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Nonvoting Shares and Efficient Corporate Governance

Dorothy Shapiro Lund

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Abstract

A growing number of technology companies, including Google, Facebook, and Snapchat, have chosen to issue stock that does not allow their investors to vote on corporate decisions. But scholars and investors are in fundamental disagreement about whether nonvoting stock is a benefit or a curse. Critics argue that nonvoting shares perpetually insulate corporate insiders from influence and oversight and therefore increase management agency costs. By contrast, proponents contend that even in spite of increased agency costs, nonvoting shares may provide benefits that exceed these costs, such as enabling corporate insiders to pursue their long-term vision for the company without interference from outside shareholders.

This paper offers a novel perspective on this debate. It demonstrates an important and previously unrecognized benefit of nonvoting stock: it can be used to make corporate governance more efficient. This is because nonvoting stock allows companies to divide voting power between shareholders who are informed about the company and its performance and those who are not. When this efficient sorting happens, the company will lower its cost of capital by *reducing* agency and transaction costs. Specifically, informed investors will pay more for voting stock that is not diluted by uninformed investor voting; indeed, a company may even entice informed investors to invest by offering two classes of shares. Likewise, uninformed investors will more highly value shares that do not require them to incur costs associated with voting. In other words, the company that issues nonvoting shares for its uninformed shareholders to buy will make itself more valuable. And because nonvoting stock trades at a discount to voting stock, uninformed shareholders will have another reason to purchase nonvoting shares, obviating the need for legal intervention.

This insight has several implications for law. Most important, this paper contends that recent proposals to restrict or deter companies from issuing nonvoting shares should be rejected because they may impede efficient corporate structuring.

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I. INTRODUCTION

In March of 2017, Snap Inc. became the first company to go public on a U.S. stock exchange offering only nonvoting shares to the public.[1] This structure ensured that the company's founders, two billionaire internet entrepreneurs in their twenties, would have perpetual control over the company.[2] Not only that, issuing only nonvoting stock allowed Snap to take advantage of exemptions from certain disclosure obligations under federal securities laws.[3] Specifically, the company would not be required to release annual proxy statements to the public that would disclose background information about the directors, including their compensation and any conflicts of interest that could affect their decisionmaking.[4] Why bother when the company's shareholders would never have a say in director elections or other matters typically resolved by a shareholder vote?

The public reaction was swift and hostile.[5] Some, including the company itself in its registration statement, predicted that Snap would pay a penalty for such a move.[6] And yet, the company encountered little resistance from the market. It priced its IPO above the marketing range, and closed its first day of trading at a 44 percent premium to the IPO price.[7]

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[1] Steven Davidoff Solomon, *Snap's Plan Is Most Unfriendly to Outsiders*, N.Y. TIMES (Feb. 3, 2017), available at: https://www.nytimes.com/2017/02/03/business/dealbook/snap-ipo-plan-evan-spiegel.html?_r=0.

[2] *See id.* (noting that the offering is structured such that the "founders' control goes away only if they die."); Snap Inc., Amendment No. 2 to Form S-1 Registration Statement 130 (Feb. 16, 2017) ("As a result [of this structure], Mr. Spiegel and Mr. Murphy, and potentially either one of them alone, have the ability to control the outcome of all matters submitted to our stockholders for approval.")

[3] Snap Inc., Amendment No. 2 to Form S-1 (explaining that the company would be exempt from reporting requirements under Sections 13(d), 13(g), 14, and 16 of the Exchange Act). A subsequent prospectus claimed that Snap would nonetheless voluntarily provide those materials to stockholders. *See* Preliminary Prospectus, available at: https://www.sec.gov/Archives/edgar/data/1564408/000119312517056992/d270216ds1a.htm.

[4] *Id.*

[5] *See* Solomon, *supra* note []; Maureen Farrell, *In Snap IPO, New Investors to Get Zero Votes, While Founders Keep Control*, WALL ST. J., http://www.wsj.com/articles/in-snap-ipo-new-investors-to-get-zero-votes-while-founders-keep-control-1484568034; Paresh Dave, Big Investor T. Rowe Price Challenges Snapchat Founders' Power, LA Times (Jan 19, 2017), http://www.latimes.com/business/technology/la-fi-tn-snapchat-voting-20170119-story.html

[6] Snap Inc., Amendment No. 2 to Form S-1 ("We cannot predict whether this structure and the concentrated control it affords Mr. Spiegel and Mr. Murphy will result in a lower trading price or greater fluctuations in the trading price of our Class A common stock as compared to the trading price if the Class A common stock had voting rights."); Ross Kerber and Liana Baker, *Lacking Voting Rights, Snap IPO to Test Fund Governance Talk*, REUTERS TECHNOLOGY NEWS (Feb. 3, 2017) (quoting a research analyst who stated that he would discount the shares by 30% because of the lack of voting rights).

[7] Maureen Farrell, Corrie Driebusch and Sarah Krouse, *Snapchat Shares Surge 44% in Market Debut*, WALL ST. J. (March 2, 2017), https://www.wsj.com/articles/snapchat-parent-snap-opens-higher-in-market-debut-1488471695. Since then, the shares have fallen below the IPO price. Corrie Direbusch,

The success of Snap's offering, however, rallied opponents of companies that issue different classes of stock with unequal voting rights, or "dual-class companies." These opponents contend that depriving investors of voting rights serves only to entrench management and insulate them from the consequences of their inefficient or disloyal decisions. These critics view the increase in dual-class offerings in the United States as a serious problem for investors.[8]

Accordingly, following Snap's IPO, the Council of Institutional Investors ("CII"), an investor advocacy group with the motto "no-vote shares have no place in public companies," ramped up lobbying efforts, contending that U.S. stock indices and exchanges should bar companies that offer nonvoting shares to the public.[9] CII also targeted companies contemplating public offerings with multiple classes of stock.[10] Large institutional investors likewise lobbied the Securities Exchange Commission ("SEC") and stock exchanges to ban nonvoting shares.[11] These efforts caught the attention of the SEC's Investor Advisory Committee, which held a hearing on dual-class stock shortly after Snap's offering.[12]

This public opposition has begun to influence stock index policy. In June 2017, FTSE Russell announced that it would not add Snap or other companies with nonvoting shares to its major U.S. stock benchmarks.[13] Soon after, S&P 500 Dow Jones Indices stated that it would exclude companies that issue multiple classes of shares.[14] These decisions dealt a major blow to Snap and provide a powerful

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Snap Shares Tumble Further Below IPO Price, WALL ST. J. (June 10, 2017), https://www.wsj.com/articles/snap-shares-tumble-further-below-ipo-price-1499784971.

8 *See* supra n. [].

9 *See* Council of Institutional Investors, *The Rise of No-Vote Shares*, available at: http://www.cii.org/dualclass_stock. The CII has also directed its advocacy overseas, lobbying the Singapore stock exchange to preserve its listing standards that exclude companies with nonvoting stock. *See* Council of Institutional Investors, *Letter to the Singapore Stock Exchange* (March 29, 2017), available at: http://www.cii.org/files/issues_and_advocacy/correspondence/2017/03_29_17_letter_to_SGX.pdf.

10 *See, e.g., Investor Group Urges Blue Apron to Ditch No-Vote Shares*, http://www.cii.org/062117_blue_apron.

11 *See, e.g.*, Madison Marriage, *State Street Asks SEC To Ban Nonvoting Shares*, FIN. T. (June 17, 2017), available at: https://www.ft.com/content/9595e5c4-51db-11e7-bfb8-997009366969; Michael Greene, *Snap IPO Gets Investors Fired Up Over Dual-Class Stock*, Bloomberg News (March 9, 2017), https://www.bna.com/snap-ipo-gets-n57982084963/.

12 Brian Shea, *SEC's Investor Advisory Committee Airs Concerns Over Multi-Tiered Offerings Following Snap's IPO,* Harvard Law School Forum on Corporate Governance and Financial Regulation (May 9, 2017), available at: https://corpgov.law.harvard.edu/2017/05/09/secs-investor-advisory-committee-airs-concerns-over-multi-tiered-offerings-following-snaps-ipo/#5.

13 Specifically, the index provider announced that it would bar companies from inclusion unless at least 5% of the voting rights are in the hands of public shareholders. *FTSE Russell Voting Rights Consultation – Next Steps* (July 2017), available at: http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf,

14 *S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rights* (July 31, 2017) (press release), available at: https://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjimulti-classsharesandvotingrulesannouncement7.31.17.pdf?force_download=true. Existing multiple-class companies, such as Alphabet and Facebook, will remain in the S&P 500. But Snap, which never made it into the index, will be excluded. *Id*.

deterrent to other companies planning to issue nonvoting stock in their public offerings. That is because index funds, which make up a significant percentage of demand for company shares,[15] will not buy stock that is not included on an index. As such, these policy changes impose a high financial penalty on dual-class companies that will likely deter companies from utilizing such a structure in the future.[16]

Hostility to dual-class companies, however, is not new. Indeed, academics and regulators have debated whether to restrict or otherwise regulate the use of dual-class structures for at least a century.[17] Yet even after so many years, the arguments on both sides remain the same. Critics of dual-class structures argue that issuing low-voting or nonvoting shares increases agency costs and results in sub-optimal decision-making.[18] That is because the corporate insiders retain voting control even as their equity stake falls below fifty percent.[19] Because of this wedge between their financial interest and control, the insiders' incentives to slack or otherwise misbehave are heightened, while outside investors who bear the brunt of the consequences have limited options to exercise influence.[20] A newer version of this critique emphasizes that dual-class structures allow the founding group to maintain control into perpetuity, even after it becomes clear that the structure is no longer efficient.[21]

By contrast, proponents of dual-class structures have consistently claimed that nonvoting or low-voting stock has valuable uses. Most importantly, they contend that dual-class structures allow those who control the company—whether it be the family in a family-owned business or the visionary founders of a successful technology company—to retain control without having to bear excessive risk.[22]

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[15] *See, e.g.*, Tom McGinty, Sarah Krouse & Elliot Bentley, *Index Funds Are Taking Over The S&P 500,* WALL ST. J. (Oct. 17, 2016), available at: http://www.wsj.com/graphics/index-funds-taking-over-sp-500/. Snap's shares sunk to an all-time low two days after the S&P announced that it would exclude Snap from its indices. Anita Balakrishnan, *Snap Shares Set New All-Time Low As Investor Concerns Pile Up*, CNBC TECH (Aug. 2, 2017), available at: https://www.cnbc.com/2017/08/02/snapchat-snap-stock-down-to-all-time-low-amid-instagram-engagement-ipo-lockup.html.

[16] *See* Andrei Shleifer, *Do Demand Curves for Stocks Slope Down*, 41 J. FIN. 579 (1986).

[17] *See* Douglas C. Ashton, *Revisiting Dual Class Stock*, 68 ST. JOHN'S L. REV. 863, 896-97 (1994).

[18] *See* Lucian Bebchuk, Reinier Kraakman, & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Creation and Agency Costs of Separating Control From Cash-Flow Rights*, CONCENTRATED CORPORATE OWNERSHIP 298- 99 (2000); Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1, 4 (1988); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 73 (1991).

[19] *Id.*

[20] *Id.*

[21] Lucian Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 101 VA. L. REV. (forthcoming 2017).

[22] If founders could not issue nonvoting or low-voting shares, they would often be forced to hold all or most of their wealth in the company to maintain control, which would subject them to substantial risk. It might also cause them to forego attractive investment opportunities because the new financing would dilute their voting control, or push them to choose debt rather than equity financing even when debt financing would be less beneficial. By issuing nonvoting stock, however, the founders can secure new capital without diluting the founders' stake. This allows founders to diversify their private wealth, as well as secure outside financing, without losing control of the company. *See* Ashton, *supra* n. [] at 870 ("Since the vote attached to the share under such a regulatory framework is not restricted in terms of exchangeability, the ultimate destination of the rights attached to the vote will be determined by the initial arrangements made between the parties when the stock is first offered publicly, and then

Although dual-class structures may lead to increased agency costs—investors will have to monitor management more closely, and when problems emerge, they will have limited recourse—the benefits of encouraging controlled companies to access capital markets, and of protecting the company from the influence of shareholders with short-term interests, exceed the costs.[23] Moreover, these proponents further claim that pressure from capital markets will discourage founders from using dual-class structures when the costs exceed the benefits.[24]

This paper posits that these arguments for and against dual-class structures ignore the fact that the world has changed dramatically in the past fifty years. Beginning in the 1970s, the shareholder base of U.S. public companies has consolidated in the hands of large institutional investors.[25] And in this new world of concentrated institutional investor ownership, nonvoting stock has a previously unrecognized but valuable function. Specifically, this paper is the first to demonstrate how corporate issuance of nonvoting shares, instead of increasing management agency costs in all cases, can actually be used to *lessen* agency and transaction costs. And this theoretical observation may partially explain why nonvoting stock has surged in popularity in the past few years: a company that offers nonvoting shares to the public can lower its cost of capital in certain cases, not because the structure protects the founding group from interference, but because it reduces inefficiencies associated with voting.

Not all shareholders value their votes equally. Some, including retail shareholders, value their vote so little that they rarely exercise it.[26] Others, such as hedge fund activists, accumulate shares with the purpose of using their voting power to agitate for changes that would increase the value of their investment. And yet, the

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later upon exchanges between existing shareholders, in which the right to vote shifts to those who value it most. Those who value voting rights the most are typically families or controlling shareholder groups. Such groups may eventually bargain with other shareholders in order to make an exchange in which capital is raised without diluting their present control positions.").

[23] *See* Bernard Sharfman, *A Private Ordering Defense of a Company's Right to Use Dual Class Structures in IPOs* at 15 (July 16, 2017), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2986164. Of course, companies also have the option to finance using debt, but this paper focuses on equity offerings, and takes the company's level of debt as given.

In defending dual class structures, Sharfman contends that although dual class companies increase agency costs, those costs are not the only costs that need to be minimized when a company goes public. Instead, as Zohar Goshen and Richard Squire have observed, companies and investors seek to minimize total control costs, which include "principal costs," or the costs that accompany investor control. *Id.* (citing Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767 (2017)). This paper takes Sharfman's observation one step further and shows that dual class shares can be used by management to entice informed investors to buy voting stock, thus *reducing* agency costs; put differently, the tradeoff between minimizing agency costs and minimizing principal costs may not always exist when companies issue nonvoting stock.

[24] *See* Sharfman, *supra* n. [].

[25] *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 887 (2013).

[26] *See* Mary Ann Cloyd, *2014 Proxy Season Mid-Year Review* (July 17, 2014), available at: http://blogs.law.harvard.edu/corpgov/2014/07/17/2014-proxy-season-mid-year-review/ (finding that, in 2014, institutional shareholders voted 90% of their shares but retail shareholders voted just 29% of their shares).

law generally prohibits shareholders from severing their voting rights from their right to receive corporate cash flows. This means that rationally apathetic investors must either incur costs associated with voting or let their rights go unused, which dilutes the influence of other investors' votes. In a better world, shareholders who did not value their votes could sell them to shareholders who do (controlling for gamesmanship by wealthy shareholders with idiosyncratic interests),[27] but the law generally prohibits shareholders from selling their votes independent of their shares.[28] This means that voting rights are rarely optimally distributed across shareholders, which leads to inefficiencies that depress the total value of the company.

This paper argues that nonvoting shares can be used to distribute voting rights to shareholders who value them most, allowing companies and investors to unlock the same efficiency gains that would result if votes could be traded on a market. Specifically, nonvoting shares can be used to allocate voting power to informed investors who value their voting rights and are motivated to use them to maximize the firm's value. For that reason, the presence of nonvoting shares may entice informed investors—think Warren Buffett—to invest in the company because they will get more influence for less.

Likewise, funneling nonvoting shares to uninformed and "weakly motivated" shareholders will make all shareholders better off. At the outset, it is important to emphasize the incentive problems that cause weakly motivated shareholders to not value their right to vote in corporate elections. These shareholders—whether they be retail shareholders or passively managed mutual funds ("passive funds")—prefer to free ride off of other investors because of acute collective action problems that make it irrational for them to invest in learning about the company and the matters at issue at shareholder elections.[29]

Take the example of passive funds. Passive funds, which include index funds and exchange traded funds ("ETFs"), often qualify as weakly motivated voters because of their investment strategy: they seek only to replicate the performance of a

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[27] For discussions of voting markets, *see* Eric Posner & E. Glen Weyl, *Quadratic Voting as Efficient Corporate Governance,* 81 U. CHI. L. REV. 251 (2014); Saul Levmore, *Voting with Intensity*, 53 STAN. L. REV. 111, 123-24 (2000); Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 852-54 (2006).

[28] *See Commonwealth Assocs. v. Providence Health Care, Inc.*, 641 A.2d 155, 158 (Del. Ch. 1993) (expressing doubt that, "in a post record-date sale of corporate stock, a negotiated provision in which a beneficial owner/seller specifically retained the 'dangling' right to vote as of the record date, would be a legal, valid and enforceable provision, unless the seller maintained an interest sufficient to support the granting of an irrevocable proxy with respect to the shares"). Developments in financial instruments, however, have made it possible for investors to decouple economic ownership of shares and voting rights. *See* Henry Hu & Bernard Black, *The New Vote Buying*, *supra* n. []. In other words, it is possible for investors to use financial instruments to "buy" votes without increasing their economic ownership of a company. This decoupling could allow votes to move to better informed hands and therefore enhance the effectiveness of shareholder oversight. *See id.* But "empty voting" can also harm the company when an investor with a neutral or negative financial interest in the company nonetheless controls the outcome of a shareholder vote. *See id.* at 821.

[29] *See* Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting*, __ J. OF CORP. L.___ (forthcoming 2018).

market index, not outperform it. For this reason, these funds will not benefit from incurring expenditures to monitor and improve the performance of the companies in their large portfolios. In fact, any investment in stewardship or voting is guaranteed to harm a passive fund's relative performance—all rival funds will benefit from the investment, while only the activist fund will bear the costs.[30] And because passive fund investors are particularly fee sensitive, any increase in fees will drive investors to rival funds.[31]

Because of collective action problems, we expect that passive funds and retail shareholders would only rarely vote in shareholder elections. And when they do vote, their lack of information, coupled with pro-management biases and other conflicts of interest, make it unlikely that their vote will be value-enhancing for the company.[32]

And yet, when a company has only a single class of shares, informed shareholders who highly value their right to vote end up with the same investment as weakly motivated voters, who do not. Therefore, weakly motivated voters impose a deadweight loss on corporate governance in three main ways. First and most important, agency costs increase when weakly motivated voters dilute the voice of the informed voters because it will be more costly and difficult for informed voters to discipline management. Second, the company experiences higher transaction costs when it must manage voting for a larger group. And third, when the weakly motivated voters have a large enough segment of the voting power and choose to exercise it,[33] the risk that they will move the company in the wrong direction increases.

Issuing nonvoting stock can enable a company to avoid these costs and therefore minimize the firm's cost of capital. By issuing two classes of stock—one with voting rights, one without[34]—a company can reduce agency costs by making management more accountable to its informed investors while minimizing the transaction costs associated with voting. In this way, nonvoting stock can function as a bonding

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[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] Although retail shareholders do not vote very often, passive funds do, either out of a mistaken sense of their fiduciary obligations to investors, or to benefit their other investments. *See id.* And the rapid growth of passive investment vehicles means that their influence is growing quickly. Already, some S&P 500 companies have passive fund ownership in excess of 20%. In addition, the growth of passive investing has given the institutional investors that dominate the passive fund market a substantial voice in corporate governance: together, Vanguard, BlackRock, and State Street Global Advisers, whose portfolios primarily consist of passive funds, constitute the largest shareholder of 88% of major U.S. companies. *See id.*; Eric A. Posner, Fiona M. Scott Morton, & E. Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, ANTITRUST L. J. (forthcoming 2017) (manuscript at 7).
[34] Although this paper focuses on nonvoting stock, low-voting stock can also be used to promote efficient corporate governance. However, there are a few reasons to believe that nonvoting stock is actually a superior tool. Most important, low-voting stock does not always trade at a discount to voting stock, meaning that it is less likely that beneficial sorting will occur between informed and uninformed voters. *See Price Differentials Between Voting and Nonvoting Stock,* Stout Advisory Services, available at: https://www.stoutadvisory.com/insights/article/price-differentials-between-voting-and-nonvoting-stock.

mechanism by signaling to potential investors that management would be especially attuned to the interests of its informed voting shareholders. The strategy is simply to channel uninformed investors to nonvoting stock.

And happily, market forces will accomplish much of this channeling because nonvoting stock generally trades at a discount to voting stock, despite having the same rights to dividends and cash flows.[35] Therefore, weakly motivated voters who by definition do not value their vote should gravitate toward the discounted stock. Likewise, informed investors will generally pay a premium to buy the voting stock, especially because the informed investors will be able to acquire influence more cheaply without weakly motivated voters diluting the votes. From an agency cost perspective, therefore, management can be understood as attracting capital at low cost with this capital structure, which will entice informed outside investors to purchase voting shares.

There are, of course, complications. Not all weakly motivated voters will gravitate toward nonvoting stock—some may prefer voting stock for its option value, anticipating a future takeover or the risk of disparate treatment. In addition, some weakly motivated passive funds may purchase voting stock because their indexing strategy requires them to do so. But even minimal dilution of weakly motivated shareholder voting power should improve the value of the firm by reducing agency and transaction costs; in other words, imperfect channeling is better than none at all.

Another complication is that the effect of issuing nonvoting stock has generally been to keep voting control with company insiders, rather than empower outside investors. However, experimentation in dual-class company structuring has only just begun; fifteen years ago, only family-owned companies dared to offer low-voting stock, and nonvoting stock was even more rare. And over time, the growing concentration of wealth, and thus, voting power, in passive funds should increase the attractiveness of company structures that concentrate voting power with informed investors.

The insights developed in this paper have important implications for policy issues currently facing regulators, stock exchanges, and stock indices. First, this analysis indicates that proposals to restrict or deter companies from issuing nonvoting stock should be rejected. As discussed, nonvoting stock can be used to lower a company's cost of capital. Restricting such companies from issuing nonvoting stock will therefore increase costs, worsen performance, and lead to declining competitiveness. And these costs will only increase as investors continue to flock to passive investment vehicles.[36]

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[35] *See id.*

[36] *See, e.g.* Tom McGinty, Sarah Krouse, & Elliot Bentley, *Index Funds are Taking Over the S&P 500*, WALL ST. J. (Oct. 17, 2016); Jason Zweig, *Are Index Funds Eating the World?*, Wall St. J. (Aug. 26, 2016); John Authers & Chris Newlands, *Exchange Traded Funds: Taking Over the Markets*, FIN. TIMES (Dec. 6. 2016).

A second implication of this analysis is that if the law were to take a stand against companies who issue nonvoting shares, a better approach would be to restrict companies from issuing *only* nonvoting stock to the public. That is so despite the fact that such structures, such as Snap's, may be efficient at the time of the offering. It may be that initially, the benefits of allowing the founders to run the company without shareholder interference exceeded the costs. But over time, the prospect for agency costs and other inefficiencies increases because the benefits of the dual-class structure likely recede over time.[37] Moreover, most dual-class structures enable the controllers to continue to reduce their equity ownership without relinquishing control.[38] This further worsens the controllers' incentives to maximize shareholder value. And yet, without votes, the outside shareholders will lack important legal mechanisms to influence the direction of the company, such as the right to nominate directors or vote against them. In addition, the company's outside shareholders will lack information about what the company's insiders are doing. Therefore, regulators and stock indices could perhaps make investors (and regulators who must monitor companies who disclose less information) better off by prohibiting companies from offering only nonvoting shares to the public.

This paper proceeds as follows. Part II provides a brief history of the use and regulation of dual-class company structures. It shows that the surge in dual-class companies corresponds with a major change in the shareholder landscape: the rise of institutional ownership and influence. Part III offers an overview of both sides of the debate over dual-class structures and demonstrates that they have ignored important benefits that nonvoting shares provide, specifically, that nonvoting shares can be used to lessen a corporation's agency costs, transaction costs, and reduce the likelihood of misguided corporate changes. It posits that, so long as both classes of stock are available to the public, beneficial sorting should occur: weakly motivated voters will have an incentive to buy discounted nonvoting stock and informed voters will be willing to pay a premium for the right to influence the direction of the company. Part IV discusses implications for law. Part V concludes.

II. BACKGROUND ON DUAL-CLASS SHARES

Academics and regulators have debated whether and how to regulate dual-class shares for the past hundred years. In the sections that follow, I briefly map the history of dual-class companies and attempts at regulation.[39] I then discuss the current controversy over nonvoting shares and proposals to restrict or deter companies from offering them to the public.

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[37] *See* Bebchuk & Kastiel, *supra* note [].

[38] *Id.*

[39] The paper focuses on dual class structures in the United States, although such structures are more common in other parts of the world. For instance, in European countries where family-owned businesses are prevalent, such as France and Italy, the dual class structure is very common. *See* Kate Bentel & Gabriel Walter, *Comparative Corporate Governance and Financial Regulation* (2016), available at: http://scholarship.law.upenn.edu/fisch_2016/217. Some countries take a more restrictive approach, requiring that corporate structures follow the one-share-one-vote system, including Russia, India, and South Korea. *Id.*

A. A Brief History of Dual-class Company Regulation

Dual-class companies depart from the "one-share, one-vote" rule by issuing different classes of common shares with unequal voting right, but equal or similar entitlements to earnings.[40] Although one-share, one-vote is the default under state corporate law, it has never been mandatory.[41] In fact, in the mid-1800s, before the adoption of general incorporation statutes, the common law rule was that corporations would follow a system of per capita voting, which required one vote per person.[42] Eventually, the common law rule became irrelevant as state legislatures took control over corporate charters. These legislative charters varied: some embraced one-share-one-vote, others limited the voting rights of large shareholders, such as by capping the number of votes that any one shareholder could cast.[43]

But by the 1900s, in the face of evidence that mandatory limits on a shareholder's ability to accumulate voting power made it difficult for companies to attract capital, states began to converge on a one-share, one-vote default.[44] This left corporations free to deviate from the statutory standard, and many did.[45] However, the growing prevalence of dual-class companies led to opposition from the public, as well as prominent academics.[46] The stock exchanges also took notice, and in 1926, the NYSE refused to list a company that issued nonvoting stock for the first time.[47]

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[40] Companies with dual class shares have different classes of common shares with unequal voting rights but equal or similar entitlements to earnings. Typically in the United States, high vote shares have ten times the votes as low vote shares, but other structures are possible, such as when the high vote class elects the majority of the board and the low vote class elects a minority of the board.

[41] *See Stephen Bainbridge*, *The Scope of the SEC's Authority Over Shareholder Voting Rights*, UCLA School of Law Research Paper No. 07-16, *available at*: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=985707; Del. Code Ann. Tit. 8 § 151 (authorizing a corporation to have different classes of stock with such rights, powers, and preferences as may be set forth in the certificate of incorporation or the board, if the certificate gives the board that power).

[42] Ashton, *supra* note [] at 890.

[43] Bainbridge, *SEC's Authority*, *supra* note [] at 4.

[44] *Id.* at 5.

[45] A variety of reasons have been noted for the preference for nonvoting stock during those years, including "(1) the investor-speculator's dual demand for a share in the huge profits earned by industry during the period and the appearance of security greater than that offered by the common share; (2) the desire of management to raise additional capital when it was easy to do so while retaining full control of the corporation; and (3) a vaguely felt or implied desire on the part of bankers and investors to have something new." Jeffirey Kerbel, *An Examination of Nonvoting and Limited Voting Common Shares-Their History, Legality, and Validity*, 15 SEC. REG. L. J. 37, 47-50 (1987). And as the use of nonvoting stock became increasingly prevalent, courts generally acquiesced to its use on the basis of freedom to contract. *See* Ashton, *supra* n. [] at 892 (collecting cases).

[46] William Ripley, a professor of political economics at Harvard, was the most prominent proponent of equal voting rights and wrote many articles and speeches designed to stop transactions that "disenfranchised" shareholders. His efforts eventually attracted the attention of President Coolidge. The public, too, grew increasingly hostile toward the use of nonvoting stock, especially after a sale by Dillon, Reed, & Company of Dodge Brothers debentures that enabled Dillon, Reed to retain voting control of the company for itself. *Id.* at 892.

[47] Bebchuk and Kastiel, *supra* n. [] at 9; *see also* Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 693–707 (1986). Nonetheless, dual class structures remained popular—in the years between 1927 and 1932, at least

This ad hoc decisionmaking materialized into a formal rule by 1940, when the NYSE adopted a listing requirement that excluded dual-class companies from the exchange.[48] This policy remained for six decades, until General Motors was permitted to issue restricted shares in conjunction with its acquisition of Electronic Data Systems Corporation in 1984.[49]

Around the same time, the NYSE designated a subcommittee to recommend a policy regarding dual-class listings.[50] The result was a policy proposal requiring two-thirds of shareholders to approve the creation of a second class of stock, in addition to approval by a majority of independent directors, the maintenance of a 10:1 ratio of voting rights between the enhanced shares and the second class of shares, and a requirement that all other rights between the shares be substantially the same.[51] If these conditions were met, the NYSE would list the shares.

This new policy, as well as a resurgence in the use of dual-class offerings brought on by the 1980s takeover wave, triggered new scrutiny by the SEC.[52] In 1988, the SEC promulgated Rule 19c-4, which restricted the NYSE, the AMEX, and NASDAQ from listing or continuing to list companies that departed from the one-share, one-vote default unless certain circumstances were met.[53] Specifically, the rule permitted issuers to offer new classes of nonvoting stock, or a special class with limited voting rights, provided the issuance did not dilute the voting power of existing shareholders.[54] Rule 19c-4 also permitted the issuance of a second class of stock in the context of a merger or acquisition with a bona fide business purpose.[55]

The SEC asserted that it had the authority to adopt the rule based on Securities Exchange Act § 19(c), which permits the agency to amend exchange rules provided that the action furthers the Act's purposes. The SEC contended that § 14(a) of the Act embodied the purpose of protecting corporate democracy.[56] The D.C. Circuit disagreed, ruling in *Business Roundtable v. SEC* that § 14(a) did not give the SEC power to regulate substantive aspects of shareholder voting, but only to regulate the

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288 corporations issued non-voting or limited voting rights shares (which was almost half of the total number of such issuances). Bainbridge, *SEC's Authority*, *supra* note [] at 7.

48 Ashton, *supra* note [] at 893.

49 *Id.* at 893-94. It appears that increased takeover activity may have prompted the stock exchange's decision to reconsider the policy. That, and the fact that an increasing number of family-run companies wished to access the public equity markets where share values were at record highs. Dual class structures were the only means of gaining access without diluting their control. Id. For these reasons, competitor stock exchanges with less restrictive dual class listing standards were attracting corporate listings and diluting the NYSE's market share.

50 *See* Seligman, *supra* note [], at 701-06.

51 *See NYSE's Proposed Rule Changes on Disparate Voting Rights*, 18 SEC. REG. & L. REP. (BNA) 1389 (Sept. 19, 1986).

52 Bebchuk and Kastiel, *supra* note [] at 10.

53 Bainbridge, *SEC Authority*, *supra* note [] at 8.

54 Ashton, *supra* note [], at 899.

55 *Id.*

56 Bainbridge, *SEC Authority*, *supra* note [] at 8.

procedures by which proxy solicitations are conducted, as well as proxy voting disclosure.[57]

Therefore, after 1990, companies were largely free to depart from the one-share, one-vote rule.[58] But before 2004, companies rarely chose to do so, with certain notable exceptions, including the New York Times and News Corp.,[59] which contended that the dual-class structure helped protect journalistic integrity;[60] closely held companies such as Berkshire Hathaway; and family-owned companies such as Ford.[61]

In 2004, Google became the first technology company to adopt a dual-class structure for the explicit purpose of keeping control of the company in the hands of the founding group.[62] To accomplish that purpose, only the low-vote shares (which had 1/10th of the voting power as the Class B shares held by the insiders) were sold to the public. In a letter to the public, the founders explained, "After the IPO, Sergey, Eric and I will control 37.6% of the voting power of Google, and the executive management team and directors as a group will control 61.4% of the voting power. New investors will fully share in Google's long term economic future but will have little ability to influence its strategic decisions through their voting rights."[63]

Since 2004, other technology companies have followed suit, either going public with dual-class structures, or engaging in stock splits to help founders maintain control. For example, in 2012, Facebook went public offering only Class A shares with a single vote per share to the public, in contrast with the Class B shares, which had ten votes and were owned exclusively by Facebook insiders. After the IPO, Facebook's CEO, Mark Zuckerberg, held over 50% of the voting power of the company despite owning less than 10% of the economic value. "This concentrated

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[57] *Bus. Roundtable v. SEC*, 905 F.2d 406, 408 (D.C. 1990).

[58] The NYSE and other major U.S. stock exchanges prohibit recapitalizations that reduce the voting rights of existing shareholders. Thus, companies that wish to remain listed are permitted issue new classes of low or nonvoting stock but they are not able to reduce the voting rights of existing stock. See Stephen Bainbridge, *Revisiting the One Share/One Vote Controversy: The Exchanges' Uniform Voting Rights Policy*, 22 SEC. REG. L. J. 175, 176 (1994).

[59] Ironically, News Corp. is the parent company of Dow Jones, the index publisher that has refused to list dual class companies.

[60] Landon Thomas, Jr., *Morgan Stanley Criticizes Stock Structure of Times Co.*, N.Y. TIMES, (Nov. 6, 20160, available at: http://www.nytimes.com/2006/11/04/business/04times.html (explaining that the structure of the New York Times Company has been in place since before the company went public in 1969 and was intended to protect the newsroom from interference). The newspaper companies usually allow the public shareholders to elect a minority of the board seats (4 in the case of the New York Times), while the insiders elect the remaining 9. *Id.*

[61] *See* Edward Kamonjoh, Investor Responsibility Research Ctr. Inst., Controlled Companies in the Standard & Poor's 1500: A Follow-up Review of Performance & Risk 84–87 (Mar. 2016), https://irrcinstitute.org/wp-content/uploads/2016/03/Controlled-Companies-IRRCI-2015-FINAL-3-16-16.pdf (listing companies with dual class structures).

[62] This paper refers to Google, although the company is now technically Alphabet Inc., after a 2015 corporate reorganization.

[63] *See* Alphabet Investor Relations, 2004 Founders' IPO Letter, available at: https://abc.xyz/investor/founders-letters/2004/ipo-letter.html

control," the company wrote in the S-1, "will limit [the investors'] ability to influence corporate matters for the foreseeable future."[64]

More recently, in April 2016, Facebook announced that it would engage in a 3-1 stock split by issuing two Class C shares with zero voting rights for every share of Class A and B stock.[65] Unsurprisingly, shareholders ratified the plan at the company's annual meeting on June 20, 2016, but the board stalled in issuing the stock because of pending litigation in the Delaware Court of Chancery. Two groups of shareholders had filed complaints alleging that the stock split was an attempt to entrench Zuckerberg, who only last year announced that he planned to give away 99% of his wealth, most of which is Facebook equity.[66] In September 2017, Facebook announced that it would abandon the stock reclassification plan, mooting the litigation.[67]

Google, too, faced shareholder litigation after it engaged in a stock split in 2012. Rather than simply doubling the number of shares outstanding as is traditionally done in stock splits, Google took the opportunity to create a new class of nonvoting shares.[68] By distributing a Class C share for every outstanding Class A and Class B share, the split allowed the founders to maintain their voting control, while creating additional equity to use for compensation and acquisition purposes. Some of Google's large institutional investors objected to the arrangement and sued Google in the Delaware Court of Chancery. The litigation eventually settled and the split went forward, but Google agreed in the settlement that if the Class C shares traded at a discount greater than 1% of the Class A shares at the end of the first year, the shareholders were entitled to compensation.[69] By the end of the year, the shares were trading at a discount of 1.4%, requiring Google to pay out more than $500 million to the Class C shareholders.[70]

The prospect of litigation has not deterred other technology companies from utilizing dual-class structures. Since 2004, several prominent tech companies, including Groupon, LinkedIn, Yelp, and Zynga, have gone public issuing only low-

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64 Facebook, Inc., Form S-1 Registration Statement (Feb. 1, 2012), available at: https://www.sec.gov/Archives/edgar/data/1326801/000119312512034517/d287954ds1.htm

65 *See* Charles Kane, *What Facebook's Latest Stock Move Means for Investors and the SEC*, FORTUNE (May 7, 2016), available at: http://fortune.com/2016/05/07/facebook-stock-mark-zuckerberg-sec/.

66 *See* Class Action Complaint, *McGinty v. Zuckerberg*, Delaware Court of Chancery, available at: http://www.professorbainbridge.com/Facebook_complaints/facebookmcginty.pdf; Class Action Complaint, *Levy v. Zuckerberg*, available at: http://www.professorbainbridge.com/Facebook_complaints/facebookcomplaintericlevy.pdf. That litigation is still pending before the Court of Chancery.

67 Facebook, Inc. Form 8-K (Sept. 22, 2017), available at: https://www.sec.gov/Archives/edgar/data/1326801/000132680117000042/form8k_92217.htm.

68 *See* Stephen Davidoff Solomon, *New Share Class Gives Google Founders Tighter Control*, N.Y. TIMES (Apr. 12, 2013), available at: https://dealbook.nytimes.com/2012/04/13/new-share-class-gives-google-founders-tighter-control/

69 *See* Google, Inc., Current Report on Form 8-K (filed Oct. 30, 2013) (reporting that the Delaware Court of Chancery approved the settlement entered into by the company, its board of directors and the plaintiffs in the class action captioned In Re: Google Inc. Class C Shareholder Litigation, Civil Action No. 7469-CS).

70 *Id.*

voting stock to the public.[71] Other companies, such as Under Armour and Zillow, engaged in stock splits and issued nonvoting stock as a tool to prevent the founding group's control from being diminished in the future.[72]

Despite the increasing popularity of nonvoting stock in stock splits, no company had been willing to offer only nonvoting stock to the public in an IPO.[73] But in March, Snap did just that. The company utilized a three-tiered structure, reserving its two classes of voting stock for company insiders, with the super-voting stock remaining with the company's two young co-founders. As a result of this structure, the founders hold 88.5% of the company's voting power, but only 18.7% of the outstanding equity.[74]

When Snap announced its plans, many wondered why investors would invest in a company with such an unfriendly governance structure.[75] And yet, Snap closed its first day of trading up 44% from its IPO price.[76] In other words, investors, including the large institutional investors who vocally opposed the nonvoting dual-class structure, were not deterred from purchasing shares.

Although no other company has followed Snap's example, other companies utilized nonvoting stock in their public offerings in the months that followed. Since Snap's IPO, two companies—Blue Apron and Altice—have utilized a triple-class structure, authorizing single-vote Class A shares for the public, super-voting class B shares for insiders, and a reserve of Class C shares with no voting rights that could be issued in the future.[77]

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[71] *See* Bebchuk and Kastiel, *supra* n. [] at 8 (reporting that since 2004, Facebook, Groupon, LinkedIn, Trip Advisor, and Zynga all adopted a dual class structure in their public offerings).

[72] *See* Angela Chen, *Zillow Approves Dividend, Creates C Class of Stock*, WALL. ST. J. (July 21, 2016, available at: https://www.wsj.com/articles/zillow-approves-dividend-creates-c-class-of-stock-1437512241; Miriam Gottfried, *A Double-Digit Return is Hiding in Plain Sight at Under Armour*, Wall St. J. (Nov. 28, 2016). Under Armour was sued by its shareholders following the split and eventually settled claims that the board of directors breached its fiduciary duties in approving the issuance of non-voting Class C shares through a stock split of current Class A shareholders' shares and amending the company's charter. The judicially approved settlement order awarded a $59 million dividend to Class C shareholders, designed to account for losses as a result of the split. *See* In re: Under Armour Shareholder Litigation, Case No. 24-C-15-003240 (Circuit Court, Baltimore County MD); Under Armour Form 10-K (Feb. 19, 2016), available at: https://www.sec.gov/Archives/edgar/data/1336917/000133691716000064/ua-20151231x10k.htm#sB757DF0B726DA0FE59E7C4E24B684F99

[73] *See* Snap Inc., Amendment No. 2 to Form S-1 Registration Statement 4 (Feb. 16, 2017) ("To our knowledge, no other company has completed an initial public offering of non-voting stock on a U.S. stock exchange.").

[74] *Id.* This control only goes away when both die or if they sell off 70% of their super-voting shares. Moreover, if one of the founders were to die, a proxy arrangement specifies that voting control would transfer to the other.

[75] *See supra*, n. [].

[76] Maureen Farrell, Corrie Driebusch and Sarah Krouse, *Snapchat Shares Surge 44% in Market Debut*, WALL ST. J. (March 2, 2017).

[77] *See* Tom Zanki, *More Companies Authorizing Dual Class Shares Despite Resistance*, Law360 (July 12, 2017), available at: https://www.law360.com/capitalmarkets/articles/943458.

B. Recent Calls for Reform

The surge in dual-class stock listings in the United States has generated heated opposition from institutional investors, lawmakers, and investor advocacy groups. Their concerns are reminiscent of complaints levied at the start of the 20th century: these critics argue that creating a wedge between an investor's economic interest the company and voting power not only decreases the controller's incentives to maximize the share price, but also reduces her accountability to the majority shareholders.[78]

In light of the SEC's limited ability to regulate dual-class listings following *Business Roundtable*, these critics have directed advocacy efforts to the stock indices. Most vocally, CII, an organization of more than 140 public, union, and corporate pension funds, has petitioned the U.S. indices—the S&P Dow Jones Indices, MSCI Inc., and FTSE Russell—to adopt a one-share, one-vote policy since 2012.[79] Under their proposed policy, the indices would bar companies with nonvoting stock unless they incorporate sunset provisions that would terminate the dual-class structure

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[78] The empirical evidence on this subject is mixed. *Compare* Paul A. Gompers et al., *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. Stud. 1051, 1051–54 (2010) (founding evidence that U.S. dual class companies exhibited increased agency costs and reduced value from 1995 to 2002); *with* Ronald C. Anderson et al., *The Dual Class Premium: A Family Affair* (Aug. 14, 2017). Fox School of Business Research Paper No. 17-021, available at: https://ssrn.com/abstract=3006669 (finding that dual class structures yield excess stock returns of nearly 350 basis points per year, suggesting that on average, these structures do not harm outside investors); Valentin Dimitrov & Prem C. Jain, *Recapitalization of One Class of Common Stock into Dual-Class: Growth and Long-Run Stock Returns*, 12 J. CORP. FIN. 342, 346–47 (2006) (suggesting that dual class structures might have some positive effects); *and* Scott W. Bauguess et al., *Large Shareholder Diversification, Corporate Risk Taking, and the Benefits of Changing to Differential Voting Rights*, 36 J. Banking & Fin. 1244, 1244–46 (2012) (same). Indeed, a recent empirical study commissioned by CII concluded only that dual-class companies did feature a meaningful increase in long term value relative to their single-class company peers. *See* Gabriel Morey, *Multi-Class Stock and Firm Value* (May 2017), available at: http://www.cii.org/files/publications/misc/05_10_17_dual-class_value_summary.pdf. *Cf.* R.C. Anderson, *Founding family ownership and firm performance: evidence from the S&P 500*, J. OF FIN. 58, 1301–1327 (2003) (concluding that family-owned firms performed better than firms that were not family owned). For an extensive survey of the empirical evidence evaluating dual class structures, *see* Renée Adams & Daniel Ferreira, *One Share-One Vote: The Empirical Evidence*, 12 REV. FIN. 51 (2008).

[79] *See* Letter from the Council of Institutional Investors to NASDAQ (Oct. 2, 2012), available at: http://www.cii.org/files/issues_and_advocacy/correspondence/2012/10_02_12_cii_letter_to_nasdaq_dual_class_stock.pdf; Letter from the Council of Institutional Investors to NYSE (Oct. 2, 2014), available at: http://www.cii.org/files/issues_and_advocacy/correspondence/2012/10_02_12_cii_letter_to_nasdaq_dual_class_stock.pdf. Ironically, many of the companies that create these indexes are CII members. *See* Council of Institutional Investors, General Members, available at: http://www.cii.org/general_members.

CII's advocacy is not confined to those IPOs with dual-class shares listed on the U.S. stock indexes. It also is attempting to persuade the Singapore, Hong Kong, and London stock exchanges not to allow dual-class share structures of any kind. *See* Council of Institutional Investors, Dual Class Stock, available at: http://www.cii.org/dualclass_stock (collecting letters). Notwithstanding these lobbying efforts, Hong Kong's stock exchange recently reversed a long-standing policy excluding dual class companies in an attempt to attract technology company listings. S*ee* Benjamin Robertson, *Hong Kong Targets Next Alibaba in Revamp of IPO Rules*, Bloomberg Markets (Dec. 15, 2017), available at: https://www.bloomberg.com/news/articles/2017-12-15/hong-kong-moves-toward-dual-class-shares-wooing-next-alibaba.

within three to five years of the issuance.[80] This policy, if implemented, would be a strong deterrent for any company considering whether to issue nonvoting shares because being listed on an index creates substantial demand for the company's equity.[81]

CII's advocacy is not limited to major stock indices—it has also written open letters to companies, including Snap and Blue Apron, asking them to abandon their dual-class IPOs or convert all dual-class structures unless the low-voting share class votes to extend it.[82] CII has also made its case to the Securities and Exchange Commission's Investor Advisory Committee, which held a meeting on March 9, 2017 centering on Snap's multi-class structure.[83]

Large and influential investors have also expressed opposition to dual-class structures.[84] For example, the California Public Employees' Retirement System ("CalPERS"), the largest U.S. pension fund, has threatened to boycott any dual-class listing that allows a minority of shareholders to control a majority of the votes.[85] The Investor Stewardship Group, a collective of some of the largest U.S. institutional investors, including BlackRock, Vanguard Group, T. Rowe Price, and State Street Global Advisors, have taken a position against dual-class companies in their January 2017 stewardship code. That code, called the Framework for Promoting Long-Term Value Creation for U.S. Companies, states as a core corporate governance principle that "shareholders should be entitled to voting rights in proportion to their economic interest."[86] Separately, T. Rowe Price, a large asset management firm, has threatened to vote against directors at dual-class companies unless they take action to reclassify the shares.[87]

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[80] *Id.*

[81] *See, e.g.*, Tom McGinty, Sarah Krouse, & Elliot Bentley, *Index Funds Are Taking Over The S&P 500*, WALL ST. J. (Oct. 17, 2016), available at: http://www.wsj.com/graphics/index-funds-taking-over-sp-500/.

[82] *Id.*

[83] In that meeting, a representative of CII, as well as certain institutional investors, urged the SEC to use its regulatory authority over the exchanges to limit the ability of companies to have dual class structures. Kurt Schacht, the Chair of the Securities and Exchange Commission's Investor Advisory Committee, agreed, describing Snap's structure as "a significant concern" and a "troubling development from the perspective of investor protection and corporate governance" if it were to spur a new trend for tech companies going. See David Berger, *Dual Class Stock and Private Ordering: A System That Works*, Harvard Law School Forum on Corporate Governance and Financial Regulation, available at: https://corpgov.law.harvard.edu/2017/05/24/dual-class-stock-and-private-ordering-a-system-that-works/https://corpgov.law.harvard.edu/2017/05/09/secs-investor-advisory-committee-airs-concerns-over-multi-tiered-offerings-following-snaps-ipo/

[84] *See* Bebchuk and Kastiel, *supra* n. [].

[85] Shanny Basar, *CalPERS Sets Sights on Dual-Class Stock Structures*, WALL ST. J. (Aug. 20, 2012), available at: https://www.wsj.com/articles/SB10000872396390443855804577601271252759472. The California State Teachers' Retirement System ("CalSTRS") and the Florida State Board of Administration ("Florida SBA") have made similar threats. Bebchuk and Kastiel, *supra* n. [].

[86] *See* Investor Stewardship Group, Corporate Governance and Stewardship Principles, Harvard Law School Forum for Corporate Governance and Financial Regulation (Feb. 7, 2017), available at: https://corpgov.law.harvard.edu/2017/02/07/corporate-governance-and-stewardship-principles/

[87] Ross Kerber, *U.S. Investor Group Urges Halt to Dual-Class Structures in IPOs*, REUTERS (March 23, 2016), available at: http://www.reuters.com/article/us-usa-ipo-votingrights-idUSKCN0WP1Q0.

Proxy advisor firms have also expressed strong opposition to dual-class structures. For example, Institutional Shareholder Services ("ISS") has denounced them as "an autocratic model of governance."[88] It has also proposed to amend its voting policies to recommend that shareholders vote against director nominees at companies that have completed an IPO with a dual-class capital structure unless there is a reasonable sunset provision.[89]

This wave of advocacy has begun to have an effect. In July 2017, FTSE Russell announced that it would bar companies from inclusion in its indices unless at least 5% of the voting rights were in the possession of public shareholders.[90] As a result, both Snap and Blue Apron, which went public with less than 2% of its voting rights held by public shareholders, have been excluded from its indices.[91]

Just days later, S&P 500 Dow Jones announced that going forward, the S&P 500, S&P 600, and S&P 400 indices will no longer admit companies with multiple share class structures.[92] This meant that Snap would be excluded, although existing dual-class companies, such as Facebook and Google, would be grandfathered into the indices. Other indices are considering whether to follow suit.[93]

These decisions dealt a major blow to Snap and provided a powerful deterrent to other companies considering whether to utilize nonvoting stock. That is because index funds, which make up a significant percentage of demand for company shares,[94] will not buy stock that is not included on an index. As such, these policy changes impose a high financial penalty on dual-class companies that is likely to eliminate future dual-class listings in the United States.

C. Changes to the Investment Landscape

The surge in dual-class companies corresponds with a major change in the shareholder landscape. In the past fifty years, the shareholder base has consolidated in the hands of large institutional investors—mutual funds, pension funds, and hedge

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[88] Institutional Shareholder Services, Inc., *The Tragedy of the Dual Class Commons* 3 (Feb. 13, 2012), http://online.wsj.com/public/resources/documents/facebook0214.pdf.

[89] Lyuba Goltser, *ISS Proposes New 2017* Voting Policies, Harvard Law School Forum on Corporate Governance and Financial Regulation (Nov. 2, 2016), available at: https://corpgov.law.harvard.edu/2016/11/02/iss-proposes-new-2017-voting-policies/.

[90] FTSE Russell Voting Rights Consultation – Next Steps (July 2017), available at: http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf; *see also* Richard Teitelbaum, *Index Firms Take Issue With Nonvoting Rights*, WALL ST. J. (Apr. 9, 2017), available at: https://www.wsj.com/articles/index-firms-take-issue-with-nonvoting-rights-1491739227.

[91] Existing index constituents were given a five-year grace period to conform their voting structure. *Id.*

[92] S&P 500 Dow Jones Indices, S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rules, Press Release (July 31, 2017), available at: https://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjimulti-classsharesandvotingrulesannouncement7.31.17.pdf. The new policy will not affect the S&P Global BMI Indices and S&P Total Market Index, which are intended to "represent the investment universe." *Id.*

[93] *See* Teitelbaum, *supra* n. [].

[94] *See* n. [], *supra.*

funds. Now, more Americans own U.S. company stock than ever before, but they do so through investment intermediaries.[95] As a result, institutional investor ownership stakes in U.S. public companies have become increasingly concentrated. For example, twenty percent of Microsoft's equity is in the hands of its five largest shareholders, and more than a third is held by its twenty largest shareholders.[96]

But that is not all. In the past ten years, another major market change has occurred: investors have been flocking to passive funds in droves. Between 2008 and 2015, investors sold holdings of actively managed equity mutual funds worth roughly $800 billion, while at the same time buying approximately $1 trillion in passive funds.[97] This past year alone, investors withdrew $340 billion from actively managed funds and invested $533 billion into passive funds, increasing the total amount of assets invested in passive funds by 9%.[98]Assets under management in passive funds now represent $4 trillion, or 34% of the U.S. mutual fund market, up from just 4% in 1995.[99] And in the past ten years, the share of total U.S. market capitalization held by passively managed funds has quadrupled to more than 8%, or 12% of the S&P 500.[100]

This explosive growth is driven by a growing awareness of the benefits of passive funds for investors: studies have generally shown that the average actively managed mutual fund is unlikely to outperform its baseline index, despite levying much higher fees.[101] As such, the rapid growth of passive funds is predicted to continue.[102]

And already, the three institutional investors that dominate the market for passive funds—Vanguard, State Street, and BlackRock—have become powerful voices in corporate governance. In 2015, together these institutions constituted the largest owner of nearly 90% of public companies in the S&P 500, which is up from

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95 Kenneth French*, Presidential Address: The Cost of Active Investing*, 63 J. FIN. 1537 (2008). Changes in federal retirement policy were the biggest drivers of the growth of institutional investing. *See generally* Gilson and Gordon, *supra* note [] at 879; Rock, *supra* note [] at 5.

96 *See* Lucian Bebchuk, Alma Cohen, & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. OF ECON. PERSPECTIVES 89 (2017).

97 Fichtner et al., *supra* note [] at 2.

98 Tergesen and Zweig, *supra* note [].

99 *Id.* at 6.

100 Gormley et al., *Passive Investors*, *supra* note [] at 49.

101 Jeff Schwartz, *Reconceptualizing Investment Management Regulation*, 16 GEO. MASON L. REV. 521, 550-51 (2009) ("[W]hen [active managed funds'] higher costs are taken into account, the average actively managed dollar under-performs a passively managed index of securities…This account leaves open the possibility that some actively managed funds will beat the market…Much, however, conspires against the average investor picking out consistently above-average performers…. Investing in an actively managed mutual fund is betting on one horse in a very crowded field…According to one study, over a fifteen year period, 84% of actively managed mutual funds failed to yield returns in excess of the stock market as a whole.").

102 Ernst & Young has forecasted annual growth rates for the ETF industry of between 15 and 30 percent in the next few years. EY Global ETF Survey: 2015 and Beyond (Oct. 7, 2014), http://www.ey.com/Publication/vwLUAssets/ey-global-etf-survey-2015-and-beyond/$FILE/ey-etf-survey-2015-and-beyond.pdf. Likewise, PricewaterhouseCoopers estimates that assets invested in ETFs will double annually until 2020. Judith Evans and Jonathan Eley, *Democratising finance: How passive funds changed investing*, FIN. T. (2015), http://www.ft.com/intl/cms/s/0/b3c0c960-a56c-11e4-bf11-00144feab7de.html.

25% in 2000.[103] When considering all listed companies in the U.S., together these three institutions were the single largest shareholder at least 40% of the time.[104]

Scholars have questioned whether the rise of passive investing, and institutional investing more broadly, is good for corporate governance. Some, including Einer Elhauge, Eric Posner, Glen Weyl, and Fiona Morton, have posited that the rise of institutional investing may lead to anticompetitive conduct because institutional shareholders with large horizontal investments across competitor firms in concentrated industries might induce those companies to compete less aggressively.[105] Others worry that the increase in passive investing will lead to a power vacuum and corporate governance distortions at public companies.[106] As the next section demonstrates, nonvoting shares may play a role in ameliorating some of these concerns.

III. NONVOTING SHARES AND EFFICIENT CORPORATE GOVERNANCE

The dispute over the use of nonvoting shares strikes at the heart of corporate law's greatest debate: whether shareholder activism should be welcomed as a beneficial force for corporate discipline, or whether it should be viewed as a distraction from the company's long term goals. Because voting is an important component of activism, discussions about dual-class shares tend to fall into one of these camps.

Critics of nonvoting shares argue that their use increases agency costs at corporations.[107] The agency cost problem in corporate law is as follows: Shareholders finance the company and delegate control to corporate insiders—the agents—but doing so creates a conflict of interest between the insiders who make the decisions and the investors who bear the consequences. When the insiders' voting control exceeds their equity stake in the company, the misalignment of incentives between corporate insiders and shareholders is even more pronounced—the insiders will reap a disproportionately small share of the gains and losses from their decisions,[108] and so they may use their voting power to maximize their private benefits, rather than maximize the value of the company's equity.[109] This misalignment can lead to distorted investment decisions,[110] tunneling,[111] and inefficient perquisite

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[103] Posner et al., *supra* note [] at 7.
[104] Fichtner et al., *supra* note [] at 17.
[105] *See* Posner et al., *supra* note []; Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1291-1292 (2016).
[106] *See* Lund, *supra* note []; Bebchuk, Cohen & Hirst, supra n. [].
[107] *See, e.g.*, Bebchuk et al., *supra* n. []; Easterbrook and Fischel, *supra* n. [].
[108] Easterbrook and Fischel, *supra* n. [].
[109] *Id.*; *see also* Eugene Fama & Michael Jensen, *Separation of Ownership and Control*, 26 J. L. AND ECON., 327 (1983); Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).
[110] Bebchuk et al., *supra* note [].
[111] Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes, & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22 (2000). Tunneling refers to the transfer of resources from a company to its controlling shareholder. *Id.*

consumption. And when this happens, the outside shareholders that are most affected will have no recourse, aside from selling their shares.

By contrast, under a one-share-per-vote system, the corporate insiders' incentives are better aligned with the outside shareholders. To keep control, the insiders must hold a controlling equity stake, meaning that they will bear a substantial fraction of the costs and benefits of their decisionmaking.[112] If they sell down their ownership stake, the outside investors with the majority of the equity will be able to vote out management out of office when problems arise (or sell to someone who can). This provides an important check against bad behavior—the insiders will realize that if they slack or self-deal, their jobs will be at risk.

In sum, economic theory embraces proportionate voting rights as an important mechanism to help the company minimize management agency costs. Proportionate voting also facilitates the market for corporate control—if the outside shareholders face high coordination costs, they can sell their shares to an outside bidder, who can use the votes to bring in new management and run the firm more efficiently.[113]

Proponents of dual-class stock do not dispute that nonvoting stock can increase agency cost problems.[114] Instead, they contend that providing some isolation from shareholder intervention may be beneficial on balance because it allows management to pursue their long term vision of the company without distraction from shareholders with short-term incentives.[115] These proponents also argue that market pressures at the time of the offering ensure that dual-class structures will only be utilized when they are truly value-enhancing, *i.e.*, when the benefits from giving the insiders freedom from interference outweighs heightened agency costs.[116]

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[112] Jensen & Meckling, *supra* n. [] at [].

[113] Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 140 (1987) (contending that "the cost of dual class common stock is that the effectiveness of the market for corporate control as a monitoring device is reduced."); Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q. J. ECON 107 (2003) (finding that the average age of companies with dual class share structures in 2001 was 12.87 years while the average age for single-class companies was 9.60 years and positing that the explanation for this difference was that the dual class companies could resist takeovers); *see also See* Stanford Grossman and Oliver Hart, *One Share-One Vote and the Market for Corporate Control*, 20 J. FIN. ECON., 175-202 (1988).

[114] *See, e.g.*, Bernard Sharfman, *A Private Ordering Defense of a Company's Right to Use Dual Class Structures in IPOs* (July 26, 2017), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2986164 (manuscript at 15); *cf.* Albert Choi, *Concentrated Control and Long-Term Shareholder Value*, HARV. BUS. L. REV. (forthcoming 2018) (arguing that the presence of controlling shareholders may enhance the company's long-term value by inducing commitment and investment by the controlling shareholder, despite the risk of increased agency costs).

[115] *See* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L. J. 560 (2016); David J. Berger, Steven Davidoff Solomon, and Aaron J, Benjamin, *Tenure Voting and the U.S. Public Company*, 72 BUS. LAWYER (2016).

[116] Sharfman, *supra* note [] at 18-22; Ronald Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807, 808—809 (1987); Jensen and Meckling, *supra* n. [] at [] (contending that rational minority shareholders expect expropriation from the controllers and thus demand a lower subscription price when the controlling shareholder turns to the capital market for new capital).

Proponents of dual class structures also contend that they encourage controllers to access the public markets. Otherwise, the controller would be forced to remain private forever—itself an

Both sides of the debate begin with the assumption that dual-class arrangements increase agency costs. This paper departs from that view by showing that in some cases, nonvoting stock can be used to *reduce* agency costs in a corporation by allocating voting control to outside shareholders that have the best incentives to maximize the residual value of the company. In other words, nonvoting stock can be used to promote efficient corporate governance. The sections that follow explain why this is the case.

A. Weakly Motivated Voters and Nonvoting Stock

In 1976, Michael Jensen and William Meckling famously posited that there is an optimal proportion of debt and equity for any given level of equity owned by insiders that would minimize total agency costs.[117] Along those lines, this paper posits that there may be an optimal proportion of nonvoting and voting outside equity that minimizes management agency costs. That is because at most corporations, some fraction of shareholders are weakly motivated voters, or shareholders who suffer from collective action problems that make it irrational for them to become informed about the company or incur costs associated with stewardship. When these weakly motivated shareholders do vote, their lack of information coupled with conflicts of interests make it unlikely that their input will be welfare enhancing.

The quintessential weakly motivated voter is the retail shareholder, who is likely to refrain from participating in governance because the benefits of doing so are unlikely to exceed the costs.[118] But retail shareholders make up a smaller and smaller fraction of the shareholder base of the modern corporation. As discussed, the majority of shares are in the hands of institutional investors—pension funds, mutual funds, and hedge funds.[119] These investors have large stakes in their portfolio companies, which somewhat reduces their incentive to free ride.[120] That is not to say that their incentives are perfect,[121] but many institutional investors have the resources

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inefficient outcome—or control a high percentage of the equity, making it more difficult for the controller to diversify. *See* Ashton, *supra* note [] at [].

117 Jensen & Meckling, *supra* note []. Jensen and Meckling emphasize the role of debt in facilitating greater insider ownership of firm equity. With greater ownership, insiders care more about the firm's performance. But there are agency costs when debt increases arising out of the insiders' heightened incentives to reallocate wealth from the bondholders to themselves by increasing the value of the equity claim through excessive risk taking. Thus, there will be an optimal ratio of outside debt and equity for any level of internal equity that minimizes these agency costs. *Id.*

118 *See, e.g.*, Adolf A. Berle, Jr. & Gardiner C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

119 Ronald J. Gilson and Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 887 (2013).

120 *See* Lund, *supra* note []; Bernard Black, *Shareholder Passivity Reexamined*, 89 MICHIGAN L. REV. 520, 575-91 (1990).

121 Large mutual funds suffer from a new collective action problem as a result of the structure of the industry—because funds compete on the basis of relative performance, it diminishes their incentives to invest in improving the performance of any one firm. *See* Gilson, *Agency Costs*, *supra* note at 887 (discussing the collective action problem facing institutional investors). Activist hedge funds face a different incentive problem by virtue of their short investment horizon. Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 458–59 (2014) (contending that empowering investors with short-term investment horizons, such as activist hedge funds, will compromise long-term company value).

and sophistication to exercise their vote intelligently, as well as a financial incentive to invest in monitoring and stewardship. For this reason, this paper refers to these institutional investors as "informed voters."[122]

There are important exceptions. Most importantly, a large (and growing) subset of institutional investors will often qualify as weakly motivated voters—passive funds.[123] Passive funds have no financial incentive to invest in voting in an informed way because their indexing strategy requires that they match the performance of an index.[124] Indeed, informed voting would almost certaintly harm the passive fund's relative performance.

A passive fund's key comparative advantage is that it does not need to hire a team of analysts or incur the costs associated with company-specific research—this is why the fund can charge such low fees.[125] But casting an informed vote would require the fund to expend additional resources to learn about the company and evaluate the proposal. And because passive funds have very large portfolios, much larger than active funds, the cost of casting an intelligent vote at each company would have to be replicated across hundreds of companies.[126] Such expenditures would eliminate the cost savings generated by the indexing strategy and would drive investors to rival funds.

Moreover, passive funds suffer from acute collective action problems—any expenditure incurred to improve governance at one of the fund's portfolio companies will benefit all rival funds in equal measure, meaning that it is guaranteed to harm the fund's relative performance.

For these reasons, many passive funds and retail shareholders are likely to qualify as weakly motivated voters: because of collective action problems, their rational strategy is to remain uninformed about the company and free ride off other investors. It may be possible, therefore, for a company to improve its

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Finally, pension funds, whose board members are appointed by politicians or elected, are particularly sensitive to political pressure. Edward B. Rock, *Institutional Investors in Corporate Governance* (University of Pennsylvania Working Paper, July 21, 2015) (manuscript at 13).

122 *See also*, Zohar Goshen and Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 714 (2006) (referring to "information traders," or investors who are "willing and able to devote resources to gathering and analyzing information as a basis for its investment decisions" and "then trade to capture the value of their informational advantage.").

123 The term "passive funds" includes index funds and ETFs, which are designed to automatically track a market index. In addition, some actively managed mutual funds may qualify as "quasi-indexers," or funds with highly diversified holdings and low portfolio turnover. *See* German Gutierrez & Thomas Philippon, *Investment-less Growth: An Empirical Investigation*, NBER Working Paper No. 22897 (Dec. 2017), available at: http://www.nber.org/papers/w22897. In other words, although they bill themselves as actively managed, quasi-indexers essentially follow an indexing strategy and thus, are unlikely to value their vote very highly.

124 *See* Lund, *supra* n. [] at [].

125 *See* Lund, *supra* n. [] at [].

126 For example, a typical S&P 500 tracker fund will have investments in 500 companies. Actively managed mutual funds are much smaller. See David M. Smith and Hany Shawky, *Optimal Number of Stock Holdings in Mutual Fund Portfolios Based on Market Performance*, 40 FIN. REV. 481, tbl.2 (showing that in 2000, the mean number of companies in a mutual fund portfolio was 92).

competitiveness and lower its cost of capital by issuing nonvoting shares for the weakly motivated voters to buy. The next sections explain why doing so would reduce management agency costs, transaction costs, and the risk of suboptimal outcomes for the company.

i. Agency Costs

When weakly motivated voters purchase nonvoting stock, agency costs fall. To see why, consider the following example. Company A is a dual-class company, and sixty percent of Company A's stock is voting. The other forty percent is nonvoting. The insiders at Company A hold one third of the voting stock, for a total of 20%.[127] The informed outside investors hold the remainder of the voting stock, for a total of 40%, and the weakly motivated voters hold all of the nonvoting stock.

If we were to compare Company A to Company B, a company that is identical in all respects except that has only a single class of voting stock, Company A's equity will be more valuable than Company B's for a few reasons. First, Company A has reduced its agency costs by issuing the nonvoting stock because doing so has made the informed investors' votes more powerful. In other words, management at Company A knows that if it fails to act in the best interests of the shareholders, it will face discipline in the form of shareholder proposals, no votes on executive compensation, no votes in director elections, and even proxy contests. This provides a powerful incentive for management to act in the shareholders' interests. Moreover, issuing nonvoting stock will make Company A more desirable to informed investors *ex ante*, further reducing agency costs.

By contrast, at Company B, management knows that if it underperforms, it has a layer of security in the form of the weakly motivated voters. For example, if threatened with a proxy contest, management need only convince thirty-eight percent of the outside shareholders—informed and weakly motivated alike—that the company's current rocky situation is part of the long term plan in order to prevail.[128] Knowing this, management will be much less likely to change its behavior to satisfy the informed investors that are unhappy with the direction of the company.

Likewise, an informed voter knows that if Company B's management underperforms, the expenses and risks associated with imposing discipline on management will increase. And for this reason, proxy battles waged by hedge fund activists have been increasingly expensive. For example, Nelson Peltz's 2017 proxy campaign against Proctor & Gamble cost his hedge fund, Trian Partners, $30

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[127] Note that in this example, the company insiders keep a minority of the voting stock, and use the nonvoting stock to sort between informed and weakly motivated voters. This is very different than the allocation of voting power in typical dual class companies, which issue nonvoting or low-voting stock to keep voting control with insiders.

[128] Indeed, companies have shown an increased willingness to lobby their largest shareholders as a defense to activism. *See* Sonali Basak & Beth Jinks, *It's Getting Harder to Keep the Barbarians at the Gate—and It's This Guy's Job*, BLOOMBERG MARKETS (Feb. 1, 2017). Note that this analysis assumes that the company employs a majority-of-the-shares voting standard for director elections, as many do. See Stephen Choi, Jill E, Fisch, Marcel Kahan, & Edward B. Rock, *Does Majority Voting Improve Board Accountability?*, 83 U. OF CHI. L. REV. 1119 (2016).

million.[129] Most of these costs were incurred in attempts to sway retail investors and passive fund managers using websites, social media, television appearances, video recordings, automated dial in messages, and marketing pamphlets.[130]

Proctor & Gamble's expenses from the proxy battle were even greater, totaling $100 million.[131] This reveals another cost of weakly motivated voting—the company may incur expanses trying to overpower the investor base's rational apathy. By contrast, if Company A performs badly, management will be able to interface with a small group of informed investors who will already be aware of the company's problems and will be interested in finding a solution—a much less expensive task.[132] In addition, because management will more easily be able to take the temperature of its voting investors, it will be more likely to reach an agreement with informed investors, obviating the need for those shareholders to wage expensive and disruptive proxy contests.[133]

This is not to say that informed investors will always agree about what constitutes the right course of action for the company. The informed investors may have different investment strategies or goals that cause them to disagree.[134] Indeed, it may be that a vocal minority of informed investors agitate for a course of action to benefit its own short term interests.[135] But management of Company A need only be

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[129] Hamlin Lovell*, Shareholder Activism Knows No Bounds*, SRZ THE HEDGE FUND JOURNAL (Dec. 2017), available at: https://www.srz.com/images/content/1/5/v2/154113/The-Hedge-Fund-Journal-Shareholder-Activism-Knows-No-Bounds-Dece.pdf.

[130] Id. For another example, take the battle between Elliot Management and Arconic, a steel company, in which the activist hedge fund sought to install four directors at the company's annual meeting. The activist investor not only made its case to investors in presentations and meetings, it mailed thousands of mini-player devices to retail investors each with one short four-minute video explaining the activist's position at a targeted company. Ronald Orol, *Paul Singer's Activist Fund is Sending Video Players to Thousands of Arconic Shareholders*, THESTREET (May 12, 2017), available at: https://www.thestreet.com/story/14131164/1/paul-singer-s-activist-fund-is-sending-video-players-to-thousands-of-arconic-shareholders.html Management, too, solicited the retail shareholders, as well as the institutional investors, for months as the activist campaign waged on.

[131] *Id.*

[132] *See* M. Todd Henderson and Dorothy Shapiro Lund, *Index Funds Are Great For Investors, Risky for Corporate Governance*, WALL ST. J. (June 22, 2017), available at: https://www.wsj.com/articles/index-funds-are-great-for-investors-risky-for-corporate-governance-1498170623.s

[133] *See* Joseph McCahery, Zacharias Sautner, & Laura T. Starks, *Behind the Scenes: The Corporate Governance Preference of Institutional Investors*, J. FIN. (forthcoming 2016), *available at*: http://onlinelibrary.wiley.com/doi/10.1111/jofi.12393/ful (providing evidence that investors only resort to the proxy machinery when informal engagement fails).

[134] *See* Iman Anabtawi and Lynn A. Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008).

[135] Critics of this proposal will likely contend that Company A may have higher transaction costs because amplifying the power of informed investors will empower activist investors, who will use their muscle to distract and influence management, perhaps even waging a higher number of proxy battles with the company. But just as the voting power of activist investors will be amplified, the power of other informed investors, including actively managed mutual funds and pension funds, will be too. And thus, those activist investors will still have to convince smart investors with longer-term interests in the company that their course of action is warranted. Likewise, management will have a better understanding of the wishes and preferences of their informed, engaged investors and thus will be less likely to cave to an activist out of a misplaced fear that it could catalyze the voting power of a majority of shareholders. By contrast, management will be more likely to settle with an activist if it

responsive to the needs of the *majority* of the informed shareholders. And the majority of the informed shareholders is more likely to push the company in the right direction when it can be heard clearly than when it is drowned out by the voices of weakly motivated voters.

Relatedly, the market for corporate control should function more efficiently in the case of Company A. In the first place, it is difficult and costly to acquire a large voting block from disparate retail shareholders. In addition, passive funds often refuse to tender their shares to hostile acquirers, even if they believe the deal is beneficial, because the gap between the offering price and closing price would interfere with the fund's ability to track the index.[136] Thus, the greater the number of nonvoting shares in the hands of weakly motivated voters, the easier it will be to accomplish a takeover, which further reduces agency costs.[137]

ii. Transaction Costs and the Risk of Suboptimal Outcomes

Issuing nonvoting shares for the weakly motivated shareholders to buy provides two additional benefits. First, Company A will have lower transaction costs than Company B. For one, Company B must incur higher costs associated with managing a larger number of voting investors, including preparing and mailing voting materials and handling calls and questions.[138] The weakly motivated voters, too, will incur greater costs when they buy voting shares such as the costs of evaluating proposals, evaluating recommendations from third party proxy advisors, and casting votes.

Second, all shareholders should prefer Company A equity because eliminating weakly motivated shareholder voting reduces the risk of sub-optimal voting outcomes. By contrast, Company B faces the risk that the uninformed voters, if they decide to exercise their votes, will move the company in the wrong direction—a risk that is all the more likely in our modern world of passive shareholder ownership.[139]

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understands that the activist has the support of a majority of the thinking investors, obviating the need for an expensive proxy contest.

136 *See Tender Offers: The New Paradigm and SEC M&A Updates*, Morrison & Foerster Presentation (Aug. 9, 2013), available at: https://media2.mofo.com/documents/130809-tender-offers-new-paradigm-sec-ma-updates.pdf; *Some Tender Offer Quirks*, Kirkland & Ellis M&A Update (Oct. 9, 2009), available at: https://www.kirkland.com/files/MA_Update/100909.pdf.

137 *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) (positing that shareholder participation in governance is not necessary to ensure firm efficiency so long as a robust market for corporate control exists).

138 The cost of mailing the proxy statement alone is not insignificant—in 2011, Broadridge estimated that it cost 12,000 companies $425 million to simply mail the proxies to shareholders. Maxwell Murphy, *Mailing Proxy Statements Costs Companies Big Bucks*, WALL ST. J, (Feb. 21, 2012), available at: https://blogs.wsj.com/cfo/2012/02/21/mailing-proxy-statements-costs-companies-big-bucks/.
Indeed, it is because of these costs that the SEC adopted e-proxy rules that permit public companies to make proxy materials available via the internet in lieu of mailing a paper copy. But so far, these rules have not materially decreased the expenses associated with creating and distributing proxy materials.

139 Recall that weakly motivated voters are more likely to be right than wrong about the best course of action for the company. According to Condorcet's jury theorem, more votes will improve the outcome of a majority vote so long as the voters are more than fifty percent likely to be right. Thus,

Although retail shareholders rarely vote, passive funds almost always do. This is because SEC regulations dictate that fund managers have a fiduciary duty to vote when doing so is in the best interests of their investors, and this mandate has been widely interpreted as requiring mutual funds to vote.[140] Moreover, regular voting may benefit the institution that houses the passive fund, even when it does not benefit passive fund investors. For example, the institution may use its voting record to appeal to clients, such as public pension funds that generally require outside asset managers to have governance expertise.[141]

But when passive funds intervene in governance, their influence is unlikely to move the company in the right direction for two reasons. In the first place, because weakly motivated passive funds lack firm-specific information and governance expertise, they are especially likely to follow preset, one-size-fits-all voting guidelines on governance questions.[142] But there is no consensus about universal governance best practices—decades of scholarship has concluded only that good governance is endogenous to the particular firm. As such, a one-size-fits-all approach to governance imposed across vastly different firms could make many firms worse off.[143]

Moreover, weakly motivated passive funds have strong conflicts of interest. Passive fund managers, like other mutual fund managers, have their compensation tied to the amount of assets that flow into the fund, rather than the fund's performance.[144] And while actively managed mutual funds can attract investors based

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by limiting the pool to the informed, motivated voters, voting will be more likely to generate the efficiency-maximizing solution.

140 *See* Lund, *supra* n. [], at 34.

141 For example, CalPERS, the largest U.S. pension fund (with $300 billion in assets under management) states clearly in its Investment Policy that "CalPERS expects all … external managers of CalPERS capital to integrate the CalPERS Principles into investment decision making, including proxy voting…." CalPERS Total Fund Investment Policy, https://www.calpers.ca.gov/docs/total-fund-investment-policy.pdf.

142 The three largest passive fund providers—Vanguard, BlackRock, and State Street—have very similar voting guidelines that they follow closely. Each institution articulates a preference for director independence, a relationship between long-term company performance and executive compensation, and a skepticism about anti-takeover provisions and major changes to the corporation, such as mergers, reorganizations, or changes to capital structure. *See* State Street Global Advisors, *Global Proxy Voting and Engagement Principles* (March 2016), *available at*: https://www.ssga.com/investment-topics/environmental-social-governance/2016/Global-Proxy-Voting-and-Engagement-Principles-20160301.pdf; BlackRock, Global Corporate Governance and Engagement Principles (2014); Vanguard, Vanguard's Approach to Corporate Governance, https://about.vanguard.com/vanguard-proxy-voting/. These institutions also rely on ISS and Glass Lewis for certain issues, and those also follow one-size-fits-all voting policies. *See* Nathan, *Proxy Advisory Business, supra* note []. As a result, the three entities are able to achieve high consistency in voting. For example, at Vanguard in 2015, only 6 out of 100,000 proposals featured a fund voting differently than its other funds. Fitchner et al., *supra* note [], at 20-21.

143 As just one example, a recent study found that the average risk-adjusted return for companies that followed proxy advisor recommendations when adjusting compensation was 0.44% lower than firms whose changes to compensation were unrelated to proxy advisor recommendations. *See* David Larcker, Alan McCall, & Gaizka Ormazabal, *Proxy Advisory Firms and Stock Option Exchanges: The Case of ISS*, Rock Center for Corporate Governance Working Paper (2011).

144 *See* WILLIAM BIRDTHISTLE, EMPIRE OF THE FUND: THE WAY WE SAVE NOW (OUP 2016).

on past performance (and thus, future expectations of performance), passive fund managers have only two ways to compete: they can compete on the basis of fees and they can develop strong relationships with clients. And because corporate pension fund assets are one of the largest pools of capital invested in passive funds, a passive fund manager may be especially inclined to support management so as to preserve the fund's access to the company's 401(k) accounts.[145]

For these reasons, passive fund voting can result in sub-optimal outcomes for the company. Suppose that a shareholder at Company B has proposed to separate the position of Chairman from CEO.[146] The insiders vociferously oppose the proposal, arguing that splitting the position will make it harder for the board to understand business operations, which are highly technical. Sixty percent of the informed investors also disagree with the proposal for the same reasons (the others, for idiosyncratic reasons, support the proposal[147]). Eighty-six percent of the weakly motivated voters support the proposal because it aligns with their internal governance guidelines, which identify good governance standards to be applied across all portfolio companies. Fourteen percent of the weakly motivated voters follow the advice from their active fund counterparts and vote against the proposal or simply abstain. In this case, the proposal will pass, even though the clear majority of informed investors disagree with it.[148]

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These examples demonstrate why all investors should prefer Company A to Company B *ex ante*. In the first place, informed investors will understand that the agents are more likely to be attuned to shareholder interests, which will reduce monitoring costs and costs of intervention when problems emerge. Likewise, weakly

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145 *See* Simon C. Y. Wong, *How Conflicts of Interest Thwart Institutional Investor Stewardship*, BUTTERWORTHS J. INTERNATIONAL BANKING AND FIN. L. (Sept. 2011), available at: http://ssrn.com/abstract=1925485.

146 Whether to separate the CEO and chairman positions is a hotly contested issue in corporate governance. In recent years, the trend has consistently moved toward separation in spite of the fact that the literature does not consider it to be unambiguously positive. David F. Larcker & Brian Tayan, *Chairman and CEO: The Controversy Over Board Leadership Structure,* Stanford Closer Look Series (June 24, 2016), available at: https://ssrn.com/abstract=2800244. In fact, there is little research that separating the two positions improves firm performance or governance quality, and a recent study has found that forced separation due to shareholder pressure is associated with a decrease in market valuation and lower future operating performance. *See* Aiyesha Dey, Ellen Engel, & Xiaohui Liu, *CEO And Board Chair Roles: To Split or Not to Split?*, 17 J. CORP. FIN. 1595 (2011).

147 Perhaps, for example, some of the informed investors are activist hedge funds that believe that separating the CEO and chairman position will make the company an easier takeover target.

148 Although this is a simplified example for explanatory purposes, this is not an uncommon occurrence. In light of the growing market share of passive institutional investors and their largely uniform preferences regarding governance, passive funds begun already influenced voting outcomes. A recent empirical study has shown that an increase in passive fund ownership is correlated with the successful implementation of controversial shareholder governance proposals, including proposals that remove poison pills and other takeover defenses, and eliminate dual class structures. Gormley et al., *Passive Investors*, *supra* n. [] at 4-5. In addition, passive institutional investors are usually viewed as the tie breakers for close proxy contests and regularly support management even when the majority of active investors support the dissident slate. *See, e.g.*, Henderson & Lund, *Index Funds Are Great For Investors, Risky for Corporate Governance*, *supra* n. [].

motivated voters will more highly value an investment that does not require them to incur costs in becoming informed, evaluating proposals from other shareholders, and casting a vote.[149] And both informed and uninformed shareholders will benefit from a reduced risk of bad outcomes. For these reasons, a company that provides nonvoting stock for weakly motivated voters to purchase will make all parties better off.

Although offering nonvoting and voting stock is a relatively new phenomenon in U.S. public companies, the concept of unlinking voting rights and the residual interest is not. A privately held company that is solely financed by debt provides one simple example. In that case, the debt holders have a claim on the residual value, but they are given no control rights unless the company is in financial distress. Such arrangements are uncontroversial, even though the residual claimants lack both the ability to costlessly exit and exercise voice through voting.

Consider also the example of a limited partnership, which includes a general partner, as well as limited partners.[150] The general partner is tasked with managing the company's day-to-day affairs; the limited partners provides equity but are uninvolved in company operations. For this reason, the partners often agree to restrict the limited partners' voting privileges to specific issues, such as amendments to the partnership agreement. The parties may also depart from proportional voting to allocate fewer voting rights to the limited partners.[151] In other words, the parties

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[149] The "empty voting" literature reveals that derivative products have the potential to enable shareholders to efficiently decouple voting rights from economic interest, which could generate similar governance benefits. *See* Black & Hu, *supra* n. []; Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PENN. L. REV. 625 (2008). And there is evidence that passively managed funds broadly lend out their shares, which suggests that they do trade voting power for a fee. *See* Simon Moore, *How Securities Lending Makes Some ETFs Free*, FORBES (Aug. 29, 2014); Susan Kerr Christofferson, Christopher C. Geczy, David K. Musto, & Adam V. Reed, *Vote Trading and Information Aggregation*, 62 J. OF FIN. 2897 (2007). But the problem with the decoupling solution is that there is no way for companies or investors to know whether it will be used to improve corporate governance. Indeed, the more likely outcome has been for hedge funds to use derivative products to neutralize their economic interest in a company and then use their voting power to benefit other investments. *See* Black and Hu, *supra* n. []. By contrast, using nonvoting shares to improve governance avoids this risk: companies that offer nonvoting stock will continue to be controlled by shareholders with a financial interest in the company. Moreover, the dual class structure will be apparent to investors *ex ante*, who can therefore account for structure when purchasing shares. Equity decoupling, by contrast, presents a hidden risk for investors.

Although this paper assumes for the sake of simplicity that equity decoupling is not possible, it is worth noting that the continued availability of nonvoting shares could ameliorate problems associated with empty voting: Weakly motivated voters are the most likely to part with their votes. If weakly motivated voters purchase nonvoting stock, they can continue to lend their shares, but there will be less of a risk that their voting power will be used in ways that could harm the company.

[150] Some limited partnerships, such as the master limited partnership, are publically traded. In a master limited partnership, the limited partners have no voting rights at all. The general partner runs the firm, which produces a return on the limited partners' investment.

[151] As another example, consider the rise of subordinated second liens as an alternative to other forms of unsecured debt. Those liens are often called "silent second liens" because the second lien holder contractually agrees to refrain from exercising rights in bankruptcy until the holders of the senior first are paid in full. *See* Kenneth Ayotte, Anthony Casey, & David Skeel Jr., *Bankruptcy on the Side*, U. Penn Inst. For Law & Econ Research Paper No. 16-25 (2016). In other words, the junior investor and hence the residual owner voluntarily gives up control because doing so benefits all parties involved—

designing the limited partnership's structure often depart from a proportional voting system to put control in the hands of people with expertise and better information.[152]

But in the case of public companies, nonvoting stock has not yet used with the explicit purpose of enticing and empowering informed outside stakeholders. More often, companies offer nonvoting stock to all of their outside investors, including the informed investors. So, what should be done to help companies to unlock the potential of nonvoting shares? The answer is not much, as will be explained in the following sections.

B. Nonvoting Shares: Demand-Side Issues

Companies seeking to reduce agency costs and transaction costs associated with voting need only take one step: offer two classes of stock, one nonvoting and one voting, to the public. When this happens, beneficial sorting will occur because nonvoting shares generally trade at a discount, averaging 3-5%, to voting shares.[153] They are otherwise identical investments, with the same rights to dividends and cash flows. This makes them especially appealing investments for weakly motivated voters, who by definition, do not value their vote very much (if at all).[154]

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the first lien holder benefits from avoiding interference from the silent second in bankruptcy, and the silent second receives a higher interest rate. *See* David Batty & Jo Ann Brighton, *Silent Second Liens – Will Bankruptcy Courts Keep the Peace?*, 9 N.C. BANKING INST. 1 (2005).

152 However, the analysis in this paper does not extend beyond shareholder democracy to civic democtacy. First and most importantly, shareholder democracy is not really a democracy at all—votes are allocated on a per-share basis, meaning that the larger the investment, the larger the investor's voting power. That is because voting is a means to an end—efficient corporate governance. By contrast, there are important sociological justifications for voting in civic elections that are not present in the corporate context. Citizen voting is thought to further self-actualization and educate the public about important issues, among other things. Second, democratic control is more important for a civic democracy, in which legislators have substantial power over the lives of citizens, than it is for a corporate democracy. Finally, shareholders have other accountability mechanisms available to them: they can exit, sue, or rely on external and internal employment markets, capital markets, and the market for corporate control to discipline management. Citizens, by contrast, generally lack the ability to exit when displeased with government, as well as the other accountability mechanisms listed above.

153 *See* Price Differentials Between Voting and Nonvoting Stock, Stout Advisory Services, available at: https://www.stoutadvisory.com/insights/article/price-differentials-between-voting-and-nonvoting-stock. The presence of a voting premium is somewhat surprising. Most often, nonvoting shares are treated exactly the same as voting shares for cash flow purposes. They receive the same dividends, the same rights in repurchase, and the same treatment in any reorganization. And yet, investors pay a premium for voting stock for two reasons. First, in the event that the company becomes a takeover target, the value of the vote will become more valuable. Second, if a firm is underperforming, the vote will rise in value because the right to influence management will be perceived as being more valuable. For example, the market may perceive that the voting shareholders have a greater ability to use their voting power to advocate for their interests. For these reasons, the voting premium is rarely static; it varies based on the market's view of the quality of management and other circumstances facing the firm.

154 Some dual class companies that offer low-voting stock instead of nonvoting stock may also reduce agency costs associated with voting, although the smaller premium may reduce the incidence of beneficial sorting. *See* Warren Buffet, Memo: Comparative Rights and Relative prices of Berkshire Class A and Class B Stock (Jan. 20, 2010), available at:

In other words, companies like Zillow, Google, and Under Armour—all companies that offer investors the choice between nonvoting and high voting shares—may increase the value of their companies by virtue of their dual-class structure, and not just for the reasons that those companies typically espouse. Put differently, the dual-class structure will benefit investors if the weakly motivated voters buy the nonvoting stock, and the informed voters buy the voting stock, because the company will reduce firm-wide agency costs.[155] And the weakly motivated voters should gravitate toward the nonvoting stock not just because it is cheaper, but also because it allows them to save on costs associated with voting.

In theory, this point is obvious. But reality, of course, is more complicated. Take Google as an example. Recall that Google split its stock in 2014, creating nonvoting shares (Class C).[156] The Class A voting shares have consistently traded at a premium (ranging from 1 to 5%) to the C shares in spite of an equal treatment clause providing that in the event of a change of control, the Class C shares will be eligible for the same rights and privileges as the A shares.[157] And despite a non-negligible voting premium, the three institutional investors that primarily invest in passive investment vehicles—BlackRock, Vanguard, and State Street—hold nearly identical amounts of voting and nonvoting stock.[158]

This presents a puzzle. Why are these institutional investors that primarily invest in passive investment vehicles not gravitating to nonvoting stock? Moreover, why are they among the investors lobbying stock indices to exclude companies that issue nonvoting stock?

One answer that CII—which represents Vanguard, Blackrock, and State Street—emphasizes is that so long as nonvoting stocks are included on an index, their

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http://www.berkshirehathaway.com/compab.pdf (positing that is not very likely that the low-voting stock would trade at more than 1% of a discount to the voting stock).

155 Note that in the case of Google, the decision to use a dual class structure to keep control with the founding group was made in 2004, years before the company recapitalization that called for the issuance of nonvoting stock and voting stock to the public. And even if the decision to keep control with the founders resulted in inefficiencies, the choice to recapitalize by issuing two share classes to the public may have actually reduced costs associated with the entrenching structure.

156 *See* Stephen Davidoff Solomon, *New Share Class Gives Google Founders Tighter Control*, N.Y. TIMES (Apr. 12, 2013), available at: https://dealbook.nytimes.com/2012/04/13/new-share-class-gives-google-founders-tighter-control/ There are also Class B shares, owned by insiders, that have ten votes per share. Those shares are not available to the public. *Id.*

157 Steven Davidoff Solomon, *Google's Stock Settlement May Not Do Much for Shareholders*, N.Y. TIMES (Sept. 11, 2013), available at: https://dealbook.nytimes.com/2013/09/11/googles-stock-settlement-may-not-do-much-for-shareholders/?_r=0 (discussing the terms of the settlement).

158 Holders of Alphabet Inc. (GOOGL), Yahoo Finance, available at: https://finance.yahoo.com/quote/GOOGL/holders?p=GOOGL (showing that Vanguard holds 19.9 million shares); Holders of Alphabet Inc. (GOOG), Yahoo Finance, available at: https://finance.yahoo.com/quote/GOOG/holders?p=GOOG (showing that Vanguard holds 19.9 million shares). Retail shareholders, however, make up a much smaller percentage of the owners of the voting shares: Google A has about 11 percent of its shares held by retail investors, versus 18 percent of Google C. *Id.* And this is likely because retail shareholders understand that nonvoting stock is cheaper and offers the same returns. *See* Bram de Haas, *Google: Why I Prefer the Nonvoting Shares*, SEEKING ALPHA (June 4, 2015), available at: https://seekingalpha.com/article/3236926-google-why-i-prefer-the-non-voting-shares.

passive funds will be forced to buy them.[159] That may explain why a company like Vanguard owns the same number of Google A and Google C shares—if both are weighted equally on the index, as they are on the S&P 500,[160] the S&P 500 tracker funds will be forced to buy both share classes in equal quantities. And because these passive institutional investors are forced to buy nonvoting shares that are listed on an index, CII argues that a market solution—reduced investor demand for dual class company shares—is unlikely to manifest, and thus, top-down restrictions are necessary.[161] In other words, the large institutional providers of passive funds are essentially lobbying the indices to save them from themselves.[162]

But if that were the only reason, there is a market solution—passive funds can depart from a pure tracking methodology, which would require the fund to buy every company in the index, in favor of purchasing a basket of representative companies that mimic the performance of an index. In fact, many do.[163] In other words, passive funds could refuse to buy the shares of some, if not all, dual-class companies if they were concerned about underperformance, weighting other companies differently to track the index's performance.

In time, however, it is more likely that the market would push index fund providers to purchase nonvoting, rather than voting stock. That is because passive funds that purchase nonvoting shares will benefit from lower costs (and thus, higher relative performance) than rival funds. Those funds will not only save on expenses associated with voting, but also benefit from purchasing the discounted stock, which

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[159] Alexandra Scaggs, *Investor Group to Exchanges: Stop Dual Class Listings*, WALL ST. J. (Oct. 11, 2012), available at: https://www.wsj.com/articles/SB10000872396390443749204578050431073959840.

[160] The S&P 500 is computed by weighted average market capitalization, and because the stock split did not affect Google's market capitalization, the two share classes are weighted equally on the index.

[161] The largely passive institutional investors explain that they are opposed to nonvoting shares because without an ability to exit, their voice is even more important. *See, e.g.*, F. William McNabb III, *Getting to Know You: The Case for Significant Shareholder Engagement*, Harvard Forum for Corporate Governance and Financial Regulation (June 24, 2015), available at: https://corpgov.law.harvard.edu/2015/06/24/getting-to-know-you-the-case-for-significant-shareholder-engagement/. And it may be that some passive funds, in spite of their acute collective action problems, find the benefits of investing in governance worth the costs. More likely, this argument provides an excuse for holding on to power that would benefit the institution in other ways, as will be discussed.

[162] Recently, BlackRock reversed its position on this issue, stating in a memo: "BlackRock is a strong advocate for equal voting rights for all shareholders. However, we disagree with index providers' recent decisions to exclude certain companies from broad market indices due to governance concerns. Those decisions could limit our index-based clients' access to the investable universe of public companies and deprive them of opportunities for returns." BlackRock, *A Potential Solution For Voting Rights and Index Inclusion Issues* (Oct. 2017), available at: https://www.blackrock.com/corporate/en-br/literature/publication/blk-a-potential-solution-for-voting-rights-and-index-inclusion-issues-october2017.pdf. Vanguard and State Street made similar statements in the wake of FTSE Russel's decision to bar dual class companies. *See* 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), available at: http://www.latimes.com/business/la-fi-snap-russell-indices-20170727-story.html.

[163] *There are Now More Indexes Than Stocks*, BLOOMBERG NEWS (May 12, 2017), available at: https://www.bloomberg.com/news/articles/2017-05-12/there-are-now-more-indexes-than-stocks.

would increase the fund's returns.[164] Investors, in turn, should gravitate to those discounted passive funds, which would promise stable returns for even lower fees.

A few considerations may limit the operation of these market forces, however, and cause weakly motivated voters to continue to buy voting stock. First, as mentioned, the institution that houses the passive funds may benefit from enhanced voting power. Most obviously, voting power could allow the institution's active fund managers to be more effective when they intervene in governance. However, when passive funds benefit from information generated by actively managed funds,[165] they cease to be uninformed.[166] As such, a passive fund that buys voting stock for this reason does not present a governance problem.

More worrisome is the risk that the institution would hold on to voting power to benefit the institution's political interests or appease clients. As an example, CalPERS and other public pensions are vocal proponents of good governance and are bound to consider governance expertise when selecting outside asset managers.[167] For that reason, the institution may believe that voting will signal engagement and help it attract assets from these investors. Retail investors, too, may seek investment vehicles that advertise themselves as being active players in governance.[168] In addition, voting power can also be used to appease another key client: company management, which is an important source of corporate 401(k) assets invested in passive funds.[169]

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164 The nonvoting index fund would likely have higher returns because an initial investment would allow the investor to purchase more shares of the nonvoting ETF or index fund, generating more dividends over time. Moreover, in the event of a takeover, the holder of the nonvoting fund would have more shares eligible for the premium (assuming the company had an equal treatment clause).

165 For evidence that beneficial information sharing occurs across large institutional investors, *see* Michelle Lowry and Peter Iliev, *Are Mutual Funds Active Voters?*, 28 REV. OF FIN. STUDIES 446 (2015) (demonstrating that although 25% of mutual funds blindly follow ISS recommendations, larger mutual funds and funds that belong to larger fund families engage in active voting more often and theorizing that this is because those large funds can spread their research costs and benefits across various funds).

166 There is a difference between following advice from informed voters, which have an incentive to maximize shareholder value, and third party proxy advisors, who suffer from many of the same biases and conflicts as weakly motivated voters. *See* Nathan, *Proxy Advisory Business, supra* note [] ("[A]s everyone connected with the institutional shareholder voting process knows or should know, proxy advisors' voting recommendations are driven by inflexible, one-size-fits-all voting policies and simplistic analytic models designed to utilize standard and easily accessible inputs that can be derived from readily available data and to avoid any need for particularized research or the application of meaningful judgment.").

167 *See* CalPERS Global Governance Principles (2015), available at: https://www.calpers.ca.gov/docs/forms-publications/global-principles-corporate-governance.pdf (explaining that improving corporate governance is at the core of the pension's investment strategy).

168 *See, e.g.*, Bank of America Merrill Lynch, Equity Strategy Focus Point, ESG: Good Companies Can Make Good Stocks (Dec. 18, 2016) (estimating the growth of assets in socially responsible investment vehicles to be 33% over two years, with much of this growth driven by millennials, 90% of which engage in "impact investing" or want to).

169 In 2015, 401(k) assets under management totaled $4.7 trillion, with 60% held in mutual funds. Sean Collins et al., *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses*, ICI Research Perspective (2016), *available at*: http://www.ici.org/pdf/per22-04.pdf; *see also* Simon C. Y. Wong, *How*

Second, weakly motivated shareholders may gravitate toward voting stock for its option value. Perhaps the weakly motivated voters will anticipate that the company will become a takeover target at some future date. This may explain why equal treatment clauses, or clauses that provide that minority shareholders will receive equal consideration in the event of a change of control, are so common in dual-class companies—those companies worry that investors will shun the nonvoting shares if they anticipate unequal treatment in a takeover.[170] But equal treatment clauses have been bypassed in the past,[171] and so some weakly motivated shareholders may prefer to buy voting stock to guarantee that they will share in any future takeover premium. Relatedly, weakly motivated shareholders might purchase voting shares to protect against other forms of disparate treatment. For example, if the holders of voting stock are employees, the insiders could pay them higher salaries or give them other perquisites to induce their loyalty in the case of a dispute.

For these reasons, it is unlikely that all weakly motivated voters would purchase nonvoting stock. But even imperfect sorting could lower agency and transaction costs. And the prospect of buying discounted stock and saving on voting expenses should increase the appeal of nonvoting shares to weakly motivated voters, meaning that sorting should increase over time.

One more caveat is necessary. Just as weakly motivated voters may purchase voting stock, it is also possible that some informed investors will gravitate toward discounted nonvoting shares. In other words, the presence of nonvoting shares could exacerbate the collective action, free riding, and passivity problems inherent in dispersed ownership.

This result is possible but unlikely. Informed voters would be most likely to free ride when the voting premium is very high. But in such cases, the market values the vote highly precisely because of the potential benefits that flow from the ability to exercise influence—perhaps the company is likely to become a takeover target, or perhaps the company is poorly managed and thus the voting shareholders will be best positioned to advocate for their interests. Under these circumstances, the informed investors will be more likely to pay a premium for voting stock to secure these benefits. In addition, the weakly motivated voters will have a harder time passing up the opportunity to secure heavily discounted nonvoting stock.

By contrast, when the company is well run and the market is optimistic about management, the voting premium may be small, perhaps as little as one percent.[172] In that case, the informed voters are likely to view the premium as a small price to pay

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Conflicts of Interest Thwart Institutional Investor Stewardship, BUTTERWORTHS J. INT'L BANKING & FIN. L. 481 (Sept. 2011), *available at*: http://ssrn.com/abstract=1925485.

170 Blue Apron, Zillow, Square, GoPro, and Snapchat have all gone public with multiclass structures and have included an equal treatment clause in their charter. *See* Kirby Smith, *The Agency Costs of Equal Treatment Clauses*, 101 YALE L. J. FORUM at 104 (forthcoming 2017).

171 See JP Konig, Moneyness Blog, *Riding on the Coattails of Sergey Brin and Larry Page…Or Not*, (Dec. 4, 2015), available at: http://jpkoning.blogspot.ca/2015/12/riding-on-sergey-brin-and-larry-pages.html (explaining that the "Canadian business community has a long history of successfully evading the triggering of coattail provisions" and providing examples.).

172 *See* Stout Advisory Servies Report, *supra* n. [].

for the ability to exercise control at some future date and purchase the voting stock for its option value. Even if the informed voters do decide to join the free riders and purchase nonvoting stock during this calm period, they will have the ability and incentive to purchase voting shares at some future point, when problems at the company manifest.

Of course, there is something perverse about requiring informed voters to pay a premium for activity that benefits all shareholders. It would be better if the informed voters received a discount or some payment for their purchase of voting stock, rather than the weakly motivated shareholders who are taking a free ride. However, the informed shareholder who purchases voting shares at a company that has channeled its uninformed voters toward nonvoting stock will get more for her money—a more powerful vote, a more valuable company. Therefore, although encouraging weakly motivated voters to bypass their governance obligations is suboptimal (it would be better if nobody took free rides at all), it is preferable to a world in which weakly motivated voters dilute the voice of informed voters.

C. Nonvoting Shares: Supply-Side Issues

Although weakly motivated voters should have incentives to buy nonvoting shares, the question of whether companies can be counted on to supply them in the right numbers and for the right reasons is more complicated. In theory, so long as market participants are not restricted from issuing nonvoting equity, market pressure should encourage certain companies to issue nonvoting stock to some, but likely not all, outside investors. In other words, because the company wants to get the highest price of its shares, it should issue nonvoting stock not for entrenchment purposes, but rather to *increase* the voting power of informed investors, which would increase the value of the company's equity.

But there are reasons to believe that management might not always use nonvoting stock in this way. The first reason is technical—it would be difficult for the company to ascertain how much nonvoting stock to issue *ex ante* because that number depends on the composition of the shareholder base, which is always changing.[173] Second and more importantly, the insider group may use nonvoting stock to silence investors so that they can reap private benefits of control. Even though this will dampen the share price, those costs would be shared with other equity holders. Indeed, nonvoting shares are generally used to keep control with insiders, rather than empower informed investors. And even though this function can be efficiency-maximizing, the prospect of entrenchment has motivated much of the backlash against nonvoting shares.

What can we infer from the fact that nonvoting shares have not been used to sort between informed and weakly motivated voters? It is possible that management cannot ever be counted on to use nonvoting shares for this purpose. Management may fear that using nonvoting stock to empower outside investors will magnify the

[173] The amount of insider stock is continually in flux as well—often, employees are paid in stock options that can be exercised at any time, making it more difficult to ascertain the level of insider ownership.

influence of hedge fund activists, who are increasingly likely to pursue campaigns directed at ousting the CEO and reducing management compensation.[174] But this is unlikely—there are many high quality management teams that would benefit from using nonvoting stock as a bonding mechanism and to signal their quality to outside investors. Other insiders (including the venture capitalists that will cash out after a company's IPO) would also benefit from the issuance of nonvoting stock under these circumstances and should demand it. It is therefore puzzling that we have not yet seen nonvoting stock used for this explicit purpose.

It is possible that the market is currently in disequilibrium, and that the potential of nonvoting stock has yet to be unlocked. True, the existence of nonvoting stock is as old as the corporate form itself, but trends in corporate governance and changes in financial markets have greatly increased its appeal as a tool to reduce agency costs. In the past ten years, shareholder power has grown dramatically.[175] Shareholders now have the ability to directly intervene and weigh in on wide-ranging corporate issues, from executive compensation to corporate strategy. At the same time, the shareholder base has become increasingly concentrated in the hands of passive institutional investors with agency problems of their own, as well as conflicts of interests.[176] To protect against distortions that occur when large passive institutional investors wield substantial voting power, companies may find the benefits of nonvoting stock to be too great to ignore. That is, so long as companies that seek to issue nonvoting stock do not face legal or market barriers, which would deter innovation of this kind.

IV. IMPLICATIONS FOR LAW

This paper demonstrates that nonvoting stock can enable a company to operate more efficiently when certain conditions are met. A prohibition on nonvoting shares, therefore, would prevent some firms from implementing optimal equity structures, harming performance and increasing the company's cost of capital. Applying this analysis, the next section considers recently enacted and proposed restrictions on dual-class company structures and concludes that they are misguided. It then offers another possible path for reform—prohibiting companies from issuing *only* nonvoting shares to the public.

A. Misguided Policies

As discussed, the recent controversy over dual-class stock has motivated investors and investor advocacy groups to lobby against dual-class structures and the use of nonvoting shares. Their actions have not fallen on deaf ears: both Dow Jones S&P 500 and Russell FTSE will not list Snap and other companies with nonvoting stock in their U.S. benchmarks. Those indices are the biggest drivers of passive fund demand for U.S. stocks, and so their decisions are likely to eliminate dual-class IPOs in the United States. Moreover, the stock indices' decision to eschew companies with

174 *See* Thomas Keusch, *Hedge Fund Activists and CEO Contracting*, Working Paper (March 6, 2017), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2746135.
175 *See* Thomas et. al., *Shareholder Voting in an Age of Intermediary Capitalism*.
176 *See* Lund, *supra* n. []; Bebchuk, Cohen, & Hirst, *supra* n. [].

nonvoting stock will undo much of the beneficial sorting that had already occurred: instead of being channeled toward purchasing nonvoting stock, weakly motivated passive funds will more likely purchase voting shares, as companies like Snapchat will be excluded from their baseline indices.

These policy changes ignore the fact that nonvoting stock can play an important role in improving firm efficiency by reducing agency costs and transaction costs associated with voting.[177] And these benefits will only grow as demand for passive investment vehicles increases.[178] In many cases, therefore, companies should be encouraged to issue some portion of nonvoting shares, rather than deterred from doing so. And although very few U.S. companies offer voting and nonvoting stock to the public,[179] it is likely that market pressure would push more and more companies in this direction, as it has already done. By deterring companies from issuing nonvoting stock, the indices impede this beneficial experimentation in company structuring.[180]

The recent wave of advocacy for mandatory sunset provisions for dual-class companies is similarly wrongheaded.[181] Sunset provisions ensure that dual-class structures sunset after a pre-determined period of time, such as three to five years, unless their extension is approved by shareholders unaffiliated with the controller.[182] These provisions are just one of many tools available to companies that seek to reduce agency costs associated with dual-class structures.[183] Requiring them, however, is a crude solution, as it is unclear *ex ante* when the dual-class structure will become inefficient. In addition, the solution is too extreme, because nonvoting shares may provide important efficiency benefits for the company, and thus, the sunset provision would undo those benefits at an arbitrary point in time. Providing shareholders an opportunity to extend the dual-class structure lessens this concern,

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177 Indeed, it is incongruous that the indexes are willing to list companies with other characteristics that could be deemed entrenching, such as poison pills. That may be because the scholarly consensus is that these pills can be welfare enhancing when used correctly. *See, e.g.*, Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845 (2002). But this paper reveals that nonvoting stock, like poison pills, has a beneficial function in certain cases, and thus, should not be subject to a blanket prohibition.

178 *See* Lund, *supra* n. [] at [] (describing the rapid rise of passive funds and their growing influence over corporate governance).

179 Although there are very few companies that issue both high and low voting stock to the public in the U.S., the structure is more common in Europe and in Canada. In fact, a recent trend in Europe is the "loyalty" share, or shares that accumulate voting rights the longer that they are held. For example, in France, shares that are registered for two years automatically receive double voting rights under the Florange Act. *See* David J. Berger, et. al., *Tenure Voting* at 297. Italy has also allowed companies to grant two votes for every share held for at least two years. *Id.*

180 *Cf.* Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 868 (1993) ("The evidence from LBOs, leveraged restructurings, takeovers, and venture capital firms has demonstrated that leverage, payout policy, and ownership structure (that is, who owns the firm's securities) do in fact affect organizational efficiency, cash flow, and therefore value.").

181 *See, e.g.*, Bebchuk & Kastiel, *supra* note [].

182 *Id.*

183 Indeed, Google and Facebook both have sunset provisions for the dual class structure that are triggered by certain events. In the case of Google, the classes would combine upon a liquidation of the company. *See* S-1, *supra* n. [].

but often, the shareholders tasked with approving the structure are the same weakly motivated voters that warranted the use of nonvoting shares in the first place.[184]

B. Possible Restrictions

Even with a greater understanding of the benefits provided by dual-class structures, it is likely that calls for regulation will continue. And if securities regulators, stock exchanges, or stock indices are compelled to take a stance against nonvoting stock, they should take a more moderate position: they could instead prohibit or deter companies from offering *only* nonvoting stock to the public. In other words, rather than a total prohibition on dual-class company structures, the law (or indices adopting standards for inclusion) could require a company that issues nonvoting stock to also issue a non-negligible amount of voting stock to the public.[185] FTSE Russel is moving in this direction—its proposed rules require companies to have at least 5% of their voting rights across all share classes in the hands of outside shareholders.[186]

It is true that offering only nonvoting stock to the public might be the most efficient structure for certain companies. If investors were extremely confident in the leadership of the company, perhaps they would pay the most for shares of a company that offered only a single class of nonvoting shares to outside investors. It is therefore possible that the Snap IPO was structured optimally at the time of the offering.

But even if it were optimal to issue only nonvoting stock at the time of issuance, it is unlikely to be optimal for an extended period.[187] Over time, the advantages of such a structure may decrease, especially for dynamic companies in which disruptive innovations and a quick pace of change are expected.[188] The costs of such a structure are also likely to increase over time—insiders will probably dilute their economic position in the company in order to diversify risk, which will only increase agency cost problems. And even when the company's structure has become patently inefficient, insiders who reap private benefits of control could have an incentive to

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[184] For example, a passive institutional investor like Vanguard might get away with purchasing nonvoting shares—investors wouldn't complain about the lower fees, and probably wouldn't notice that some of the shares in the portfolio lacked voting rights. But Vanguard might worry that were it to vote to extend a company's dual class structure, this highly visible decision would attract the ire of their clients.

[185] This means that if the company issued only a handful of voting shares, it would qualify as an issuer of nonvoting shares. The right number of voting shares will depend on each company, but ideally, the number would sufficiently substantial that it would give the outside investors leverage over management and potentially a path toward unseating management in the future. *See* Kastiel, *supra* note [] (discussing mechanisms available to activist investors who wage successful campaigns at controlled companies, most of which require the power to vote).

[186] Chris Dieterich, Maureen Farrell & Sarah Krouse, *Stock Indexes Push Back on Dual Class Listings*, WALL ST. J. (Aug. 2. 2017), available at: https://www.wsj.com/articles/stock-indexes-push-back-against-dual-class-listings-1501612170.

[187] *See* Bebchuk & Kastiel, *supra* n. [].

[188] *Id.*

maintain it.[189] When this happens, the informed investors will lack important mechanisms that could accelerate change, such as the ability to nominate directors and cast votes at annual meetings.[190]

When a company issues some voting shares to the public, however, it will be vulnerable to influence from shareholders about the direction of the company, including the efficiency of the dual-class structure. If the outside investors believe that management is entrenched and insufficiently attuned to shareholder interests, they have several legal tools at their disposal as a result of their voting rights. Those outside shareholders can submit a shareholder proposal requesting reclassification of the company's stock.[191] They can vote against board nominees or executive compensation at the annual meeting.[192] They can nominate a director candidate to the board and encourage other voting shareholders to support her,[193] or they can threaten to veto M&A transactions initiated by the controlling shareholder.[194] They can even form coalitions with insiders in an attempt to unseat some of the incumbents.

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189 *Id.* These concerns have motivated calls for mandatory sunset provisions for dual class structures, which for the reasons discussed, provide a clumsy and partial solution.

190 Holders of nonvoting stock can drum up negative publicity about the company as leverage for its demands. *See generally* John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151, 2175 (2001) (claiming that social norms matter and constrain controlling shareholders). However, without some legal bargaining chip, such as the ability to veto an M&A transaction or nominate a minority director, the insiders are much more likely to ignore the demands of a minority shareholder. *See* Kobi Kastiel, *supra* note [] at 110 (reviewing activist campaigns waged against controlled companies and finding that only 11% of those campaigns without a bargaining mechanism other than the threat of a reputational penalty were successful). In addition, the likelihood of securing media coverage for an activist campaign is strongly correlated with the decision to wage a proxy battle. *See id.* at 115. Lawsuits against the company, too, are more successful when the minority shareholders can point out that the company ignored its demands that were clearly articulated in a shareholder vote.

191 *See* Rule 14a-8 of the Securities Exchange Act of 1934.

192 *See* Section 951 of the Dodd–Frank Act, Pub. L. No. 111-203, 124 Stat. 1899 (2010) (giving shareholders the right to cast an advisory vote on executive compensation).

193 Ronald Orol, *Activist Investors Target Snapchat Parent Snap Over Non-voting IPO Shares*, THESTREET (Feb. 8, 2017), available at: 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 hopes that a large vote of the noninsider shareholders will back their nominees, sending an embarrassing message to the company that change is needed."). For companies that allow the right to nominate and elect minority directors, this tool is even more powerful. *See* Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. L. BUS. R. 61, 90 (2016). For example, an activist campaign targeting Dillard's, Inc., which had a dual class structure but allowed the minority shareholders to nominate a director, was able to secure major changes, including compensation cuts, by using the ability to nominate a director as a bargaining chip. *See id.* at 93.

194 In Delaware, companies are not required to get the approval of a majority of the minority voting shareholders before consummating a conflicted going-private transaction, but courts incentivize companies to secure such approval. *See Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (holding that a controlling stockholder's related party transaction will be subject to the business judgment rule if a proposed transaction receives both the affirmative recommendation of a functioning special committee and approval by a majority of the minority stockholders). This provides another important channel of activism at companies for minority shareholders. See Kastiel, *Against All Odds*, *supra* n. [] at 101.

Therefore, even though minority investors lack the power to change the company's structure unilaterally, a showing of unified outside investor displeasure will send a clear message to management and the board, one that is harder to ignore. It will also send a clear message to the capital markets and other investors, depressing demand for and thus the price of the company's shares (and complicating future fundraising efforts).

If it seems implausible that a company would pay attention to a shareholder without power to threaten management's control, consider this example. In 2016, Forest City Realty Trust Inc. agreed to abandon its dual-class structure that had allocated voting control to the family that had run the company for the past hundred years.[195] Forest City reclassified its shares because of pressure from an activist investor, Scopia Capital Management, that had a 9.8% stake in the company. Scopia had no chance of acquiring control—even if the insiders had parted with their stock, the high vote shares would convert to low vote shares upon a transfer—and thus lacked the ability to threaten a proxy contest or engineer a takeover. Nonetheless, Scopia's persistent public campaign, coupled with threats to call for a nonbinding vote on the structure, eventually moved the needle.

Likewise, in the case of Reader's Digest, pressure from an activist investor sped up the unwinding of the publisher's dual-class structure. Reader's Digest offered voting and nonvoting shares to the public, but voting control remained with an entity created by the founders.[196] In the early 2000s, outside investors became increasingly unhappy with the company's structure and strategy and began to pressure the company for changes. Most prominently, Highfields Capital Management, an investment firm that owned about 10% of the nonvoting stock and a small fraction of the voting stock, made an offer to buy the voting shares with the explicit purpose of eliminating the dual-class structure.[197] The company rejected the offer, but the investor pressure accelerated discussions to reclassify the shares.[198] One month after the offer, the company agreed to replace its two classes of shares with a single voting class.

There are other examples in which a dual-class company has bent to the wishes of a minority investor with some voting power. In 2006, activist investor Morgan Stanley Investment Management put pressure on the New York Times to eliminate its dual-class structure. That structure permitted the low-vote Class A shareholders to elect a minority (four out of thirteen) of the company's directors.[199] The company resisted this pressure for two years, even after 42% of the Class A shareholders

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195 David Benoit, *Activist Pressures Ratner Family to Relax Control of Forest City*, WALL ST. J. (Aug. 10, 2016), available at: https://www.wsj.com/articles/activist-pressures-ratner-family-to-relax-control-of-forest-city-1470801603.
196 Matthew Rose, *Reader's Digest's Shareholders To Give Up Control of Publisher*, WALL ST. J. (Apr. 15, 2002), available at: https://www.wsj.com/articles/SB1018822198298046520.
197 *Id.*
198 *Id.* (noting that "pressure from Highfields accelerated their planning" to move to a single class structure).
199 Joshua Chaffin, *Hedge Fund Lashes Out at NYT Board*, FIN. T. (Jan. 28, 2008), http://www.ft.com/intl/cms/s/0/5eae7fba-cd3a-11dc-9b2b- 000077b07658.html#axzz42LvTOajM.

withheld their votes for directors at the company's 2007 annual meeting.[200] Eventually, Morgan Stanley exited the investment, but the campaign attracted the attention of another group of activist investors, the hedge funds Harbinger Capital Partners and Firebrand Partners. These funds eventually secured a settlement with the company that allowed them to appoint their nominees to the board.[201] And in the years following the campaign, the company implemented the activists' proposed policy changes, reducing spending, lowering its operating costs, and divesting underperforming assets.[202]

These examples demonstrate how shareholders with voting rights are able to influence management even when they are not able to credibly threaten their control.[203] And although the founder's grip on the company may be tight at the time of the offering, that grip may loosen over time, providing even greater opportunity for the voting shareholders to influence or even unseat management.

There is another reason why regulators might wish to prohibit companies from issuing only nonvoting shares to the public: the companies that do this may avoid certain disclosure requirements under securities law. For example, without issuing voting securities, a company need not hold an annual meeting, nor provide a proxy statement to shareholders, which would otherwise be required under Section 14(a) of the Securities and Exchange Act of 1934.[204] Those proxy statements include financial statements, background information about the company's directors including potential conflicts of interest, board compensation, executive compensation, and the

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200 Merissa Marr, *New York Times Co. Relents on Board Seats*, WALL. ST. J. (Mar. 18, 2008), http://www.wsj.com/articles/SB120577291969142019

201 *Id.*

202 Kastiel, *supra* note [] at 63.

203 Advisory shareholder votes on executive compensation have also proven to be influential. For example, in 2012, a strong showing of investor disapproval in the form of an advisory say-on-pay vote by Citigroup shareholders against CEO Vikram Pandit's pay package led to his departure and substantial changes to executive compensation. 55% of Citigroup shareholders voted against the pay package, which was taken as a strong signal of displeasure. *See* Jessica Silver-Greenberg & Nelson D. Schwartz, *Citigroup's Chief Rebuffed on Pay by Shareholders*, N.Y. TIMES (Apr. 17, 2012), available at http://dealbook.nytimes.com/2012/04/17/citigroup-shareholders-reject- executive-pay-plan/; Tom Braithwaite, Dan McCrum & Kara Scannell, *Citigroup Sees Off Shareholder Revolt on Executive Pay*, FIN. T. (Apr. 24, 2013), available at: http://www.ft.com/intl/cms/s/0/ef667544-ace1-11e2-b27f-00144feabdc0.html#axzz2dOEJ6hvL. One analyst described the vote as follows: "This is a milestone for corporate America. When shareholders speak up about issues on which they've been complacent, it's definitely a wake-up call." Silver-Greenberg & Schwartz, *supra*. That was so even though the vote was non-binding. Empirical evidence has generally revealed that Dodd-Frank's mandatory say-on-pay vote for public companies has influenced compensation practices, in spite of the fact that the vote is nonbinding. *See, e.g.*, Yonca Ertimur, Fabrizio Ferri & David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay* 3 (Working Paper 2013), available at: http://ssrn.com/abstract=2019239.

204 *See* Snap Inc., Amendment No. 2 to Form S-1. Snap did indicate in its SEC filings that it intends to afford the holders of nonvoting stock the same materials it gives to its voting shareholders, although it caveated that promise in ways that indicate that it plans to disclose less than would be required for holders of voting stock. *See* Brian Shea, SEC's *Investor Advisory Committee Airs Concerns Over Multi-Tiered Offerings Following Snap's IPO*, Harvard Law School Forum on Corporate Governance and Financial Regulation (May 9, 2017), available at: https://corpgov.law.harvard.edu/2017/05/09/secs-investor-advisory-committee-airs-concerns-over-multi-tiered-offerings-following-snaps-ipo/#6b

composition of the audit committee.[205] And this information would be of particular interest to outside shareholders of a company that has such a high potential for agency costs. Moreover, those disclosure requirements are not just important to shareholders, but to regulators who monitor the company.

But that is not all. Issuers that offer only nonvoting stock to public are exempt from other disclosure obligations that help investors and regulators understand what company insiders are doing. Shareholders of companies like Snap are exempt from filing obligations under Sections 13(d) and 13(g), which require anyone who owns 5% or of any class of a company's equity to file a report with the Securities and Exchange Commission.[206] They are also exempt from the "short swing" profit rule embodied in Section 16(b).[207] That rule requires insiders to disgorge any profits on trades that occur within six months of each other and is enforced by private right of action.[208] Without protection from this rule, insiders will have no obligation to disclose when they profit from short swing trading, and shareholders will lack the right to seek disgorgement of the profits.

In sum, shareholders of companies that offer only nonvoting stock to the public will have much less information about the behavior of those who control the company. In turn, those insiders will be able to ignore influence from informed outside investors. For some companies, the benefits provided by insulating insiders from interference may outweigh the risks, but this is unlikely to occur very often, and even when it does, will unlikely to remain efficient into perpetuity. Therefore, a requirement that companies make a non-negligible amount of voting shares available to the public when issuing nonvoting shares would be least likely to impede efficient structuring, while also protecting shareholders from inefficiencies in the future.

V. CONCLUSION

Nonvoting shares are under attack. Investors, regulators, and stock indices are united in their view that nonvoting shares are tools of managerial entrenchment and have supported proposals that would restrict companies from issuing them. But this paper shows that nonvoting shares have important benefits. Specifically, the paper posits that some combination of voting and nonvoting stock might well reduce agency costs and prove to be a firm's best way to attract capital. Weakly motivated voters can get in the way of informed investors' ability to discipline management; accordingly, a company can better attract informed investors by issuing nonvoting stock for the weakly motivated investors to buy. Moreover, weakly motivated voters should prefer purchasing discounted stock that allows them to avoid duplicative

205 *See* Exchange Act Rule, 17 C.F.R. Section 240.14a. Snap will be required to file quarterly and annual reports, as well as Form 8-K reports within four days of a material event. But these reports require much less information than the proxy statement. The SEC in comment letters is urging Snap to better disclose how it intends to address these issues. *See* Mark Butler, *The SEC Reacts to Snap's Unconventional IPO* (May 8, 2017), available at: https://www.intelligize.com/the-sec-reacts-to-snaps-unconventional-ipo-2/.

206 *See* Exchange Act Rule, 17 C.F.R. Section 240.13d; 13g.

207 *See* Exchange Act Rule, 17 C.F.R. Section 240.16b.

208 *Id.*

information gathering costs and other costs associated with voting. In sum, *ex ante*, all investors should prefer a company in which nonvoting stock is available for weakly motivated voters to buy.

For these reasons, recent stock index policy changes refusing to list companies that issue nonvoting stock are misguided. These policies are a powerful deterrent to companies that are considering whether to go public with a dual-class structure. And when optimal forms of structuring are taken off of the table, the result is corporate inefficiency and higher capital costs. If regulation is inevitable, a better form would require companies that issue nonvoting stock to also issue voting stock, providing investors a choice between engagement and passivity in governance.