 6. The authors go on to note that it is possible to promote social value through *concessionary* investments in primary issuances of shares of companies one wants to promote, but at risk-adjusted returns affected adversely by the size of the concession. *Id.* at 15. To affect the behavior of firms deemed socially harmful, they suggest it is necessary to activate multiple kinds of stakeholders, with the most effective levers being the power public awareness, reputation, shame, and new ways to appeal to the interests of values neutral investors (by persuading them the hoped-for outcome is value positive). *Id.* at 6, 19–20.

The challenges inherent in impact investing in public markets apply with equal force to the effort to apply governance sanctions through index exclusion. If the stock prices of companies excluded from indexes (whether benchmark, ESG, or otherwise) decline below their fundamental value as a result of index exclusion, value-neutral investors (in our case, those who accept founder control through multi-class share structures) will buy underpriced stocks and bid up the price. The stock market prices of companies included in an index may rise, but if the rise in price is disconnected from a company's intrinsic value, governance-neutral investors may be expected to sell at or above "actual" value, again returning the stock to a level unaffected by the index inclusion effect. Such governance-neutral investors achieve outsized profits while there is no change in the cost of capital for the company. In short, index providers and institutional investors cannot succeed in materially increasing the cost of capital for multi-class companies unless all investors in the market agree not to invest.

2. The Disappearing Index Inclusion Effect

Even if public markets did not eliminate incentives for adopting stock structures eligible for index inclusion, the index inclusion effect upon which the exclusion sanction is premised has vanished in recent years. Despite the intuitive appeal of the notion that increasing assets under management at passive index funds following benchmark equity indexes would perpetuate an index inclusion effect, several recent studies have shown that precisely the opposite trend is occurring. Increasing passive investment management is not increasing the index inclusion effect. On the contrary, the index inclusion effect appears to be diminishing to the vanishing point despite increased flows of capital into passive index fund investments.[132]

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[132] Chan Wung Kim et al., *Adaptation of the S&P 500 Index Effect*, 8 J. INDEX INVESTING 29 (2017) (finding no evidence of a positive price drift between the announcement date and the effective date for newly added stocks from 2010 to 2013, and that nearly all of the price impact for newly added stocks occurs prior to the opening of the market on the day immediately following the announcement, and afterward stocks actually tend to drift downward); Nimesh Patel & Ivo Welch, *Extended Stock Returns in Response to S&P 500 Changes*, 7 REV. ASSET PRICING STUD. 172, 207 (2017); Konstantina Kappou, The Diminished Effect of Index Rebalances 22 (May 19, 2017) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2971211 (finding "there are currently no tradable abnormal returns between announcement and event dates . . ., indicating smoother rebalancing" by banks); Cameron Scari, On the Changes to the Index Inclusion Effect with Increasing Passive Investment Management 19 (2016) (unpublished thesis, Wharton School), http://repository.upenn.edu/joseph_wharton_scholars/5.

In their 2017 paper, *Extended Stock Returns in Response to S&P 500 Changes*, Nimesh Patel and Ivo Welch comprehensively review the S&P 500 index inclusion effect using more advanced abnormal return modelling techniques than were available for use in earlier papers. Utilizing these techniques to test the effect over longer time periods than prior papers, the authors conclude that the investor demand shift upon addition to the S&P 500 has always been temporary, and that firms should not expect meaningfully reduced costs of capital.[133] They conclude that, "In sum, the portfolio evidence suggests that corporations no longer enjoy meaningful long-term benefits when being included in, or harm when being removed from, the S&P 500. The announcement effect is no longer as large as it used to be and fully or near-fully reverts in short order."[134]

In contrast with prior studies, Patel and Welch also found that companies removed from the S&P 500 at the discretion of S&P (that is, not in connection with an M&A transaction or bankruptcy but rather, as a result of declining capitalization or other set-backs) actually experienced positive abnormal returns after an initial stock price setback.[135]

Ten years ago, a team of researchers at S&P found that similar trends were present in other markets including the Nikkei 225, TSX 60 and DAX 30+, though not the FTSE 100. They explained the trends by reference to increases in the number and scale of index arbitrageurs over time and changes in market structure and trading patterns of index funds.[136] Other scholars have attributed the decline in the index inclusion effect to better market recognition of the effects of index-fund behavior around index changes,[137] or a decline in information asymmetry in the markets due to changes in global financial market regulation (decimalization) and tighter disclosure rules (Regulation FD and Sarbanes-Oxley certification requirements).[138]

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133 Patel & Welch, *supra* note 132, at 173, 192, 207 (stating that "[t]he data no longer suggests a cost-of-capital advantage for corporations when they are included in the S&P 500").

134 *Id.* at 197. Reversion occurs in no more than three-to-six months. *Id.* at 201.

135 *Id.* at 173, 197.

136 Aye M. Soe & Srikant Dash, *The Shrinking Index Effect: A Global Perspective*, STANDARD & POOR'S 1 (Nov. 1 2008), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568122.

137 Lynch & Mendenhall, *supra* note 64, at 375.

138 Rashiqa Kamal et al., *Additions to S&P 500 Index: Not So Informative Any More*, 38 MANAGERIAL FIN. 380, 381 (2012).

3. The Impact of Active Investing

While the financial press has feverishly reported on the rise of index investing and the growing influence of index providers over recent years,[139] the truth is that active investment funds and other active investors still have far more assets under management than index funds—86% versus 14% of the market capitalization of the S&P 500, for example.[140] There is substantially more cash invested in actively managed funds, and as a result there is more than enough capital that can be invested in companies shut out of major indexes. In addition, active accounts also trade far more than passive accounts—for every one passive dollar, twenty-two active dollars and purchases and sales of stocks by ETF creation and redemption processes account for only 5% of all US stock market trading.[141] Thus, active investing is inevitably more influential in price discovery than passive investing. In sum, the benefits of index inclusion are unlikely to be enough to persuade company founders to give up control when so much capital is still held in active accounts.[142]

4. The Declining S&P 500 Dominance

It is possible that the index inclusion effect has been declining in part due to diversification in the index investing market. During the years in which the S&P 500 index inclusion effect was strongest, the 1990s and the early 2000s, the index investing trend was nascent, and index funds linked to the S&P 500 were growing much more rapidly than other index funds. In the last ten years, by contrast, index investing has exploded, and the number of index funds has proliferated exponentially. There are now 70 times as many index funds as

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139 *See* Tracy Alloway et al., *Index Providers Rule the World—For Now, at Least: Decisions About What to Include Are Leaving Some on the Outs*, BLOOMBERG (Nov. 26, 2017, 7:00 PM); Fox, *supra* note 79.

140 According to S&P, as of May 31, 2018, USD$3.4 trillion of assets were indexed to the S&P 500. S&P 500 Fact Sheet, S&P DOW JONES INDICES (May 2018) (on file with author). The total market capitalization of the S&P 500 as of the end of April 2018 was USD$23.7 trillion. BlackRock reports that in aggregate, 12.4% of U.S. equity market value is held by index mutual funds and ETFs. *Index Investing Supports Vibrant Capital Markets*, BLACKROCK 6 (Oct. 2017), https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-index-investing-supports-vibrant-capital-markets-oct-2017.pdf.

141 *Index Investing Supports Vibrant Capital Markets*, *supra* note 140.

142 James Rufus Koren, *Will Tech Companies Bow to S&P's New Snap-Inspired Rules? Probably Not*, L.A. TIMES (Aug. 21, 2017, 5:00 AM), http://www.latimes.com/business/la-fi-snap-consequences-20170809-story.html.

there are listed stocks in the world.[143] Table 1, adapted from the Investment Company Institute's 2018 Investment Company Fact Book illustrates this shifting of the tides of index investing. It lists only mutual fund net assets, and does not include ETFs or hedge funds, so it does not capture the entire investment market. In fact, S&P states that the total assets indexed to the S&P 500 are more than double the figure in the table, as of December 31, 2017. However, the trend is clear and illustrative. S&P 500 index funds now constitute a much smaller percentage of the index assets under management than they did in the 1990s, as they have been completely outpaced by growth in other domestic and world indexes.

Table 1 Growth in Equity Mutual Fund Total Net Assets
(billions of U.S. dollars, year-end)[144]

Year	Active Domestic	Active World	S&P 500 Index	Other Domestic Indexes	World Indexes
1993	603	112	19.7	3.3	1.2
1999	3,108	572	284	63	13
2007	4,042	1,622	394.5	257.8	95.6
2008	2,307	848	252.9	177.9	67.8
2012	3,455	1,453	429	439	161
2016	4,645	1,798	806	962	363
2017	5,266	2,299	987	1,228	524

B. S&P 1500 Event Study

In the prior section we explained why we think a policy of index exclusion will not impose a sufficient sanction on listing companies to discourage dual-class listings. To test our hypothesis that such a policy will not work as a sanctioning mechanism, we conduct an "event study" of the dates surrounding Standard and Poor's announcement that the S&P

143 Tom Bailey, *There Are Now 70 Times More Stock Market Indices Than Listed Stocks in the World*, MONEY OBSERVER (January 24, 2018), https://www.moneyobserver.com/news/there-are-now-70-times-more-stock-market-indices-listed-stocks-world. The situation is similar in the United States. *See There Are Now More Indexes Than Stocks*, BLOOMBERG (May 12, 2017, 5:00 AM), https://www.bloomberg.com/news/articles/2017-05-12/there-are-now-more-indexes-than-stocks.

144 INV. CO. INST., *supra*, note 78, at 249.

Composite 1500 would no longer include companies with multi-class share structures.[145]

An event study is a statistical tool used to measure the effect of an "event" on the trading price of a set of securities. The effect size of the event is determined by comparing the actual realized asset return to the return predicted by the contemporaneous return on a market index and/or an index of similarly situated securities.[146] To test whether the event in question had an identifiable impact on the price of these securities, we compare the difference between the actual and predicted returns from our model to a measure of the variation in the model's prediction.[147] If the difference between the actual and predicted return is large enough in comparison to this variation, we can be confident that the event changed the price of the impacted securities with a reasonable degree of confidence.

To examine the impact of the S&P announcement, we focus on two discrete events: the April 3, 2017 announcement that the S&P Dow Jones Indices were "conducting a consultation with members of the investment community on the eligibility of non-voting share classes in S&P DJI indices" in which they asked about the possible exclusion of all dual-class shares,[148] and the July 31, 2017 announcement of their decision to restrict indexation for firms with dual-class structures.[149] We separate the securities in our study

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145 *Decision on Multi-Class Shares and Voting Rules*, *supra* note 93. We considered analyzing the effect of the index exclusion policy announced by FTSE Russell. However, under the FTSE Russell rule, only firms with less than a 5% minimum voting rights hurdle would be excluded from their indices. Voting Rights Consultation - Next Steps, *supra* note 21, at 3. Because firms can satisfy this requirement by issuing a relatively small percentage of shares with voting rights, one would not expect to see substantial pricing effects on the date of the announcement even if index exclusion itself was material, as the constraint does not bind.

146 *See, e.g.*, Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. REV. 1421, 1433 (1994).

147 Jonah B. Gelbach et al., *Valid Inference in Single-Firm, Single-Event Studies*, 15 AM. L. & ECON. REV. 495, 502 (2013).

148 S&P Consultation Press Release, *supra* note 87.

149 *Decision on Multi-Class Shares and Voting Rules*, *supra* note 93. It is possible that rumors regarding the possibility of excluding all multi-class shares, as opposed to only non-voting shares, leaked into the market before these dates, but we have not found any public references to any such rumors. The first reference to excluding multi-class shares we found was the April 3, 2017 S&P Dow Jones announcement of its consultation, in which it questioned whether *all* shares *of companies with a class of non-voting shares* should be excluded. The first public suggestion that indexers should exclude or limit not just non-voting shares, but multi-class shares more generally appears to have been CII's letter to FTSE Russell dated March 24, 2017. *See* E-mail from Bertsch to FTSE Russell, *supra* note 47. The first suggestion that index providers might consider limiting multi-class shares more broadly appears to have been FTSE Russell's consultation paper, which appears to

between the "treated" securities (those companies with dual-class structures which were not yet included in the indices, and thus subject to the new rule), and the "control" securities (those firms with dual-class structures that were grandfathered into the indices). We conduct the event study using the following two estimating equations:

$$(1)\quad LRETit \;= \alpha_i + \beta_1 \times MKT_t + \gamma_1 \times D1 + \gamma_2 \times D2 + \epsilon_{it}$$

$$(2)\quad LRET_{it} = \alpha_i + \beta_1 \times MKT_t + \beta_2 \times IND_t + \gamma_1 \times D1 + \gamma_2 \times D2 + \epsilon_{it}$$

The models are estimated using trading data from the calendar year preceding the event in question. The dependent variable—*LRET*—is the natural logarithm of the return of security *i* on date *t*; *MKT* is the return on the Center for Research in Security Prices (CRSP) equally weighted return index,[150] a commonly used proxy for the return on the overall market; *IND* is the return on a portfolio of firms (excluding those in our sample) from the same Fama-French 17 industry classification;[151] and D1 and D2 are indicator variables for the date of the event (D1) and the date following (D2). We include both the date of and the date following the event to ensure we are capturing the announcement (which could occur after the close of trading on the event date), and to allow for a slower diffusion of information. The security specific abnormal returns associated with the event date are captured by γ_1 (the event date) and γ_2 (the date after the event).

Following the framework of the canonical study on the use of event studies by A. Craig MacKinlay,[152] we combine the individual security abnormal returns to derive an aggregate measure of the market impact of the event using the following equation:

$$\overline{AR} = \frac{1}{N}\sum_{i=1}^{N} AR_i$$

have been dated May 26, 2017, according to a comment letter from Norges Bank Investment Management. *See* Letter from Johnsen to FTSE Russell, *supra* note 96.

150 *Index Definitions & Calculations*, CTR. FOR RES. SECURITY PRICES, http://www.crsp.com/products/documentation/index-definitions-calculations (last visited Nov. 10, 2018).

151 The Standard Industrial Classification (SIC) codes associated with each of the 17 industries can be downloaded from Ken French's academic website. Kenneth R. French, *Detail for 17 Industry Portfolios,* CURRENT RES. RETURNS, http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data_Library/det_17_ind_port.html (last visited Nov. 11, 2018).

152 A. Craig MacKinlay, *Event Studies in Economics and Finance*, 35 J. ECON. LIT. 13 (1997).

where N indexes the individual security. In other words, the overall abnormal return for an event date is equivalent to the average of the individual security's abnormal returns. We determine whether the cumulative abnormal return is statistically distinguishable from zero (or no effect), by computing the ratio of the overall abnormal return to a measure of its dispersion (known in the economics and statistics literature as a *t*-statistic).[153] The variance and the overall *t*-statistic are calculated using the following equations:

$$Var(\overline{AR}) = \frac{1}{N^2}\sum_{i=1}^{N}\sigma_{\epsilon_i}^2$$

$$t = \frac{\overline{AR}}{\sqrt{Var(\overline{AR})}}$$

where $\sigma_{\epsilon_i}^2$ is the mean squared error from the estimating regression for security *i*.

If the absolute value of the *t*-statistic is greater than the threshold associated with conventional levels of statistical significance (most commonly a 95% confidence interval, suggesting that we would only find an effect of such magnitude by chance 5% of the time), then we can reject the claim that the event had no effect. On the other hand, if the absolute value of the event *t*-statistic is smaller than the threshold value in absolute terms, we cannot reject the null hypothesis that the event had no effect on the price of the impacted securities.

Finally, because we have two dates for each event, we adjust for the multiple estimates when calculating the cumulative abnormal return associated with a given event. For each of our two events the *cumulative* abnormal return and the *cumulative* *t*-statistic for the event are calculated as:

$$\overline{CAR(D1,D2)} = \sum_{d=D1}^{D2}\overline{AR}_d$$

$$Var\left(\overline{CAR(D1,D2)}\right) = \sum_{d=D1}^{D2}Var(\overline{AR}_d)$$

$$t = \frac{\overline{CAR(D1,D2)}}{\sqrt{Var\left(\overline{CAR(D1,D2)}\right)}}$$

153 The ratio of any estimate to its standard error is called a *t*-statistic, and in this instance is also known as a "studentized residual." *See* Gelbach et al., *supra* note 147, at 502.

The results of our event study are presented in Table 2. The left side of Table 2 presents the estimates for our treated sample—firms with a dual-class structure that were not yet included within the S&P Composite 1500—and the right side the control firms—those with a dual-class structure but which are grandfathered in to the indices notwithstanding the new rule. For both the control and treated samples we use both estimating equation (1), which controls only for the return on the aggregate market (1 Factor), as well as equation (2), which controls for both the aggregate market return and the return on firms of the same industry classification (2 Factor). As is evident from the results in Table 2, there is little evidence that either the April 3 or July 31 event had any discernable impact on the returns of the treated *or* control firms. None of the abnormal or cumulative abnormal returns are

Table 1

	Treated Sample				Control Sample			
	1 Factor		2 Factor		1 Factor		2 Factor	
	AR	t	AR	t	AR	t	AR	t
April 3	-0.123%	-0.34	-0.082%	-0.22	-0.050%	-0.24	0.032%	0.16
April 4	-0.192%	-0.52	-0.063%	-0.17	-0.066%	-0.32	0.113%	0.56
April 3 + April 4	-0.315%	-0.43	-0.145%	-0.20	-0.116%	-0.28	0.145%	0.36
July 31	-0.309%	-0.91	-0.174%	-0.51	-0.325%	-1.62	-0.304%	-1.54
Aug 1	0.428%	1.26	0.437%	1.29	0.013%	0.06	-0.121%	-0.61
July 31 + Aug 1	0.118%	0.17	0.262%	0.39	-0.312%	-0.78	-0.425%	-1.08

statistically significant at conventional levels (a *t*-statistic greater than or equal to approximately 1.96). Moreover, for the July 31 announcement it would appear that, if anything, the control firms (those unaffected by the new proposed rule) had *more* negative returns than the treated firms. In conclusion, there is no evidence that market penalized firms affected by the new Standard and Poor's index eligibility rule.

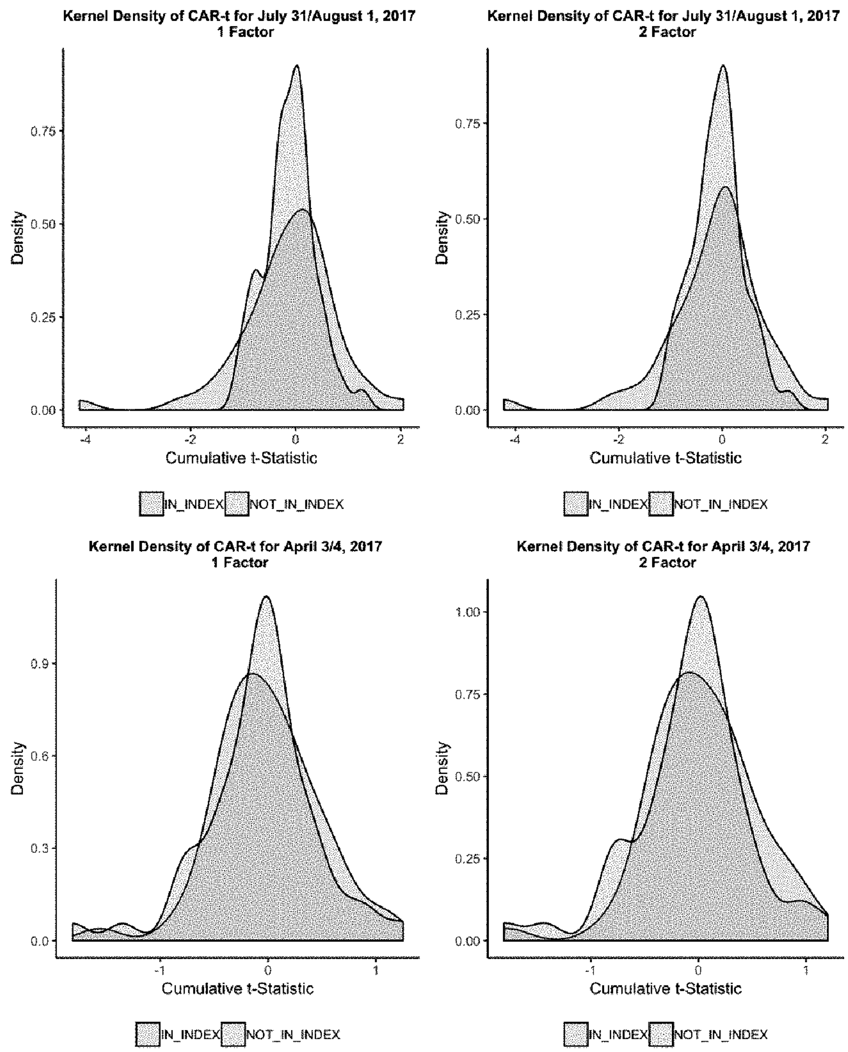
Another way to look at the event study results is to analyze the distribution of the individual *t*-statistics from the firm-level regressions. It is possible than an outlier in the data could impact the cumulative abnormal returns, generating or masking differences in the market response between control and treatment firms. In Figure 1 we plot kernel density estimates of the distribution of the *t*-statistics between our two sets of firms.[154] The first

154 A kernel density estimator is a more sophisticated version of the common histogram, and is particularly useful when your data is continuous. *See* ANDREW S. ZIEFFLER ET AL., COMPARING GROUPS: RANDOMIZATION AND BOOTSTRAP METHODS USING R 53 (2011) ("Nonparametric kernel density estimation can be thought of as a method of averaging and smoothing the density estimate provided by the histogram. More formally, kernel

row presents the densities for the July 31 announcement and the second row shows the earlier April 3 discussion, while the left column shows the results using equation 1 (1 Factor) and the right column uses equation 2 (2 Factor). In all cases, there is a little evidence of any systematic shift in the distribution of the cumulative *t*-statistics, while the treated firms appear to be more consistently more centered around zero. This is again consistent with there being little to no discernable impact from the S&P announcement on firms now excluded from its indices. Thus, we conclude that exclusion may not be expected to materially adversely affect the cost of capital of excluded firms and is not an adequate sanctioning mechanism to discourage dual-class stock listings.

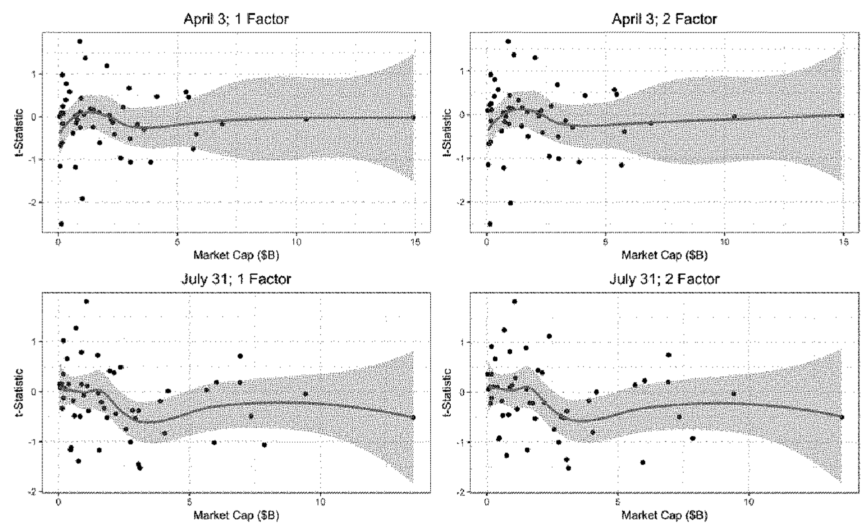
density estimation is a sophisticated form of locally weighted averaging of the sample distribution.").

Figure 1



Finally, one potential criticism of our event study analysis is that it does not distinguish between larger firms that are likely to enter the S&P indices in the future and smaller firms for which this possibility is more remote. To the extent that many of the firms in our treatment sample have a low market capitalization, investors may not find that index exclusion materially shifts market expectations. Given that our results in Table 1 group together both small and large firms, our test would be biased against finding a significant result.[155] To address this concern, we plot in Figure 2 the individual firm t-statistics by firm market capitalization, grouping by announcement date and market model type. There is no evidence that the market penalized firms with higher market capitalization, again suggesting that the index exclusion effect is unlikely to deter firms from choosing a dual-class structure.

Figure 2



C. Founder Choices Are Not Changing

So far, the index provider decisions excluding or reducing the exposure of multi-class companies to benchmark equity indexes do not seem to have stemmed the flow of multi-class companies coming to market. A number of companies completed multi-class initial public offerings in the second half of 2017 and the first half of 2018, and numerous parties have opined that the index provider decisions will not prevent companies that want them from

155 However, this criticism cuts both ways. Under this critique, there will not be a significant abnormal return if either 1) investors don't believe the firm will be eligible for index inclusion in the future, or 2) the effect of index inclusion is minimal or non-existent. However, in that circumstance we still would not expect index exclusion to alter the decision-making process of managers when deciding whether or not to structure their equity as dual-class, rendering index exclusion ineffective as a policy matter.

adopting founder-friendly structures.[156] This is completely consistent with our expectations given the inefficacy of the sanction provided by index exclusion.

To be sure, all things being equal, companies would prefer to have the opportunity to be included in an index, but few minds will be changed by the new rules. Corporate sentiment seems to be summarized well by a spokesperson for Eaton Vance, a dual-class issuer with only non-voting shares listed, shortly before the FTSE Russell and S&P decisions, who said that while they do not wish to be removed from indexes, "we cannot control what they decide to do."[157] The shrugging shoulders are palpable.

David Brown, head of U.S. Equity Capital Markets at Ernst & Young Capital Advisors, has noted that it can be hard for investment bankers who advise IPO candidates to quantify the risks associated with introducing a special share class: "Right now it's almost a free option, so if they want it why not take it?"[158] On the investor side, at least some recognize that governance structure is more important for some companies than for others: "Governance has a different level of importance for different companies."[159]

V. CONSEQUENCES OF AN INEFFECTIVE SANCTION

A. Violating Indexing Theory

By excluding some significant companies from benchmark equity indexes that have historically been used as proxies for the market, or the large cap companies that dominate it, the index providers are violating one of the fundamental tenets of indexing theory—that benchmark indexes should accurately reflect the investable market. While S&P has suggested that the S&P Composite 1500 is not such a broad-based index intended to capture the

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156 David J. Berger et al., *The Continuing Support for Dual-Class Stock by Companies and Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 2, 2017); Huston, *supra* note 56 (noting that Roku Inc. and MongoDB Inc. listed with dual-class shares after the FTSE Russell and S&P decisions); Koren, *supra* note 142 (quoting Chris Jones of investing start-up Acorns and formerly chief investment officer for domestic equity of Blackrock as saying that "[t]here is a lot of evidence that company management won't care [about S&P's action to ban multi-class shares]").

157 Ross Kerber, *Lack of Voting Rights May Keep Snap, Others from MSCI Indexes*, REUTERS (July 17, 2017, 7:11 AM), https://www.reuters.com/article/us-snap-indexes-idUSKBN1A210S?.

158 Anita Balakrishnan, *Start-Ups Go Public to Get Your Money – Your Input on How It's Spent Is Now Optional*, CNBC (Aug. 5, 2017 2:43 PM), https://www.cnbc.com/2017/08/05/snap-exclusion-from-sp-500-wont-stop-multiple-share-classes.html.

159 *Id.* (quoting Liz Myers, Managing Director and Global Head of Equity Capital Markets, JPMorgan).

market,[160] that is not consistent with the historical market view or S&P's own description of the index, which refers to it as "designed to reflect the U.S. equity market and, through the market, the U.S. economy."[161]

This is not lost on the largest U.S. institutional asset managers, who prefer one-share-one-vote capital structures but do not support excluding dynamic growth companies from the benchmark indexes to achieve that result: "The passive philosophy is to own the market, and these companies are part of the market," noted Lynn Blake, an index investment manager at State Street Corp.[162] Vanguard and State Street have also commented that index providers should not exclude companies with non-voting public shares from their indexes, although they oppose dual-class structures.[163]

BlackRock has issued two public statements criticizing the index provider actions. In October 2017, BlackRock issued a public statement arguing that "[p]olicymakers, not index providers, should set equity investing and corporate governance standards" and proposing that multi-class companies should get periodic shareholder approval of the structure and provide equal voting rights on issues involving management conflicts, such as executive pay and related-party transactions.[164] Subsequently, BlackRock issued a more extensive critique in a letter to MSCI, Inc. commenting on its proposal to apply vote-based weighting to the multi-class constituents in its benchmark indexes. Stating that "[i]n constructing indexes, index providers should make every effort to reflect the investable marketplace in the broad benchmark indexes they produce," BlackRock suggested that "MSCI pursue an alternative approach that would allow index investors to choose between (i) broad market indexes that reflect the investable universe and (ii) indexes that

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160 S&P sought to distinguish the methodologies for the S&P 1500 Composite from methodologies for S&P Global BMI Indices and S&P Total Market Index, saying they "should not consider governance arrangements when selecting the universe of constituents" for the latter two indices because they are "broad market indices intended to represent the investment universe." *Decision on Multi-Class Shares and Voting Rules*, *supra* note 93.

161 *Id.*

162 Kerber, *supra* note 15.

163 Chris Dieterich et al., *Stock Indexes Push Back Against Dual-Class Listings*, WALL ST. J. (Aug. 2, 2017, 11:34 AM), https://www.wsj.com/articles/stock-indexes-push-back-against-dual-class-listings-1501612170 ("'As a fundamental governance matter, one-share, one-vote remains a really important tenet of our principles,' said Glenn Booraem, a principal at Vanguard who works on its governance efforts. 'The question is whether index construction is the right place to solve the problem.'"); Koren & Dave, *supra* note 106.

164 *A Potential Solution for Voting Rights and Index Inclusion Issues*, BLACKROCK (Oct. 2017), https://www.blackrock.com/corporate/literature/publication/blk-a-potential-solution-for-voting-rights-and-index-inclusion-issues-october2017.pdf.

have alternative weightings or screen companies based on governance principles, similar to index offerings with tobacco or social screens."[165] This alternative approach "would allow investors who feel strongly about corporate governance issues to 'vote with their feet' without creating the market disruption or transaction costs associated with the proposed [weighting] approach."[166] BlackRock also proposed that the International Organization of Securities Commissions (IOSCO) consider principles for the regulation of the listing of multi-class share structures since, in their view, there is currently a corporate governance race to the bottom among the major stock exchanges of the world and none of them are likely to take action on their own.[167]

Weighting by free float, which many indexers do in their benchmark equity indexes, makes sense because it is an objective measure of investability. If the public float of a company is limited, its actual investability is equally limited. Weighting for voting rights may not make sense because it is not related to whether or not it is possible to acquire shares representing value equal to the security's pro rata portion of the overall index's market capitalization.

B. Injuring Index Investors

One of BlackRock's core concerns about the index provider's actions is that it could deprive BlackRock's clients of access to the investable universe of public companies and opportunities for returns. The MSCI proposal to subject multi-class firms to weighting would also impose significant trading costs on market participants as they reconstitute their portfolios to accurately reflect the new weightings of the securities in the MSCI indexes. In its letter to MSCI, BlackRock stated that "[i]n addition to limiting the opportunity set for index investors, the proposed changes will be costly for investors in index products that reference these indices, and these costs would be incurred for changes not related to accurate representation of the investable universe."[168]

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165 Letter from Barbara Novick, Vice Chairman, BlackRock, to Baer Pettit, President, MSCI, Inc. 1–2 (Apr. 19, 2018) [hereinafter Novick Letter], https://www.blackrock.com/corporate/literature/publication/open-letter-treatment-of-unequal-voting-structures-msci-equity-indexes-041918.pdf.

166 *Id.*, at 2; *see also* Robin Wigglesworth, *BlackRock Wades into Corporate Governance Conundrum*, FINANCIAL TIMES (Apr. 19, 2018), https://www.ft.com/content/ca3d7012-441a-11e8-93cf-67ac3a6482fd.

167 Novick Letter, *supra* note 165, at 3–4.

168 *Id.* at 1.

The FTSE Russell voting hurdle eligibility rule impacts investors less dramatically than the S&P prohibition and MSCI weighting rules because far fewer companies are covered under its terms, given that most multi-class companies have more than 5% of their voting stock held in public hands despite the multi-class structure. In its most recent list of grandfathered companies that will be ineligible for inclusion in the Russell 3000 without a change to their capital structure within five years of the inception of the rule change, FTSE Russell lists only 48 companies.[169] Companies can also easily game the FTSE hurdle by including provisions in their charters ensuring that public shareholders always have just above 5% of the vote, regardless of their cash flow rights.[170] Companies could continue to use this approach even if FTSE Russell increases the voting hurdle to higher levels, such as 25%, since there is no rule in Delaware corporate law requiring voting rights to track cash flow rights. This would presumably work in a manner similar to the charters of dual-class stock companies, such as Nike and the New York Times, that permit investors to elect a set number or percentage of the directors of the company.[171]

MSCI's weighting approach, while at first blush more reasonable than the exclusion approach taken by S&P and FTSE Russell, will also ultimately leave index investors worse off if dual-class companies perform well and other investors acquire the shares of such companies in amounts proportional to their total market capitalization. Thus, although dual-class companies included in an MSCI index will theoretically receive less capital than fully weighted index constituents, since active investors may acquire any excess shares left by index funds following weighted index investing, it is index investors and not issuers that will be most penalized by the MSCI weighting proposal.

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169 Index Announcement, FTSE Russell, Minimum Voting Rights Hurdle: June 2019 Update to Indicative List of Affected Securities - Update (May 31, 2019), https://www.ftserussell.com/products/index-notices/Home/GetNotices/ALL.

170 Memorandum from Davis Polk on Snap Decision: Leading Index Providers Nix Multi-Class Shares to Clients 1–2 (Aug. 1, 2017) [hereinafter Memorandum from Davis Polk], https://www.davispolk.com/files/2017-08-01_snap_decision_leading_index_providers_nix_multi-class_shares.pdf; Brian V. Breheny et al., *Capital Markets Alert: Global Index Providers Announce Decision to Exclude Companies with Multi-Class Capital Structures or Limited Public Voting Rights*, SKADDEN (Aug. 7, 2017) [hereinafter Skadden Capital Markets Alert], https://www.skadden.com/insights/publications/2017/08/global-index-providers-announce-decision.

171 *See* Andrew William Winden, *Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures*, 2018 COLUM. BUS. L. REV. 852, 867–69 (2018)

The injury to investors prevented from investing in companies with multi-class stock structures could be significant. MSCI has determined that unequal voting rights stocks have higher earnings growth, higher profit margins and higher return on equity but also pay lower dividends and trade at premium valuations relative to the broad market. Companies with unequal voting rights have high growth and profitability, are relatively large and have relatively high earnings variability and high company-specific risk, are less leveraged and offer lower yield compared to other companies in the MSCI ACWI index.[172] MSCI found that companies with unequal voting rights in aggregate outperformed the market in the period from November 2007 to August 2017.[173] Excluding them from indexes would have reduced the indexes' total returns by approximately 30 basis points per year over the ten-year period.[174] State Street Global Advisors found similar results when it reviewed the performance of multi-class companies in the S&P 500, concluding that the index's returns would have fallen from 86.5% to 84.6% over the last decade if such companies had been excluded from the index.[175]

Additional institutional investors are beginning to see the harm caused by the exclusion of dual-class shares from benchmark indexes and consensus supporting the effort is eroding. Norges Bank Investment Management, the Norwegian sovereign wealth fund, with $960 billion under management, initially endorsed the weighting voting approach to indexing proposed by MSCI in letters commenting on FTSE Russell's voting rights hurdle proposal and MSCI's initial proposal to exclude companies listing only non-voting shares, noting such listings were rare.[176] Nine months later, NBIM reversed itself, calling on MSCI not to institute a vote-weighted system of index

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172 MSCI Unequal Voting Discussion Paper, *supra* note 118, at 12.

173 Dmitris Melas, *Putting the Spotlight on Spotify: Why Have Stocks with Unequal Voting Rights Outperformed?*, MSCI (Apr. 3, 2018), https://www.msci.com/www/blog-posts/putting-the-spotlight-on/0898078592 (discussing why stock-specific effects had a greater impact on this outperformance than common characteristics, despite some commonalities in country, sector and style factor exposures).

174 *Id.*

175 STATE STREET GLOBAL ADVISORS, *supra*, note 13, at 3.

176 Letter from Petter Johnsen, Chief Inv. Officer Equities, Norges Bank Inv. Mgmt., and Jonas Jølle, Head of Policy Dev., Norges Bank Inv. Mgmt., to MSCI, Inc. (Aug. 17, 2017), https://www.nbim.no/en/responsibility/standard-setting/consultations/2017/consultation-on-the-treatment-of-non-voting-shares-in-the-msci-equity-indexes/; Letter from Johnsen to FTSE Russell, *supra* note 96; Mark Gilbert, *World's Biggest Wealth Fund Refuses to Be Silenced*, BLOOMBERG (June 26, 2017), https://www.bloomberg.com/news/articles/2017-06-27/norway-sovereign-wealth-fund-is-refusing-to-be-silenced.

construction because passive investors would become underweight dynamic growth companies.[177]

Ultimately, because retail investors in the United States are increasingly invested in index funds, they have the most to lose if the index providers persist in excluding or reducing the weighting of dynamic growth companies with multi-class capital structures from their benchmark indices. Institutional investors, including the large pension funds making up most of the membership of the Council of Institutional Investors, the staunchest backer of index exclusion, are able to invest separately in such stocks even if they are excluded from indexes, and often invest in the same multi-class companies before they go public as limited partners in venture capital and other private funds. Thus, retail investors may miss out on the positive returns provided by many of the country's most dynamic companies, while actively investing institutional investors, many of them managing the assets of America's wealthiest citizens, continue to invest in such companies.[178] That is a result that seems unfair and unfortunate from a policy perspective.

C. Further Decline in Benchmark Influence

The natural result of violating indexing principles and injuring index investors is that the three largest index providers, FTSE Russell, MSCI and S&P, may begin to lose influence and clients over time. If their benchmark equity indexes are no longer representative of the market or underweight some of the most dynamic stocks in the market, it will only be a matter of time before competitors publish competing indexes that include such companies in their representations of the market and investors defect.[179]

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177 Letter from Carine Smith Ihenacho, Chief Corp. Governance Officer, Norges Bank Inv. Mgmt. & Séverine Neervoort, Senior Analyst, Policy Dev., Norges Bank Inv. Mgmt., to MSCI, Inc. (May 31, 2018), https://www.nbim.no/en/responsibility/standard-setting/consultations/2018/consultation-on-the-treatment-of-unequal-voting-structures-in-the-msci-equity-indexes/; Gwladys Fouche, *Norway Wealth Fund Opposes MSCI Proposal on Unequal Voting Rights*, U.S. NEWS & WORLD REPORT (June 1, 2018, 9:15 AM), https://money.usnews.com/investing/news/articles/2018-06-01/norway-wealth-fund-opposes-msci-proposal-on-unequal-voting-rights.

178 *Major Stock Index Providers to Limit Inclusion of Multi-Class Companies: What It Means and Why It Matters*, WILSON SONSINI GOODRICH & ROSATI (Aug. 8, 2017) [hereinafter WSGR Index Providers Limit Inclusion], https://www.wsgr.com/WSGR/Display.aspx?SectionName=publications/PDFSearch/wsgralert-multi-class-companies.htm.

179 Koren, *supra* note 142 (quoting Chris Jones of investing start-up Acorns and formerly chief investment officer for domestic equity of Blackrock as saying that "[t]here is a lot of evidence that company management won't care [about S&P action to ban multi-class shares]").

When State Street Global Advisors polled its clients about whether or not non-voting and reduced voting rights shares should be included in indexes following the Snap IPO, only around 50% said such shares should not be included in indexes. Some clients were unsure, but almost half of their clients said reduced voting shares *should* be included. Only 38% of their U.S. clients were interested in investing in an index that excluded reduced voting shares.[180]

D. Discouraging Listings, Not Changing Structural Choices

A number of prominent law firms active in initial public offerings of technology companies have noted that entrepreneurs could respond to the exclusion of multi-class share structures by choosing not to publicly list their companies.[181] In prior sections, we have explained why the index exclusion of multi-class stock structures should not materially adversely affect the cost of capital for multi-class companies and should not cause company founders to choose a single-class stock structure or to avoid listing. This would be the case, for example, if the index providers retain their eligibility criteria disfavoring multi-class stock structures, and index funds develop a sufficient monopoly of influence through additional index investing to make index exclusion a material sanctioning mechanism against such companies; however, it is possible that pre-IPO companies could choose not to list in lieu of listing with a single-class stock structure, which could reduce the investment opportunity set for all public investors, not just index investors. FTSE Russell recognized this risk in its index announcement of the voting hurdle but proceeded nonetheless.[182] This flies in the face of efforts by Congress, the SEC, and others to encourage more innovators to obtain financing to grow their businesses in the U.S. public markets.

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180 STATE STREET GLOBAL ADVISORS, *supra*, note 13, at 2.

181 Memorandum from Davis Polk, *supra* note 170, at 2; Skadden Capital Markets Alert, *supra* note 170; *Stock Indices Take Action to Exclude Multi-Class Share Structures*, KING & SPALDING (Aug. 7, 2017), https://www.kslaw.com/attachments/000/005/182/original/ca080717.pdf?1502111524; Ben-Tzur, *supra* note 11; WSGR Index Providers Limit Inclusion, *supra* note 178.

182 Voting Rights Consultation – Next Steps, *supra* note 21, at 4.

VI. CONCLUSION

Benchmark index exclusion has not provided a sufficient sanction to discourage dual-class stock structures. Companies are undaunted by the prospect of exclusion from benchmark equity indexes and are continuing to list with multi-class stock structures. The index inclusion effect, if it ever created long-term cost of capital benefits, is no longer operative, and will not act as a sufficient sanction to discourage private companies from choosing multi-class stock structures for their initial public offerings. As our event study of the effect of S&P 1500 exclusion shows, investors are not penalizing companies based on their prospective exclusion; the response from the market has been a collective shrug. The effects of multi-class exclusion on investors and indexers themselves are significant, however, and will undoubtedly create pressure on indexers to alter their eligibility criteria to include multi-class companies again. Because the effects on retail investors are unfair, and the effects on indexers are undesirable, index providers should relent and allow companies with multi-class stock structures to remain in their benchmark indexes.