WHY DUAL-CLASS STOCK: A BRIEF RESPONSE TO COMMISSIONERS JACKSON AND STEIN

Two SEC Commissioners—Robert Jackson and Kara Stein—separately visited Silicon Valley last week, and both used the opportunity to sharply criticize the practice among some companies—most notably but not exclusively technology companies—to adopt so-called "perpetual" dual-class stock.[1] In typical dual-class structures, one group of stockholders (typically the founders and other insiders) receive stock with multiple votes per share, while shares purchased by investors in the company's initial public offering ("IPO") or thereafter on the open market have just one vote per share. [2]

The purpose of this short response is to (1) identify some of the underlying causes that have led companies, including many of our most innovative and dynamic public companies, to adopt dual-class stock and (2) offer some broader solutions that the SEC can consider as it seeks to address some of the perceived problems with dual-class stock. In

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[1] *See* Commissioner Robert J. Jackson, Jr., *"Perpetual Dual-Class Stock: The Case Against Corporate Royalty,"* February 15, 2018, available at https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty; and Commissioner Kara M. Stein, *"Mutualism: Reimagining the Role of Shareholders in Modern Corporate Governance,"* February 13, 2018, available at https://www.sec.gov/news/speech/speech-stein-021318. Professors Lucian Bebchuk and Kobi Kastiel have previously called for an end to perpetual dual-class stock, in favor of a mandatory sunset provisions on public companies with dual-class structures, a position similar to that proposed by Commissioner Jackson. *See* Bebchuk and Katstiel, "*The Untenable Case for Perpetual Dual-Class Stock*," 103 Va.L.Rev.585 (2017). I previously opposed this view, and as discussed more fully below continue to believe that focusing simply on dual-class stock structures ignores the broader challenges faced by our corporate governance system. *See* David J. Berger, "*Dual-Class Stock and Private Ordering: A System that Works*," Harv. Corp. Gov. Blog, May 24, 2017.

[2] Although the primary focus of Commissioner Jackson's talk was against "Perpetual dual-class stock," most technology companies do not have perpetual dual-class stock structures. Ironically, perpetual dual-class stock structures are most common in companies founded by very conservative, supposedly "free-market" entrepreneurs, such as Rupert Murdoch's News Corp., the Smith family's Sinclair Broadcast Group, and John Malone's Liberty Media Group. In March 2017 the Council of Institutional Investors ("CII") published the most complete list of dual-class companies. *See* http://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf.

particular, while Commissioners Jackson and Stein focused on some of the perceived and/or potential problems with dual-class stock, the challenges faced by our corporate republic are far greater than those caused by dual-class stock.

The problem arises as a result of the growing "financialization" of our corporate governance structures since the 1980s, which includes allowing equity capital to become the lone determinant voice of what constitutes "good governance." These issues have become exasperated by the changing nature of equity capital itself, as the retail investor has largely disappeared and been replaced by a handful of large institutional investors.

The issues with dual-class stock should not be addressed in isolation, but rather as part of a broader review of the issues facing our corporate "republic." This includes looking at the changing nature of share ownership, the role of the institutional investor (and shareholder activists) and an understanding that about half of all households in the U.S. have no direct or indirect ownership of equities—and thus no say in what constitutes good corporate governance or how corporations should behave—yet are often reliant on these same corporations for everything from employment to retirement, while the corporation is equally dependent on these households for finding qualified employees to consumers for their products. Within this broader context the notion of dual-class stock should be considered, as it really was developed to respond to the changing nature of our corporate republic.

The rest of this response addresses these issues. Part I quickly summarizes the growth and use of dual-class stock today. Part II briefly reviews the changes in our corporate governance regime since the 1980s, including the financialization of corporate governance, the changing role of institutional investors, and how these factors led to the growth of dual-class stock. The essay concludes by offering some suggestions and options for the SEC to consider if it wants to address these issues more broadly.

I. The Current Use of Dual-Class Stock

Dual-class or multi-class stock is common in private companies, as private companies often have multiple classes of "preferred" stock that have differential voting and economic rights.[3] Yet despite the significant attention paid to dual-class stock in public companies, dual-class stock in public companies remains the exception, even among tech companies who have recently gone public. For example, as the *Wall Street Journal* article covering Commissioner Jackson's speech noted that only 16% of companies going public since 2013 have adopted some form of multi-class stock, while Commissioner Jackson stated that just 14% of the companies that went public in 2015 (and many of these companies were not technology companies). While the use of such structures has been increasing, the prominence of dual-class stock is more notable because of the success or profile of the companies adopting it rather than its pure numerical growth.

Despite its relatively infrequent use, the dual-class structures of some highly successful technology companies, including Google (now Alphabet), Facebook, Alibaba, and others, has led to criticisms, particularly by the "Acela Express" governance experts within the Cambridge/New York/Delaware/DC corridor.[4] The concerns over dual- or multi-class stock for public (but not private) companies raised by Commissioners Jackson and Stein last week can be broadly divided into three categories: (1) dual-class corporate structures are inconsistent with our democratic values of "one share/one vote," (2) the stock price performance of dual-class companies is lower than the performance of companies without such structures and (3) public shareholders lack an effective ability to monitor and "police" companies with dual-class stock because the control group can ignore the demands made by public shareholders.

Yet even assuming there is some validity to each of these concerns—and the empirical, philosophical and historical evidence generally relied upon by the critics of dual-class stock remains highly questionable and subject to considerable debate—the real problem with

[3] In recent years it has become common for many of the same institutional investors who complain about dual-class stock in private companies to buy preferred stock in some of the most prominent private technology companies, including such companies as Spotify, Airbnb and Uber.
[4] The Acela Express is the Amtrak train that runs from Boston to Washington DC.

the debate over dual-class stock, especially for technology companies, is that critics of dual-class stock fail to properly consider the broader factors that are leading many of our most innovative and successful companies to choose to either stay private or only go public with multi-class structures.[5]

A major factor leading those companies that go public today to select a dual-class structure is the "financialization" of our corporate governance markets. As a result, in today's capital markets it is virtually impossible for a publicly-traded company to focus on any metric other than shareholder value. Yet it is increasingly recognized that our experiment of equating shareholder value with good corporate governance has largely failed, for shareholders and for society more broadly. [6]

The failures resulting from the financialization of our capital markets was the focus of Stanford Professor Anat Admati's recent article "*A Skeptical View of Financialized Corporate Governance.*" As described by Professor Admati, in the name of creating "shareholder value" corporate managers (whose compensation is often closely linked to an increase in share price, which since the 1980s has also been considered "good governance") have incentives to engage in conduct that, at a minimum, is focused on increasing stock price over the short-term rather than building long-term value. More broadly, as shown by Professor Admati, "managers whose compensation depends on financial targets have incentives to distort information and to divert time and energy to actions that improve the appearance of meeting or exceeding short-term financial targets."[7]

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[5] As a practical matter, determining the long-term performance of technology companies with dual-class stock is a challenge given that most of these companies have not been public for more than a few years (if that). Indeed Google (now Alphabet), which is largely viewed as the model for the dual-class structures now in place, has been a public company for less than 15 years (WSGR represented Google in its IPO, and continues to represent Alphabet), while Facebook has been public for less than 6 years.

[6] *See generally* Anat R. Admati, *"A Skeptical View of Financialized Corporate Governance," Journal of Economic Perspectives"* (2018) (forthcoming) available at https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/jep-final.pdf.

[7] Id. at 5. For this reason it should not be surprising that a recent study by McKinsey found that 79% of executives and directors felt substantial pressure to deliver

A second core problem with our governance system today is that the only voices heard in the governance debate are those of equity capital. This is a real problem for many reasons. First, about half of all Americans have nothing invested in the market, whether through 401(k) programs, pensions or directly through stock ownership or mutual funds.[8] This means that the corporate governance "republic" cited by Commissioners Jackson and Stein as a reason why dual-class stock should be limited excludes about half of all households in America, who have absolutely no say in how these corporations are governed simply because they do not own stock in any corporation.[9]

The exclusion of such a large percentage of households from any say in what constitutes good corporate governance should be an immediate cause for concern. There is a symbiotic relationship between many of these households and public corporations, as at a minimum many households that own no stock rely on public corporations for everything from employment to retirement, while corporations seek employees and consumers from these same households. To utterly exclude these people from all discussion of corporate governance because they are not shareholders excludes a critical voice from this debate.

Another problem with limiting the debate to the voices of equity capital is the changing nature of equity capital itself. For many years the

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results in two years or less, despite the fact that 86% of the participants said that using a longer time horizon to set strategy and make business decisions would have a positive effect on both financial returns and innovation. *See* Dominick Barton & Mark Weisman, *Focusing Capital on the Long-Term*, HARV. BUS. REV., Jan-Feb. 2014, https://hbr.org/2014/01/focusing-capital-on-the-long-term.

[8] *See, e.g.,* Patricia A. Cohen, *"We All Have a Stake in the Stock Market, Right? Guess Again,"* New York Times, February 8, 2018 ("Roughly half of all households don't have a cent invested in stocks…"). *See also*, Strine, Leo E. Jr., "*Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System,*"126 Yale L.J. 1870, 1872 (2017) (hereinafter "*Hedge Fund Activism*") (same).

[9] In fact, the stock market is even more skewed towards the wealthy than other measures of economic inequality, as 84% of all stocks owned by Americans belong to the wealthiest 10% of households. Cohen, *supra,* note 5.

prevailing notion was that the owners of equity capital had a long-term stake in the company itself, were direct owners known to the company and those most active in the company's affairs had a long-term interest in the company's performance. At the same time, the company was expected to have a long-term interest in its employees, customers and its community, including an interest in the externalities of corporate decisions.

In contrast, today's equity markets are dominated by a handful of institutional investors. These investors are highly concentrated and, given both their ownership stakes and the fact that equity capital is the only governance voice that counts, have a virtual monopoly on what constitutes "good corporate governance." For example, and as Commissioner Stein has previously noted, in 2016 institutional investors owned 70% of public shares, and just three money managers held the largest stock position in 88% of the companies in the S&P 500.[10]

Many of these institutions support the goals of hedge funds and other activist investors who generally become stockholders after deciding to change the company, and focus almost exclusively on stockholder value. The result is that it has become far too common for activists and investors to focus only on shareholder return, with little concern about long-term corporate health and even less interest in issues such as linking higher corporate profits to long-term wage growth or improvements in the community where the corporation is based.

Another problem with vesting virtually all power for corporate governance issues in the hands of institutional investors is that the money managers for these investors who make the critical decisions about, among other things, who should serve on a company's board, are typically incentivized to achieve short-term results. This is because the key metric for these managers is assets under management ("AUM"),

[10] *See* The Hon. Kara M. Stein, Commissioner, Securities and Exchange Commission, *The Markets in 2017: What's At Stake*, (Feb. 24, 2017), https://www.sec.gov/news/speech/stein-sec-speaks-whats-at-stake.html.

and AUM increases when short-term performance of the fund increases.[11]

For all of these reasons the "corporate republic" analogy of Commissioners Jackson and Stein as it currently exists serves neither the corporation nor broader society. Specifically, the current "corporate republic" (1) excludes about half of all American households who own no equity (2) most of the "voting republic" consists of money managers who manage other people's money and are compensated on relatively short-term results while (3) the loudest voices in the "republic" tend to be activists who look at three years as a "long-term" investment. In contrast, the people who rely on corporations for jobs and benefits, as well as the typical Americans who do turn their money over to large institutional investors, have time frames measured in decades—since they are often investing for such things as their children's college education and their own retirement—rather than just a few years.[12]

Because the definition of "good corporate governance" today is often narrowly defined to mean actions taken to improve shareholder value (often in the short-term) it should come as no surprise that young entrepreneurs who are interested in building an enterprise for the long-term and care about issues in addition to shareholder value seek alternative stock structures that allows them to experiment with broader goals. One such structure is to keep the company private, and avoid all of the problems with being a publicly traded company. Perhaps not surprisingly, the number of US-listed domestic companies has declined by about half since 1996,[13] while many of the most

[11] *See generally*, John Abraham, "*Breaking Down Asset Managers: Active and Passive Fund Incentives for Anti-Competition*," (2017)available at http://www.law.harvard.edu/programs/olin_center/Prizes/2017-1.pdf.

[12] For a much more thorough and eloquent discussion of this conflict *see* Strine, "Hedge Fund Activism," *supra* note 8.

[13] During the late 1990s there were approximately 8000 US-listed domestic public companies in the US, while over the last several years the number of publicly-traded domestic companies has varied from 4000-4400 companies. *See generally* Ernst & Young, Looking Behind the Declining Number of Public Companies, (May 2017) available at http://www.ey.com/Publication/vwLUAssets/an-analysis-of-trends-in-the-us-capital-markets/$FILE/ey-an-analysis-of-trends-in-the-us-capital-markets.pdf.

successful and exciting technology companies have chosen to remain private rather than go public.

At the same time several companies who have gone public in recent years have chosen to utilize dual-class stock, precisely to push back against the financialization and short-term focus of the public markets. This was made clear in Google's prospectus from 2004, which included the following disclosure:

> Google is not a conventional company. We do not intend to become one…. As a private company, we have concentrated on the long-term, and this has served us well. As a public company, we will do the same….If opportunities arise that might cause us to sacrifice short-term results but are in the best long-term interest of our shareholders, we will take those opportunities.
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> Many companies are under pressure to keep their earnings in line with analysts' forecasts…Google has had adequate cash to fund our business and has generated additional cash through operations. This gives us the flexibility to weather costs, benefit from opportunities and optimize our long-term earnings…Our long term focus does have risks. Markets may have trouble evaluating long-term value, thus potentially reducing the value of our company. Our long-term focus may simply be the wrong business strategy. Competitors may be rewarded for short term tactics and grow stronger as a result. [Yet we] will not shy away from high-risk, high-reward projects because of short-term earnings pressure.
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> We encourage our employees, in addition to their regular projects, to spend 20% of their time working on what they think will most benefit Google. This empowers them to be more creative and innovative. Many of our significant advances have happened in this manner. For example, AdSense for content and Google News were both prototyped in "20% time." [While] [m]ost risky projects fizzle, often teaching us something. Others succeed and become attractive businesses.
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> In the transition to public ownership we have set up a corporate structure that will make it harder for outside parties to take over or influence Google. We understand some investors do not favor dual class structures. Some may believe that our dual class structure will give us the ability to take actions that benefit us, but not Google's shareholders as a whole. We have considered this point of view carefully, and we and the board have not made our decision lightly…we believe the stability afforded by the dual-class

> structure will enable us to retain our unique culture and continue to attract and retain talented people who are Google's lifeblood.[14]

There are a number of steps that regulators may adopt to address some of the underlying causes that are leading companies to consider dual-class stock. For example, the SEC could promulgate regulations making it easier for issuers to adopt "tenure voting," which would give long-term shareholders more voting power than short-term holders.[15] Tenure voting grants shareholders additional votes the longer they hold their shares. While a few companies have tenure voting policies today, actions taken by the SEC in the mid-1980s resulted in the exchanges limiting the use of tenure voting; it is time for the SEC to revisit these actions.

The SEC could take additional actions to ensure that the incentives of institutional investors are aligned with the long-term savers who trust their money to these institutions. For example, the SEC could establish disclosure requirements for institutional investors that would have them disclose their relevant compensation and incentive policies, trading practices and policies on proxy voting as well as ensuring that shareholder litigation brought by ERISA fiduciaries is in the interest of plan beneficiaries. The SEC has authority under both the '40 Act and ERISA to adopt such policies.[16]

Another relatively simple step the SEC can take is to use their regulatory authority over the exchanges to limit disclosures on short-term guidance, in favor of disclosures that know more about the company's long-term strategic investments. Listing requirements with these types of disclosure policies are reportedly under consideration by

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[14] The full text of Google's 2004 Founders' IPO letter can be found here: https://abc.xyz/investor/founders-letters/2004/ipo-letter.html.

[15] I have previously written about many of the issues surrounding tenure voting, including potential listing limitations arising out of the historic views of the SEC opposed to tenure voting. *See* David J. Berger, Steven Davidoff Solomon and Aaron Benjamin, *Tenure Voting and the U.S. Public Company,* 72 BUS. LAW. 295 (2017).

[16] Many of these ideas are taken from the *American Prosperity Project*, sponsored by the Aspen Institute. A copy of the full report is located at https://assets.aspeninstitute.org/content/uploads/2017/01/American-Prosperity-Project_Policy-Framework_FINAL-1.3.17.pdf. I participated in this project and was a signatory to the Report.

Eric Reis' Long-Term Stock Exchange, which is developing listing policies to better align companies and long-term investors.[17]

Admittedly none of these policies addresses the systemic problem arising out of the fact that the holders of equity capital are the only ones able to vote on directors, and thus are the only ones with real influence over directors. It may very well be that until this governance misalignment is fixed, so that other corporate stakeholders have at least a more direct role in the governance of our corporations, companies will continue to adopt dual-class structures.[18] However there are many policies that are available to the SEC that would better incentivize long-term investors, and in this way allow companies who want to invest for the long-term consider alternatives to dual-class structures. Yet until we look more closely at these alternatives many of our country's most innovative and novel companies will continue to explore alternative capital structures rather than risk responding to the short-term realities that are all too often the driving force in our capital market.

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[17] *See generally* Andrew Ross Sorkin, "*Fixing the Brain Damage Caused by the IPO Process*," New York Times, September 18, 2017, available at https://www.nytimes.com/2017/09/18/business/dealbook/ipo-chamath-palihapitiya.html; Eric Reis, LTSE's founder and CEO, is a frequent author on these topics. *See, e.g.,* Eric Reis, "*The Long-Term Stock Exchange Comes to Life,*" October 16, 2017 available at https://blog.ltse.com/the-long-term-stock-exchange-comes-to-life-c497f29bbc73.

[18] I have discussed this governance misalignment in a prior appearance before the SEC's Investor Advisory Committee. *See* David J. Berger, "*Multi-Class Stock and the Modern Corporation: A View From the (Left) Coast on Governance Misalignment and the Public Company*," March 9, 2017, available at https://corpgov.law.harvard.edu/wp-content/uploads/2017/03/mutli-class-stock_berger.pdf.