MULTI-CLASS EQUITY STRUCTURE

November 2017

NEAAZ MOZUMDER
Proxy Analyst

The debate on multi-class shares has taken center stage ever since the highly publicized Snap IPO. After the rare move to issue non-voting shares to the public, the larger debate of whether such structures should be allowed ensued and the investor community has largely been on the same page – all shares should carry equal rights. Historically, Northern Trust has been no exception. Our policy has been to vote against dual class offers and recapitalizations since the inception of our voting guidelines. While there are arguments on both sides, our belief is that the benefits of a one share, one vote policy outweigh the potential negatives.

Multi-class shares have been rising in popularity in recent years, but they still make up a small percentage of the overall market. Only about 10% of publically listed companies carry a multi-class equity structure, including popular names such as Facebook, Alphabet (previously Google), and Nike.[1] Although there was a period of time in the US when the New York Stock Exchange had restrictions in place to prohibit non-voting shares and limit the number of those that carried superior-voting rights, competition amongst the different stock exchanges coupled with the changing corporate landscape in the 1980s lead to the eventual elimination of such restrictions. Today there are no similar restraints on capital structure within the U.S. On the international stage, the U.S. is not an anomaly by any means, but a few jurisdictions currently disallow the use of multi-class shares; Singapore and Hong Kong are two examples.

Inequitable voting rights are not bound to any industry in particular, but the proliferation in the tech industry appears to have garnered the most scrutiny. Between 2012 and 2016, approximately 15% of US tech companies have gone public with a multi-class equity structure compared to 8% between 2007 and 2011, according to University of Florida

[1] David Berger, "Dual-Class Stock and Private Ordering: A System That Works," *Harvard Law School Forum on Corporate Governance and Financial Regulation,* May 24, 2017, https://corpgov.law.harvard.edu/2017/05/24/dual-class-stock-and-private-ordering-a-system-that-works/

professor Jay Ritter.[2] The Snap IPO is a relatively egregious example, which has led to the launch of a consultation process by index providers to seek feedback on whether to include companies with non-voting rights into their popular indices. As of this writing, FTSE Russell will, going forward, exclude public companies which have less than 5% of their voting rights in the hands of public shareholders, while S&P Dow Jones Indices will exclude future companies with multi-class shares from the S&P 1500 Composite Index. MSCI, Inc. will temporarily ban new companies that have unequal voting rights from its ACWI IMI and U.S. Investable Market 2500 indices.

The rationale for the use of multi-class shares has been to preserve control by the founders and deter hostile takeovers. Hostile takeovers are a rarity in today's environment, but the desire to preserve company control remains. Founders believe the multi-class structures are necessary as public markets have a myopic view, which prevents them from effectively pursuing their long-term vision. Critics argue that such a structure is risky because it provides founders unchecked control of company operations without a proportionate level of economic risk.

The argument that a multi-class structure allows an unobstructed path for companies to pursue long-term goals sounds logical, but there is a lack of definitive evidence showing that shareholders stand in the way. Anecdotal evidence will often be cited, such as the ouster of Steve Jobs in the '80s that lead to the near bankruptcy of Apple, but it is far from conclusive. Today, matters of corporate governance, such as proxy contests, "vote no" campaigns, and other forms of activist intervention have become more publicized. However, more often than not, shareholders have been supportive of management.

EXHIBIT 1: 2016 PROXY FIGHTS

WINNER	# FIGHTS	% OF TOTAL
Management	28	25.69
Dissident	9	8.26
Split	1	0.92
Sub-Total (Proxy Fights that Went to a Vote)	38	34.86
Pending	0 (0 Went Definitive)	0.00
Settled	50 (11 Went Definitive)	45.87
Withdrawn	27 (7 Went Definitive	19.27
Total (All Proxy Fights)	109	100.00

SOURCE: Data Provided by FactSet Shark Repellent

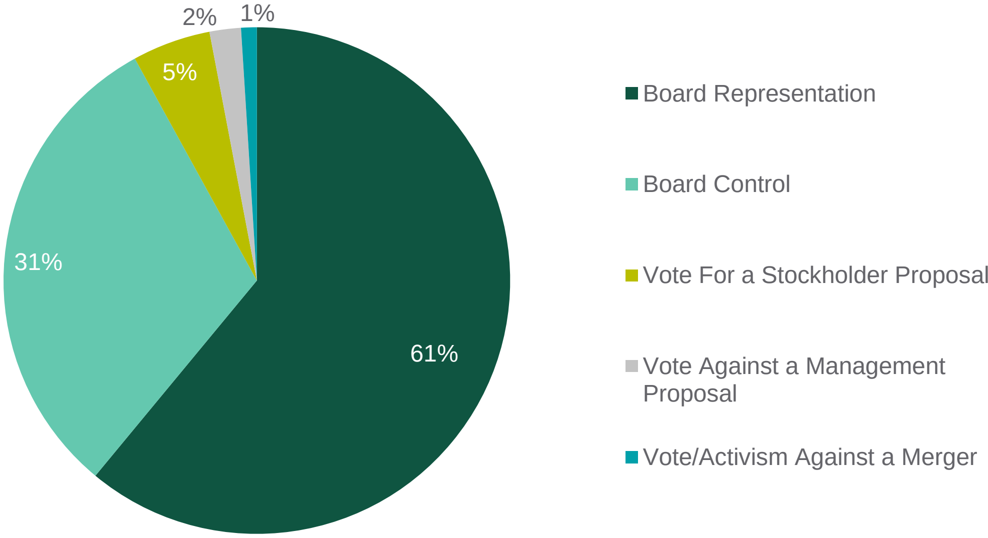
Taking 2016 as an example year, management has been successful at 25% of the proxy fights, while approximately 45% have been settled and 19% withdrawn. Furthermore, the

[2] Chris Dieterich, Maureen Farrell, and Sarah Krouse, "Stock Indexes Push Back Against Dual-Class Listings," *Wall Street Journal,* August 2, 2017, https://www.wsj.com/articles/stock-indexes-push-back-against-dual-class-listings-1501612170

primary goal of the overwhelming majority of the proxy contests is to seek board representation as opposed to outright board control or any sort of merger prevention.

EXHIBIT 2: PRIMARY CAMPAIGN TYPE

2016 Proxy Fights



SOURCE: Data Provided by FactSet Shark Repellent

To go even further, in 2016, the average support for director elections at Russell 3000 companies was 96%, pay packages received an average support level of 91.2%, all mergers and acquisitions at Russell 3000 companies passed, and shareholder proposals received an average support of 21.3%.[3] While on the surface it may seem shareholders are often at odds with management when it comes to voting matters, the data shows a relationship that is more congenial than hostile. And when it comes to overall performance, a 2016 study by the Investor Responsibility Research Center Institute found that there is "no empirical support to the 'controlled companies outperform' theory." [4] Additionally, a study released by the John M. Olin Center for Law, Economics, and Business found that "over time, the potential benefits of dual-class structures can be expected to decline and the potential costs to increase." [5] The study goes on to suggest that there are significant costs when control via multi-class stocks is retained in perpetuity.

[3] Data provided by Institutional Shareholder Services
[4] Edward Kamonjoh, "Controlled Companies in the Standard & Poor's 1500" , *Investor Responsibility Research Center Institute*, March 2016, https://irrcinstitute.org/wp-content/uploads/2016/03/Controlled-Companies-IRRCI-2015-FINAL-3-16-16.pdf
[5] Bebchuk and Kastiel, *The Untenable Case for Perpetual Dual-Class Stock,* Cambridge, Harvard Law School, 2017

Although, there are numerous flaws in a multi-class share structure, Northern Trust recognizes some of the benefits it provides, such as affording management the ability to take calculated risks without shareholder backlash. Common arguments against multi-class structure are arguably hyperbolic and hold little merit when studied closely. For example, there is no conclusive evidence of performance discrepancies between companies with multi-class shares versus those with a single class structure. Companies that recapitalized to a dual stock “experienced long-term positive stock returns and superior operating performance over the four years after the recapitalization.[6] Some of the other concerns regarding concentrated control, such as conflicts of interests, abuse of control, majority non-independent boards, etc. are all mitigated by, among other things, existing corporate law - directors have a fiduciary duty of loyalty to their shareholders and stock exchanges have board independence requirements. Additionally, a strict ban on dual-class could have unintended consequences, such as the reduction in IPOs and business lost to overseas competitors, which could ultimately result in a less vibrant US public market system.

This topic is certainly going to be debated for years to come and will ebb and flow depending on the latest IPO trends. In the US, the issue started in the 1920s, and almost a century later, the discussion continues. Given the information we have today, Northern Trust prefers a one share, one vote structure. If a dual class structure is in place, there should be a time-based sunset provision in place, at the end of which the multi-class structure would convert to a single-class structure. Northern Trust’s position is that this is a reasonable middle-ground that addresses the needs of developing companies and preserves the rights of shareholders.

---

[6] Glover and Thamodaran, “Capital Formation,” Insights: The Corporate & Securities Law Advisor 27, no. 3 March 2013