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The Importance of Inferior Voting Rights in Dual-Class Firms

Dov Solomon[*]

Over the past several years, corporate law scholarship has carefully analyzed the effects of dual-class capital structures, which allocate superior voting rights to insiders and inferior voting rights to public shareholders. This Article adds to the literature by focusing on a unique and novel type of dual-class structure—one in which the public shares have no voting rights at all. It notes that this structure is fundamentally different because in the absence of even highly diluted voting rights in public hands, the firm does not have to abide by certain types of disclosure rules and corporate governance standards. Nonvoting shareholders are deprived of these significant components of investor protection.

After carefully identifying the serious consequences of nonvoting common stock for investor protection, the Article suggests two ways to address them. First, the Securities and Exchange Commission should act to protect nonvoting shareholders by requiring the same level of disclosure when nonvoting stock is issued as is required when voting stock is issued. Towards implementing this proposal, the Article distinguishes between the situation of no voting rights and the long-standing federal court decision asserting that the regulation of voting rights is beyond the delegated authority of the Commission. Second, stock exchange rules should impose requirements for listed firms aimed at protecting holders of nonvoting stock. These rules would grant nonvoting shareholders certain

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disclosure and governance rights they do not otherwise have under federal or state law. The Article's proposals directly address the implications of nonvoting stock for disclosure and corporate governance, and therefore are preferable to the current incidental reaction of major index providers to dual-class capital structures.

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I. INTRODUCTION

Snap Inc., Silicon Valley's social-media star, is a groundbreaking company that is reinventing the camera.[1] In March 2017, it proved its ability to innovate in the financial field as well

1. Snap states on its website that "[w]e believe that reinventing the camera represents our greatest opportunity to improve the way people live and communicate." SNAP INC., https://www.snap.com/en-US/ (last visited Oct. 21, 2019).

when it went public with a unique dual-class capital structure.[2] In contrast to other companies that have also issued dual-class shares, such as Google or Facebook, the public float in Snap's initial public offering (IPO) had no voting rights at all. The issuance of nonvoting common stock has serious implications for corporate governance and investor protection that go far beyond those of the traditional dual-class structures.[3]

A dual-class capital structure creates a gap between voting rights and cash-flow rights.[4] A company founder who wants to raise capital without relinquishing effective control of the company can issue different classes of shares with unequal voting rights. While her shares enjoy superior voting rights, the shares issued to the public investors grant either inferior voting rights or no voting rights at all. By issuing two or more classes of shares with unequal voting rights, the founder can avoid the dilution that an IPO normally creates and hold on to most of the voting rights in shareholder meetings, despite her relatively low equity investment. In this way, she can entrench her control of the company even after it goes public.

There are two main incentives for going public with a dual-class capital structure: first, it allows the company's founder to pursue her idiosyncratic vision for producing above-market returns; second, it insulates management from short-term market pressures and thus promotes long-termism.[5] However, the controller of a

2. Steven Davidoff Solomon, *In Snap's I.P.O., Evidence of Bankers' Strategy*, N.Y. TIMES (Mar. 1, 2017), https://www.nytimes.com/2017/03/01/business/dealbook/in-snaps-ipo-evidence-of-bankers-strategy.html.

3. Following Snap's IPO, Kurt Schacht, the Chairman of the SEC's Investor Advisory Committee, referred to the possibility that the issuance of nonvoting common stock will be the new trend with unicorn companies as a "troubling development from the perspective of investor protection and corporate governance." *See* Therese Poletti, *Potential Snap IPO Effect: More Unicorns to Wall Street, but with Horrible Terms*, MARKETWATCH (Mar. 2, 2017), https://www.marketwatch.com/story/potential-snap-ipo-effect-more-unicorns-to-wall-street-but-with-horrible-terms-2017-03-02.

4. Stock pyramids and cross-ownership structures are alternative ways to create a gap between voting rights and cash-flow rights. *See* Lucian Arye Bebchuk, Reinier Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 295 (Randall K. Morck ed., 2000).

5. *See, e.g.*, Letter from Larry Page & Sergey Brin, Cofounders, Google, 2004 Founders' IPO Letter: "An Owner's Manual" for Google's Shareholders, https://abc.xyz/investor/founders-letters/2004/ipo-letter.html (last visited Oct. 21, 2019)

dual-class firm has two fundamental characteristics that result in agency problems: weak ownership incentives and entrenchment.[6] The combination of these characteristics produces situations where a controller might have interests that substantially diverge from those of public shareholders, and no threat of replacement exists to prevent her from pursuing these interests. This may lead to a distortion of various business choices, such as the extraction of private benefits of control at the expense of other shareholders. Moreover, since the controller can extract private benefits from capital that is inside the firm, while she bears only a fraction of the costs of deploying the capital in the firm rather than using it more efficiently elsewhere in the economy, her incentives may become distorted when considering whether the firm should expand, contract, or remain the same size.

Furthermore, agency problems in dual-class firms are substantially exacerbated when public shareholders are not entitled to voting rights. In the absence of even highly diluted voting rights in public hands, the firm does not have to abide by certain types of disclosure rules and corporate governance standards. For example, if a company has registered only nonvoting shares, it is not required to distribute a proxy or information statement under federal securities law.[7] Moreover, holders of nonvoting stock are unable to express their voice on a company's key issues and raise shareholder proposals under Rule 14a-8 of the Securities Exchange Act of 1934.[8] On the other hand, so long as shareholders have voting rights, even inferior ones, they are protected by certain disclosure and governance requirements for listed firms. From the perspective of investor protection, therefore, there are significant differences between issuing nonvoting and low-voting common stock.

[https://perma.cc/5YQK-LMHP] ("We are creating a corporate structure that is designed for stability over long time horizons. By investing in Google, you are placing an unusual long term bet on the team, especially Sergey and me, and on our innovative approach."). For a detailed discussion of these incentives, see *infra* Part III.

6. Lucian A. Bebchuk & Kobi Kastiel, *The Perils of Small-Minority Controllers*, 107 GEO. L.J. 1453, 1465–66 (2019).

7. *See, e.g.*, 17 C.F.R. § 240.14c-2 (2018) (requiring the distribution of an information statement to every shareholder "of the class that is entitled to vote" on a shareholder meeting).

8. *See id.* § 240.14a-8 (2018) (requiring a shareholder to hold at least $2,000 in market value, or one percent, of the company's "securities entitled to be voted" in order to be eligible to submit a proposal for inclusion in a proxy statement).

It should be noted that passive investors, such as index funds, are forced to invest in nonvoting common shares despite their effects on investor protection.[9] Therefore, major index providers have recently revised their policies regarding multiclass shares and moved to exclude the stock of dual-class firms from stock indices.[10] The exclusion of the stock of some of the most-innovative companies, however, would prevent the indices from being as expansive and diverse as the underlying industries and economies whose performance they seek to capture. The indices then may no longer reflect the investable universe of public companies or represent the wealth-creating power of the U.S. economy. As a result, the access to the investment marketplace of Main Street investors, who often own stock in U.S. public companies through an index, would become limited.

Therefore, the Article suggests two different ways to address the consequences of nonvoting common stock for disclosure and corporate governance, which are not limited to the indices' inclusion policy, but reflect a broader perspective of the issue. Instead of addressing these consequences incidentally by means of the index providers, and thus creating a gap between the indices and the economy, they should be directly addressed through Securities and Exchange Commission (SEC) regulation and stock exchange rules.

First, the case of nonvoting stock should be distinguished from the case of low-voting stock, the latter of which was the subject of the *Business Roundtable* decision in 1990.[11] This long-standing federal court decision asserted that regulating voting rights, which traditionally have been the exclusive province of state corporate law, is beyond the authority of the SEC.[12] When public shareholders have no voting rights at all, however, there are direct negative

9. Index funds buy and hold stock in an underlying index, such as the S&P 500, and they consequently own certain shares irrespective of their performance and prospects.

10. *See* FTSE RUSSELL, FTSE RUSSELL VOTING RIGHTS CONSULTATION—NEXT STEPS 3 (2017), http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf [hereinafter FTSE RUSSELL PROPOSAL]; *S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rules*, S&P DOW JONES INDICES (July 31, 2017), https://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjimulti-classsharesandvotingrulesannouncement7.31.17.pdf?force_download=true.

11. *See* Bus. Roundtable v. SEC, 905 F.2d 406, 408 (D.C. Cir. 1990).

12. *Id.*

implications for investor protection, which is indisputably subject to the SEC's delegated authority under the Securities Exchange Act of 1934.[13] Therefore, the SEC can and should act to protect nonvoting shareholders by requiring the same level of disclosure when nonvoting stock is issued as is required when voting stock is issued.

Second, stock exchanges should impose requirements for listed firms aimed at protecting holders of nonvoting stock. Since the exchanges have strong incentives to maintain good reputations, the concern that the competition to attract new listings may put "race to the bottom" pressure on listing standards is not reasonable. Indeed, stock exchange rules grant nonvoting shareholders certain disclosure and governance rights they do not otherwise have under federal or state law. The New York Stock Exchange (NYSE) rules, for instance, require that any materials sent to voting shareholders, including proxy material, also be sent to nonvoting shareholders.[14] However, these rules are limited in protecting nonvoting shareholders.[15]

The Article proceeds as follows: Part II describes the rise of dual-class capital structures in general and the issuance of nonvoting common stock in particular. Part III analyzes the incentives a company's founder has to use dual-class shares—to pursue her idiosyncratic vision and promote long-termism—and sheds light on their limits in justifying dual-class structures. Part IV analyzes the agency problems that characterize dual-class structures, followed by a presentation of empirical evidence for their costs. Part V focuses on dual-class structures in which the common shares have no voting rights at all. It reveals the negative effects of the absence of even highly diluted voting rights on investor protection. Therefore, Part VI suggests addressing the serious consequences of nonvoting common stock for disclosure

13. Protecting investors is one of the three key statutory mandates of the SEC. *See* 15 U.S.C. § 78c(f) (2012).

14. *See* Voting Rights, NYSE Listed Company Manual § 313.00(B)(2) (2019), https://nyseguide.srorules.com/listed-company-manual/document?treeNodeId=csh-da-filter!WKUS-TAL-DOCS-PHC-%7B0588BF4A-D3B5-4B91-94EA-BE9F17057DF0%7D--WKUS_TAL_5667%23teid-99 [hereinafter NYSE Listed Company Manual] ("[H]olders of any listed non-voting common stock must receive all communications, including proxy material, sent generally to the holders of the voting securities of the listed company.").

15. *See infra* Section VI.C.

and corporate governance through SEC regulation and stock exchange rules. It also explains the priority of these two proposals over the alternative of excluding nonvoting stock from market indices. Finally, Part VII concludes the discussion.

II. THE RISE OF DUAL-CLASS FIRMS

Nonvoting shares are not newcomers. In the early twentieth century, dual-class capital structures that included nonvoting shares gained in popularity in the United States.[16] However, under public pressure in response to the listing of nonvoting common stock by the Dodge Brothers Company, in 1926 the NYSE began to pay more attention to shareholder voting rights when reviewing listing applications.[17] Finally, the NYSE formally announced a flat rule against listing nonvoting common stock in 1940.[18]

In contrast to the American Stock Exchange (AMEX) and the Nasdaq stock exchange (Nasdaq), which permitted dual-class share structures, the NYSE retained its "one-share, one-vote" listing standard for almost six decades. Over time, however, companies have recognized the potential power of dual-class stock schemes as a defense against hostile takeover bids. An increasing pressure from these companies and the competition from other U.S. exchanges led the NYSE to impose a four-year moratorium on this standard in the mid-1980s.[19] Despite a later proposal for the SEC to relax existing restrictions on listings of dual-class stock,[20] the SEC rejected the NYSE's proposal in 1988 and instead promulgated Rule 19c-4, which barred national securities exchanges from listing shares of issuers that nullified, reduced or restricted voting rights of existing public stockholders.[21] In 1990, Rule 19c-4 was challenged in federal court on the ground that the SEC had exceeded its

16. Douglas C. Ashton, *Revisiting Dual-Class Stock*, 68 ST. JOHN'S L. REV. 863, 891–92 (1994); Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19C-4*, 69 WASH. U. L.Q. 565, 568–69 (1991).

17. Bainbridge, *supra* note 16, at 569; Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 697 (1985).

18. Bainbridge, *supra* note 16, at 569; Seligman, *supra* note 17, at 699.

19. Bainbridge, *supra* note 16, at 577.

20. *Id.*

21. *See* Voting Rights Listing Standards; Disenfranchisement Rule, 53 Fed. Reg. 26,376 (July 12, 1988) (codified at 17 C.F.R. § 240.19c–4 (2018)).

rulemaking authority under the Securities Exchange Act of 1934.[22] In the *Business Roundtable* decision, the District of Columbia Court of Appeals ultimately struck down the new rule as being a matter for state corporate law and beyond the SEC's delegated authority.[23]

Despite the *Business Roundtable* decision, the SEC succeeded in persuading the main stock exchanges to adopt a policy similar to the former Rule 19c-4 in their listing standards. Although both the NYSE's and Nasdaq's policies generally granted companies wide latitude in structuring disparate voting rights for multiple classes of common stock at the time of an IPO, they set limitations on subsequent actions that reduce or restrict voting rights of existing public stockholders.[24] Therefore, while U.S.-listed companies face constraints on a dual-class recapitalization, they have been largely free to go public with a dual-class capital structure.

More than 13.5% of the 133 companies listing shares on U.S. exchanges in 2015 have set up a dual-class structure, compared with 12% in 2014, and just 1% in 2005.[25] The trend of multiple-share classes gained steam in 2004 when Google decided to go public with a dual-class capital structure, granting its cofounders, executive management team, and directors 61.4% of the voting power.[26] In the years since, the multiclass capital structure has become the norm in Silicon Valley among many hi-tech companies.[27] It has enabled the founders of companies that have gone public such as Google, Facebook, Zynga, Groupon, LinkedIn and Yelp to hold the majority of voting rights and entrench their control of the company by issuing special classes of shares that give

22. For the statutory mandates of the SEC, see 15 U.S.C. § 78c(f) (2012).

23. *See* Bus. Roundtable v. SEC, 905 F.2d 406, 408 (D.C. Cir. 1990).

24. *See* NYSE Listed Company Manual, *supra* note 14, § 313.00(A)–(B); Voting Rules, Nasdaq Stock Market Listing Rules § 5640 (2019), http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_3_8_31&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F [hereinafter Nasdaq Listing Rules].

25. Kristin Lin, *The Big Number,* WALL STREET J. (Aug. 17, 2015, 10:41 PM), https://www.wsj.com/articles/the-big-number-1439865699.

26. *See* Page & Brin, *supra* note 5.

27. Jeff Green & Ari Levy, *Zuckerberg Stock Grip Becomes New Normal in Silicon Valley*, BLOOMBERG (May 6, 2012, 10:01 PM), https://www.bloomberg.com/news/articles/2012-05-07/zuckerberg-stock-grip-becomes-new-normal-in-silicon-valley-tech. Lise Buyer, principal at Class V Group in Portola Valley, California, stated that "[i]t may be everybody tries [a dual-class structure], because the market seems to be giving everyone a pass." *Id.*

them more votes than the holders of other classes of shares.[28] These technology companies followed in the footsteps of veteran media corporations like the New York Times, News Corp., and Viacom, which had adopted the multiple-class share model for their IPOs.[29]

The trend of listing dual-class shares on U.S. stock exchanges is not limited to U.S. companies. Since the United Kingdom and Hong Kong prohibited the use of dual-class stock,[30] some foreign companies have chosen to list their dual-class shares on U.S. exchanges. For example, in 2012, Manchester United, the famous English soccer club, preferred to list its shares on the NYSE rather than the London Stock Exchange due to the option of using a dual-class capital structure.[31] Similarly, in 2014, Alibaba, the Chinese e-commerce giant, went public on the NYSE rather than the Hong Kong Stock Exchange in order to use a dual-class structure.[32]

In contrast to IPOs in which the public float had at least some voting rights, Snap's IPO in March 2017 appears to be the first nonvoting listing IPO on a U.S. exchange since the NYSE in 1940 generally barred multiclass common stock structures with unequal voting rights.[33] Following its IPO, Snap has a three-tiered capital

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28. James Surowiecki, *Unequal Shares*, NEW YORKER (May 21, 2012), http://www.newyorker.com/magazine/2012/05/28/unequal-shares.

29. It was argued that "insulation from the vagaries of the" capital market could help protect a news outlet's editorial independence. *See* Green & Levy, *supra* note 27.

30. *See* H.K. EXCHS. & CLEARING LTD., *Concept Paper: Weighted Voting Rights*, at 25–28 (Hong Kong), III-12 to III-13 (UK) (Aug. 2014), https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2011-to-2015/August-2014-Weighted-Voting-Rights/Consultation-paper/cp2014082.pdf. The Hong Kong Stock Exchange has recently revised its rules regarding dual-class shares. *See* Benjamin Robertson, *Hong Kong Adds Dual-Class Shares, Paving Way for Tech Titans*, BLOOMBERG (April 24, 2018, 4:38 AM), https://www.bloomberg.com/news/articles/2018-04-24/hong-kong-approves-dual-class-shares-paving-way-for-tech-titans.

31. Steven Davidoff Solomon, *In Manchester United's I.P.O., a Preference for American Rules*, N.Y. TIMES: DEALBOOK (July 10, 2012, 2:32 PM), http://dealbook.nytimes.com/2012/07/10/in-manchester-uniteds-i-p-o-a-preference-for-u-s-rules.

32. *See* Shen Wei & Angus Young, *Dual Share Plan in Context: Making Sense of Hong Kong's Decision Not to Embrace Alibaba's Listing*, 26 INT'L COMPANY & COM. L. REV. 4 (2015).

33. Indeed, since their dual-class IPOs, Google and Under Armour also listed nonvoting shares that were issued to existing public shareholders in a stock split, while Facebook attempted to do the same but gave up the midstream issuance of nonvoting shares following shareholder litigation. Yet, public shareholders of Google and Under Armour, in contrast to Snap, received at the IPOs at least some voting rights. *See* Google Inc., Definitive Proxy Statement (Form DEF 14A) 56–87 (May 9, 2012); Under Armour Inc., Definitive Proxy Statement (Form DEF 14A) 5–35 (July 13, 2015); Facebook, Inc., Current Report (Form 8-K) (Sep. 21, 2017); *see also* Steven Davidoff Solomon, *Snap's Plan Is Most Unfriendly*

structure. The founders, Evan Spiegel and Bobby Murphy, hold Class C shares and are entitled to ten votes per share on matters submitted to Snap's shareholders for approval. Pre-IPO VC investors and other insiders hold Class B shares and are entitled to one vote per share. Public investors hold Class A shares and are entitled to no vote. Following the IPO, the founders can exercise voting rights with respect to their Class C common stock, which represents approximately 88.5% of the voting power of Snap's outstanding capital stock.[34]

Snap's unique dual-class capital structure with its nonvoting common stock has serious implications for investor protection that need to be understood and addressed. To achieve these goals, the next two Parts of the Article will discuss and analyze the pros and cons of dual-class structures in general and then the following Parts will discuss dual-class structures in which the common shares have no voting rights at all.

III. INCENTIVES FOR DUAL-CLASS STRUCTURES

Founders articulate two main reasons for going public with a dual-class structure. The first is that it enables them to pursue their idiosyncratic vision for the company. The second is that it insulates management from short-term market pressures, allowing management to make decisions that enhance long-term value.[35] This Part analyzes these incentives and sheds light on their limits in justifying dual-class structures.

A. The Founder's Idiosyncratic Vision

A dual-class structure enables a company's founder to hold the majority of voting rights and entrench her control of the company even after it goes public. It is argued that uncontestable and indefinite control allows a talented founder to implement her

to Outsiders, N.Y. TIMES (Feb. 3, 2017), https://www.nytimes.com/2017/02/03/business/dealbook/snap-ipo-plan-evan-spiegel.html.

34. Snap Inc., Registration Statement (Amendment No. 3 to Form S-1/A) 4 (Feb. 24, 2017) [hereinafter Snap Prospectus].

35. *See, e.g.*, Page & Brin, *supra* note 5.

idiosyncratic vision,[36] which may produce above-market returns, benefiting not only the founder but also the investors.[37] Therefore, the allocation of superior voting rights to the founder and inferior voting rights, or even no voting rights at all, to the investors is value-enhancing and thus justified.

This argument assumes that (a) founders have superior business skills and knowledge relative to other shareholders, and (b) they utilize their superior skills and knowledge to benefit all shareholders. However, neither of these assumptions is always or necessarily correct.

Given the specific risk of investing in a single company, shareholders often diversify their capital market investments.[38] A byproduct of their investments across many corporations is that they accumulate professional knowledge and enhance their expertise. Shareholder meetings in different corporations often deal with similar issues, such as corporate governance and executive compensation. Thus, shareholders—particularly institutional investors—acquire knowledge, experience, and expertise through their investments in many corporations.[39] Therefore, at least with regard to matters that are frequently debated at shareholder meetings, founders do not necessarily wield superior knowledge or expertise as compared to other shareholders.[40]

Even if we were to accept the assumption that founders of dual-class firms have superior business skills and knowledge, there is no guarantee that these advantages will be applied in a way that will maximize the aggregate shareholder wealth. Quite the contrary: a founder might exploit her advantages to advance courses of action that serve her private interests but conflict with the interests of public investors. For example, she might extract private benefits of

36. Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 565 (2016) ("[C]ontrol allows entrepreneurs to pursue business strategies that they believe will produce above-market returns by securing the ability to implement their vision in the manner they see fit.").

37. *Id.* at 590.

38. *See* RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 196–98 (10th ed. 2011).

39. Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 852–53 (1992).

40. Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 881 (2005).

control at the expense of other shareholders.[41] Since we cannot assume that a founder necessarily utilizes her superior skills and knowledge to benefit all shareholders, the "founder's idiosyncratic vision" argument loses its justification.

B. Long-Termism

Another argument often used to justify dual-class structures is that they insulate management from short-term market pressures and thus promote long-termism.[42] A commonly held view is that corporate law should not promote short-termism but should rather strive to support long-term shareholder value.[43] For example, two prominent judges on the Delaware Supreme Court have expressed concern about the consequences of investors' short-termism and urged managers to promote the long-term interests of investors.[44] With a lock on control, dual-class structures promote long-termism. They protect the founder from the risk of being ousted due to her short-term performance and thus release her from concern about

41. *See infra* Section IV.A.

42. Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 611–12 (2017); George W. Dent, Jr., *Dual Class Capitalization: A Reply to Professor Seligman*, 54 GEO. WASH. L. REV. 725, 748 (1986). For empirical evidence supporting this argument, see Bradford D. Jordan, Soohyung Kim & Mark H. Liu, *Growth Opportunities, Short-Term Market Pressure, and Dual-Class Share Structure*, 41 J. CORP. FIN. 304 (2016) (finding that dual-class firms face lower short-term market pressure than single-class firms).

43. Hansmann & Kraakman state decisively that "[t]here is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value." Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001); *see also* John H. Matheson & Brent A. Olson, *Corporate Cooperation, Relationship Management, and the Trialogical Imperative for Corporate Law*, 78 MINN. L. REV. 1443, 1444 (1994) ("[T]he *raison d'être* of large publicly held corporations is to maximize 'longterm shareholder' and corporate value." (footnote omitted)); Michael E. Porter, *Capital Disadvantage: America's Failing Capital Investment System*, HARV. BUS. REV., Sept.–Oct. 1992, at 65, 79 ("[L]ong-term shareholder value should be identified as the explicit corporate goal.").

44. Jack B. Jacobs, Lecture, *"Patient Capital": Can Delaware Corporate Law Help Revive It?*, 68 WASH. & LEE L. REV. 1645, 1649–50 (2011); Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 10, 17–18 (2010). *But see* Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554, 1557 (2015) (arguing that managers serving long-term shareholders may well destroy more economic value than managers serving short-term shareholders; thus, favoring the interests of long-term shareholders could reduce, rather than increase, the value generated by a firm over time).

short-term market pressures.[45] Rather, the founder can focus on the company's results in the long run and make decisions that enhance long-term value.[46]

However, the assumption that investors push managers into adopting myopic policy aimed at reaping quick profits in the short term, even if it causes harm to the company in the long run, is not empirically supported. The biggest investors in the capital markets that own a vast majority of the shares of public companies are institutional investors, such as pension funds, insurance companies and mutual funds.[47] They are characterized by a long-term investment horizon, which allows them to meet their long-term obligations.[48] Empirical studies have shown that institutional ownership is associated with higher long-term investment.[49] Sunil Wahal and John McConnell surveyed 2500 companies and found a strong correlation between institutional share ownership and expenditures for property, plant, equipment, and research and development (R&D).[50] Similarly, Gary Hansen and Charles Hill analyzed data from 129 companies and found a positive correlation between institutional ownership and R&D expenditure.[51] These findings refute the premise that investors suffer from myopia. Instead, what emerges is that institutional investors seek long-term

45. The economic and legal literature discusses critical problems created by short-term interests of shareholders. *See, e.g.*, Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 267–71 (2012); Justin Fox & Jay W. Lorsch, *What Good Are Shareholders?*, HARV. BUS. REV., July–Aug. 2012, https://hbr.org/2012/07/what-good-are-shareholders [https://perma.cc/M6CB-E66Q].

46. *See, e.g.*, Letter from Larry Page & Sergey Brin, Cofounders, Google, 2011 Founders' Letter (Apr. 2012) https://abc.xyz/investor/founders-letters/2011/ ("In our experience, success is more likely if you concentrate on the long term. Technology products often require significant investment over many years to fulfill their potential . . . . We have protected Google from outside pressures and the temptation to sacrifice future opportunities to meet short-term demands . . . . We have a structure that prevents outside parties from taking over or unduly influencing our management decisions.").

47. For the important role played by institutional investors in the capital markets around the world, see Dov Solomon, *The Voice: The Minority Shareholder's Perspective*, 17 NEV. L.J. 739, 750–51 (2017).

48. Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564 (2006).

49. Mark J. Roe, *Corporate Short-Termism — In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 993–96 (2013).

50. Sunil Wahal & John J. McConnell, *Do Institutional Investors Exacerbate Managerial Myopia?*, 6 J. CORP. FIN. 307, 310 (2000).

51. Gary S. Hansen & Charles W. L. Hill, *Are Institutional Investors Myopic? A Time-Series Study of Four Technology-Driven Industries*, 12 STRATEGIC MGMT. J. 1, 6, 9 (1991).

economic results from the companies they invest in.[52] In light of these findings, there is no essential need to insulate management from short-term market pressures.

Furthermore, even if we were to accept that investors push management into adopting short-term policy, there is no clear evidence to suggest that dual-class structure is the solution for this myopia. We cannot assume that dual-class firms focus on the long term, and thus invest more for the long run. Onur Arugaslan, Douglas Cook and Robert Kieschnick examined data on U.S. IPOs from 1980 through 2008 and found that post-IPO dual-class firms do not invest in R&D more than single-class firms.[53] Moreover, Martijn Cremers, Beni Lauterbach and Anete Pajuste examined a matched sample of 504 U.S. dual-class firms and 504 U.S. single-class firms that had an IPO from 1980 to 2015 and documented that dual-class firms tend to invest in R&D less than single-class firms.[54] Therefore, the "long-termism" argument for dual-class structures also loses its justification.

IV. AGENCY PROBLEMS IN DUAL-CLASS FIRMS

The controller of a dual-class firm has two fundamental characteristics that result in agency problems: weak ownership incentives and entrenchment.[55] A controller with low equity holdings bears only a small fraction of the negative effects of her actions on the firm value while capturing the full private benefits of control, and thus her incentives may be distorted.[56] The smaller the controller's equity stake in the dual-class firm, the greater the severity of the incentive distortions. At the same time, entrenchment insulates the controller from the disciplinary force of

52. *See* Black, *supra* note 39, at 862–64.

53. Onur Arugaslan, Douglas O. Cook & Robert Kieschnick, *On the Decision to Go Public with Dual Class Stock*, 16 J. CORP. FIN. 170, 171 (2010).

54. Martijn Cremers, Beni Lauterbach & Anete Pajuste, *The Life-Cycle of Dual Class Firm Valuation* (European Corp. Governance Inst. – Fin., Working Paper No. 550, 2018), https://ssrn.com/abstract=3062895. *But see* Jordan, Kim & Liu, *supra* note 42, at 305 (analyzing data from 1994 to 2011 and finding that dual-class firms have higher R&D intensity than single-class firms).

55. *See* Bebchuk & Kastiel, *supra* note 6.

56. Solomon, *supra* note 47, at 746 (explaining and demonstrating how a disparity between voting rights and cash-flow rights exacerbates conflicts of interest between majority and minority shareholders and encourages the controller to act against the public investors' interests).

the market for corporate control that otherwise might limit the ability of a poorly performing controller—whether due to agency problems or otherwise—to continue leading the firm.[57] Indeed, the controller of a dual-class firm is able to entrench control while her incentives may become misaligned with the preferences of public investors. It should be stressed that it is the *combination* of weak ownership incentives and entrenchment, which characterizes dual-class firms, that produces these serious agency problems.

The combination of weak ownership incentives and entrenchment sets dual-class firms apart from single-class widely held or controlled firms. With low equity holdings but no entrenchment, as in widely held firms, the extent to which a single-class firm can underperform or run in ways departing from the interests of public investors is limited by the market for corporate control.[58] In a single-class controlled firm, conversely, while an entrenched controller with high equity holdings cannot be replaced and thus disciplined by the market for corporate control, she may be incentivized to maximize the firm's value by holding a majority of the cash-flow rights affected by her actions.[59] In contrast to these two types of single-class firms, the absence of both strong financial incentives and market discipline in dual-class firms produces a situation where a controller might have interests that substantially diverge from those of public investors, and no threat of replacement exists to prevent her from pursuing these interests.

The negative effects of the combination of weak ownership incentives and entrenchment will be discussed in the next section, followed by a presentation of empirical evidence for these effects.

A. Extraction of Private Benefits

The aforementioned combination of weak ownership incentives and entrenchment may lead to a distortion of various business choices. Because a controller of a dual-class firm takes into account the effects of her decisions not only on the firm value but also on her level of private benefits, she may favor choices that

57. For the importance of the market for corporate control as a disciplinary mechanism for lowering agency costs, see Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

58. Bebchuk & Kastiel, *supra* note 42, at 603.

59. *Id.*

increase her private benefits of control even if those choices are not optimal from the perspective of maximizing the firm value. The discussion below will illustrate some situations of distorted choices in which controllers extract private benefits at the expense of minority shareholders, a practice known as "tunneling."[60]

Let us take, for example, a dual-class firm in which the controlling shareholder holds the majority of voting rights but only ten percent of the cash-flow rights. For every dollar that the company produces in profits and distributes as dividends to the shareholders, the controller will receive only ten cents, while ninety cents will be divided up amongst the other shareholders. The controlling shareholder is thus likely to use her control of the company to pass decisions that will increase her private benefits at the expense of minority shareholders: for instance, to engage in inefficient self-dealing transactions between the company and an entity affiliated with the controller on terms that favor the entity and thus, in turn, the controller.[61] Consider, for example, a transaction in which the company sells an asset to an entity controlled by the controller, which results in a loss of one hundred dollars to the company, but a profit of forty dollars to the buyer entity. This transaction would be in the interest of the controller because the controller makes forty dollars profit but bears a loss of only ten dollars (ten percent of the loss of one hundred dollars to the company). In fact, because of the controller's distorted choices, any private benefit of control larger than ten dollars creates an incentive to carry out this self-dealing transaction, despite its being undesirable from the perspective of the company and inefficient for the overall economy.

A second kind of distorted choice also stems from weak ownership incentives and entrenchment: usurping an opportunity that would be more valuable in the hands of the company rather

60. Extraction of private benefits of control is commonly referred to as "tunneling." *See, e.g.*, Vladimir Atanasov et al., *Law and Tunneling*, 37 J. CORP. L. 1, 2 (2011) (using the term "tunneling" to describe the extraction of wealth from firms by insiders, i.e., managers and controlling shareholders); Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22, 22 (2000) (using the term "tunneling" to describe the transfer of assets and profits out of firms for the benefit of those who control them).

61. *See In re* Ezcorp Inc. Consulting Agreement Derivative Litig., C.A. No. 9962-VCL, 2016 WL 301245, at *2 (Del. Ch. Jan. 25, 2016) ("As control rights diverge from equity ownership, the controller has heightened incentives to engage in related-party transactions and cause the corporation to make other forms of non-*pro rata* transfers.").

than the controller. For example, assume that the company has the right to an opportunity which will result in a profit of one hundred dollars to the company but which the controller can take from the company for the controller's private benefit, resulting in a profit of forty dollars to the controller. If the controller takes the opportunity, she will benefit by forty dollars, but bear only ten dollars of the foregone benefit to the company (ten percent of one hundred). Therefore, the controller has an incentive to take this opportunity, even though it is undesirable from the point of view of the company as well as inefficient for the overall economy. Here again, because of distorted choices, any private benefit of control larger than ten dollars will create an incentive to usurp such an opportunity.

A third kind of distorted choice involves the appointment or retention of the controller or her family member as an executive rather than a better outside candidate. Suppose that choosing an incompetent family member as an executive, rather than the best person available outside the family, would result in a private benefit of control of forty dollars from having the family member serve, but produce a loss of one hundred dollars to the company. However, the controller bears a loss of only ten dollars (ten percent of one hundred dollars) and thus has an incentive to appoint the family member rather than the better candidate. Moreover, the controller might choose to retain her family member as an executive even if the family member underperforms and would be replaced but for her relationship with the controller. In fact, any private benefit larger than ten dollars creates an incentive for the appointment and retention of the controller or her family member as an executive, even though it is undesirable from the perspective of the company and inefficient for the overall economy.

The analysis of agency problems and incentive distortions in dual-class firms has so far proceeded on the assumption that the firm has a given amount of capital, with the relevant question being how the firm manages that capital. However, agency problems also arise when the size of the pie changes. Therefore, the following discussion points to a different set of distorted choices concerning whether the firm should expand, contract, or remain the same size.[62]

It should be noted that the considerations of whether to raise additional capital are separate from the question of whether the company currently is using its existing capital efficiently. A company may effectively deploy its existing capital, but may not have additional opportunities for profitable investments, and should therefore not expand. Moreover, even if a company has operated profitably in the past, there is always a question whether, going forward, it will be able to deploy its existing capital more efficiently than that capital could be deployed elsewhere in the economy. If the answer to this question is negative, then the company should not remain at its current size but contract by returning capital to its investors.

From the point of view of public investors and of society in general, it is desirable that a company should raise more capital only if it can deploy that capital efficiently, which is not always the case. If the company cannot use the additional capital efficiently, then it is not desirable for it to expand. However, in the context of a dual-class firm, a controller has a substantial structural bias in favor of expanding more than is desirable, as well as a strong structural incentive to avoid contracting, even when contraction is desirable. Because the controller can extract private benefits from capital that is inside the firm while bearing only a fraction of the costs of deploying the capital in the firm rather than elsewhere in the economy, her incentives become distorted when considering whether the firm should expand, contract, or remain the same size.

This section demonstrates a wide range of distorted choices aimed at increasing private benefits of control at the expense of minority shareholders. The distortion of various choices results from the combination of weak ownership incentives and entrenchment, which characterizes dual-class firms. The next section will discuss the empirical evidence on the negative effects of dual-class structures.

62. *See generally*, Sanford J. Grossman & Oliver D. Hart, *Corporate Financial Structure and Managerial Incentives*, *in* THE ECONOMICS OF INFORMATION AND UNCERTAINTY 107 (John J. McCall ed., 1982) (analyzing agency problems of expansion and management's tendency to avoid distributing cash or assets to shareholders).

B. Empirical Evidence

The majority of the empirical findings support the above analysis of agency problems in dual-class firms. Studies around the world have shown that the combination of weak ownership incentives and entrenchment distorts controller incentives, increases extraction of private benefits of control, and thus decreases firm value. Some studies have compared the effect of dual-class shares on firm value to the effect of other mechanisms of separating cash-flow rights and control rights. For example, Stijn Claessens, Simeon Djankov, Joseph Fan and Larry Lang studied 1301 companies from eight East Asian economies to examine the impact of dual-class shares, pyramid structures and cross-holdings among firms on firm value.[63] They found that firm value increases with the cash-flow rights of the largest shareholder, but decreases when the voting rights exceed the cash-flow rights.[64] Additionally, the value discount generally increases with the size of the wedge between voting and cash-flow rights.[65] Morten Bennedsen and Kasper Meisner Nielsen used a sample of 4096 companies from fourteen European countries, and found that companies with a separation of cash-flow rights and control rights have lower firm values and that dual-class shares are associated with a significantly larger value discount than pyramid structures.[66] Belen Villalonga and Raphael Amit used a sample of 515 companies from the United States and found that dual-class shares have a negative impact on firm value, while pyramids have the opposite effect.[67]

Other studies have focused specifically on dual-class structure among the mechanisms for separating cash-flow rights and control rights and have shown its negative effects. Research published by IRRC and ISS found that dual-class firms have worse economic results in the long term as compared to companies with a one-

63. Stijn Claessens, Simeon Djankov, Joseph P. H. Fan & Larry H. P. Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741, 2742–43 (2002).

64. *Id.* at 2743–44.

65. *Id.*

66. Morten Bennedsen & Kasper Meisner Nielsen, *Incentive and Entrenchment Effects in European Ownership*, 34 J. BANKING & FIN. 2212, 2212–13 (2010).

67. Belen Villalonga & Raphael Amit, *How Are U.S. Family Firms Controlled?*, 22 REV. FIN. STUD. 3047, 3049 (2009).

share-one-vote structure.[68] Paul Gompers, Joy Ishii and Andrew Metrick analyzed a comprehensive list of dual-class firms in the United States and found evidence that firm value is positively associated with insiders' cash-flow rights and negatively associated with insiders' voting rights.[69] Moreover, they found that the larger the wedge between the controller's voting rights and cash-flow rights, the greater the reduction in the firm value.[70] Ronald Masulis, Cong Wang and Fei Xie used the same sample as Gompers, Ishii and Metrick and examined how the divergence between insider voting and cash-flow rights in dual-class firms affects the extraction of private benefits of control.[71] They found "that as this divergence widens, corporate cash holdings are worth less to outside shareholders, CEOs receive higher [levels of] compensation," insiders are more likely to make shareholder value-destroying acquisitions, "and capital expenditures contribute less to shareholder value."[72] These findings support the agency hypothesis that insiders with excess voting rights over cash-flow rights are more prone to pursue private benefits at the expense of outside shareholders. These findings also explain why firm value decreases as insiders control more voting rights relative to cash-flow rights.

Moreover, studies have shown that the unification of dual-class shares into a single-share class increases firm value. Ingolf Dittmann and Niels Ulbricht analyzed the decisions of thirty-two German dual-class firms to consolidate their share structure from dual to single-class equity between 1990 and 2001.[73] They found a significant positive effect of the announcement of a stock unification on a firm's value.[74] Scott Smart, Ramabhadran Thirumalai and Chad Zutter studied thirty-seven dual-class firms

68. INV'R RESPONSIBILITY RESEARCH CTR. INST. & INSTITUTIONAL S'HOLDER SERV., CONTROLLED COMPANIES IN THE STANDARD & POOR'S 1500: A TEN YEAR PERFORMANCE AND RISK REVIEW 8 (2012).

69. Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1054 (2010).

70. *Id.* at 1084.

71. Ronald W. Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697, 1700 (2009).

72. *Id.* at 1698–99.

73. Ingolf Dittmann & Niels Ulbricht, *Timing and Wealth Effects of German Dual Class Stock Unifications*, 14 EUR. FIN. MGMT. 163, 164 (2007).

74. *Id.*

that unified their share classes during the five years following their IPOs and found a significantly positive stock price reaction to unification announcements.[75] Beni Lauterbach and Anete Pajuste studied 121 voluntary dual-class share unifications in Europe from 1996 through 2009 and found that unification significantly increases firms' long-term market value.[76] These findings suggest that unifications per se are beneficial to public shareholders, most probably because of the corporate governance improvements accompanying them.

However, some empirical studies examining the change from a single-class to a dual-class structure suggest that such a change might also have positive effects. Valentin Dimitrov and Prem Jain studied a sample of 178 firms that changed from a one-share-one-vote structure to a dual-class structure between 1979 and 1998, and found that dual-class recapitalizations are shareholder value-enhancing corporate initiatives.[77] Scott Bauguess, Myron Slovin and Marie Sushka used a sample of 142 firms that changed from a single-class to a dual-class structure from 1978 through 1998, and found that performance improves for the firms where insiders sell a sizeable amount of their economic interests while maintaining voting control.[78]

Changes in a firm's valuation over its lifecycle may explain some of the mixed results regarding the effects of dual-class structures. Lucian Bebchuk and Kobi Kastiel argue that dual-class structures become value-decreasing over time because any potential benefits of these structures decline after the IPO, while the associated agency costs increase.[79] Indeed, Martijn Cremers, Beni Lauterbach and Anete Pajuste found that the relative valuation of

75. Scott B. Smart, Ramabhadran S. Thirumalai & Chad J. Zutter, *What's in a Vote? The Short- and Long-Run Impact of Dual-Class Equity on IPO Firm Values*, 45 J. ACCT. & ECON. 94, 112–13 (2008).

76. Beni Lauterbach & Anete Pajuste, *The Long-Term Valuation Effects of Voluntary Dual Class Share Unifications*, 31 J. CORP. FIN. 171 (2015).

77. 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).

78. Scott W. Bauguess, Myron B. Slovin & Marie E. Sushka, *Large Shareholder Diversification, Corporate Risk Taking, and the Benefits of Changing to Differential Voting Rights*, 36 J. BANKING & FIN. 1244, 1244–45 (2012).

79. Bebchuk & Kastiel, *supra* note 42 (suggesting that dual-class structures would sunset after a fixed period of time subsequent to the IPO unless their extension were approved by shareholders unaffiliated with the controller).

dual- versus single-class firms depends on the firm's lifecycle.[80] They documented that while at the time of the IPO dual-class firms tend to have a higher market valuation than their matched single-class firms, the valuation premium declines over time and becomes on average negative about six years after the IPO. Hyunseob Kim and Roni Michaely observed that relative to single-class firms, dual-class firms experience a ten percent larger decline in valuation as they mature.[81] Moreover, firms that switch from dual- to single-class structures exhibit a Tobin's q that is 0.55 higher than average dual-class firms, with similar characteristics, five years and more following their IPOs. Finally, Lindsay Baran, Arno Forst and Tony Via found that multi-class structures correlate with more innovation and value creation in the five-year period following the IPO, but from the sixth year onwards a strong deterioration occurs in the innovation and value-enhancing properties of a dual-class firm.[82] These findings suggest that any potential benefits of dual-class structures decline after the IPO, while the associated agency costs at the time of the IPO increase over time.

V. NONVOTING V. LOW-VOTING STOCK

There are two ways to structure a dual-class firm: with low-voting or nonvoting common stock. This Part turns to focusing on the more unique type of dual-class structure in which the public shares have no voting rights at all. It notes that this structure is fundamentally different from the regular dual-class structures because the absence of even a highly diluted vote means that the firm does not have to abide by certain types of disclosure rules and corporate governance standards. Since disclosure and corporate governance are important to investor protection, from the investors' perspective there are significant differences between issuing nonvoting and low-voting common stock. The next two sections will discuss these differences.

80. Cremers, Lauterbach & Pajuste, *supra* note 54.

81. Hyunseob Kim & Roni Michaely, *Sticking Around Too Long? Dynamics of the Benefits of Dual-Class Voting* (European Corp. Governance Inst. – Fin., Working Paper No. 590, 2019), https://ssrn.com/abstract=3145209.

82. Lindsay Baran, Arno Forst & M. Tony Via, Dual Class Share Structure and Innovation (Dec. 21, 2018) (unpublished manuscript), https://ssrn.com/abstract=3183517.

A. Disclosure

Corporate disclosure is crucial to the functioning of a market economy. Disclosure reduces the information asymmetry between corporate insiders and current and potential investors and creditors. A rich information environment and low information asymmetry facilitate the efficient allocation of resources and contribute to market liquidity and capital market development.

Some of the disclosure requirements of public companies are linked to registered stock with voting rights. Therefore, issuing shares with no voting rights at all raises the concern of a decrease in the level of transparency of public companies. Without allocating voting rights to its public investors, a dual-class firm can evade the obligation to issue proxy statements and other disclosure requirements.

Federal securities law requires public companies to distribute proxy or information statements prior to soliciting votes from their shareholders.[83] If a company has registered only nonvoting shares, however, it is not required to distribute a proxy or information statement.[84] Snap, for example, has three classes of common stock: Class A shares, Class B shares, and Class C shares.[85] Since Class A is the only class of stock registered under Section 12 of the Securities Exchange Act of 1934 and is nonvoting, Snap acknowledges that it is not required to file proxy statements under Section 14 of the Securities Exchange Act unless a vote of the Class A holders is required by applicable law.[86]

However, stock exchange rules may require that any proxy statement sent to voting stockholders also be sent to nonvoting stockholders. Indeed, the NYSE requires that "holders of any listed non-voting common stock must receive all communications, including proxy material, sent generally to the holders of the voting securities of the listed company."[87] Therefore, Snap has indicated

83. *See* 15 U.S.C. § 78n (2012) (governing the solicitation of proxies in respect of registered securities).

84. *See, e.g.*, 17 C.F.R. § 240.14c-2 (2008) (requiring the distribution of an information statement to every shareholder "of the class that is entitled to vote" on a shareholder meeting).

85. *See supra* note 34 and accompanying text.

86. Snap Prospectus, *supra* note 34, at 5, 40.

87. *See* NYSE Listed Company Manual, *supra* note 14, § 313.00(B)(2).

in its SEC filings that it intends to afford Class A holders the same degree of transparency as holders of shares with voting rights. The company promises in its prospectus that "we will provide holders of our Class A common stock, at the same time, any information that we provide generally to the holders of our Class B common stock and Class C common stock, including proxy statements, information statements, annual reports, and other information and reports."[88] However, this promise is limited in some important respects. First, if the company does not deliver any proxy statements to the holders of its Class B shares and Class C shares, then it similarly will not provide any proxy statements to the holders of its Class A shares.[89] Second, because Snap is not required to file proxy statements under Section 14 of the Securities Exchange Act, it acknowledges that any proxy statement delivered may not include all the information under Section 14 that a public company with voting securities registered under Section 12 of the Securities Exchange Act would be required to provide to its shareholders.[90]

Even though Snap is not bound by the proxy filing requirements of federal law, it is still obligated to comply with the ongoing periodic and current disclosure requirements of the Securities Exchange Act. For example, as a public company it must report certain material corporate events on a current basis by filing a Form 8-K.[91] Although a Form 8-K would include material information regarding a corporate event, it is less detailed and more open-ended in terms of content requirements than a proxy statement. This means that Snap's disclosure on a Form 8-K may include significantly less information than would otherwise be required in a proxy statement of a public company with voting shares. Similarly, annual reports on Form 10-K and quarterly reports on Form 10-Q do not include all the information required under Section 14 of the Securities Exchange Act.[92] For example, if Snap takes any action in an extraordinary meeting of stockholders

88. Snap Prospectus, *supra* note 34, at 5.

89. *Id.* at 5, 40.

90. *Id.* at 5–6, 40.

91. Form 8-K is used for current reports under Section 13 or 15(d) of the Securities Exchange Act of 1934, filed pursuant to Rule 13a-11, 17 C.F.R. § 240.13a-11 (2016), or Rule 15d-11, 17 C.F.R. § 240.13a-11 (2016).

92. Form 10-K and Form 10-Q are used for annual and quarterly reports, respectively, under Section 13 or 15(d) of the Securities Exchange Act of 1934.

where the holders of Class A common stock are not entitled to vote, it will not be required to file a preliminary proxy statement under Section 14. Since Form 10-K and Form 10-Q do not include the information required under Section 14 with respect to extraordinary meetings of stockholders, holders of Class A common stock may not receive that information.[93] To sum up, although Snap is obligated to disclose information on a current and ongoing basis as a public company, Form 8-K, Form 10-K and Form 10-Q do not provide investors with the same level of transparency and disclosure as proxy statements.

Issuing nonvoting shares further reduces market transparency due to other disclosure requirements that are linked to shares with voting rights, such as beneficial ownership reporting rules. When a person or group of persons acquires beneficial ownership of more than five percent of a voting class of a company's equity securities registered under Section 12 of the Securities Exchange Act, they are required to file a Schedule 13D or Schedule 13G with the SEC.[94] As noted under Section 13(d) of the Securities Exchange Act, the term "equity securities" does not include securities of a class of nonvoting securities.[95] Since Snap's Class A common stock is the only class of stock registered under Section 12 of the Securities Exchange Act and is nonvoting, beneficial owners of more than five percent of Snap's common stock are not required to disclose their ownership on a Schedule 13D or 13G.[96] As a result, there is less transparency in the marketplace regarding the company's significant stockholders and their intentions.

Finally, the short-swing profit rule under Section 16(b) of the Securities Exchange Act requires a company's insiders to return any profit made from the purchase and sale of the company's stock

93. *See* Snap Prospectus, *supra* note 34, at 6, 40.

94. Schedule 13D and Schedule 13G are filed with the SEC under Rule 13d, 17 C.F.R. § 240.13d (2010), and are provided to the company that issued the securities and each exchange where the security is traded.

95. 17 C.F.R. § 240.13d-1(i) (2010); *see also* Gulf United, SEC No-Action Letter, 1979 WL 13078 (Apr. 28, 1979) ("[A]ll non-voting securities have been removed from the definition of an equity security stated in Rule 13d-1(d) . . . .").

96. Snap stated in its prospectus that "[b]ecause our Class A common stock is non-voting, significant holders of our common stock are exempt from the obligation to file reports under Sections 13(d), 13(g), and 16 of the Exchange Act." *See* Snap Prospectus, *supra* note 34, at 40.

if both transactions occur within a six-month period.[97] Its purpose is to prevent insiders, who have greater access to a company's material information, from taking advantage of the information to make short-term profits. To implement this rule, officers, directors, or significant stockholders—that is, holders of more than ten percent of a company's equity securities registered under Section 12 – are required to file reports with respect to their purchases and sales of securities.[98] Again, since Snap's Class A nonvoting common stock is the only class of stock registered under Section 12, significant stockholders, other than directors and officers, are exempt from the short-swing profit rule.[99] As a result, stockholders will be unable to bring derivative claims for disgorgement of profits for trades by significant stockholders under Section 16(b) unless the significant stockholders are also directors or officers.

The above examples prove that issuing shares with no voting rights at all decreases the level of transparency in the capital markets. Furthermore, because private enforcement depends on the flow and quality of information provided to investors, less disclosure makes private enforcement less effective.

B. Corporate Governance

Voting rights are a "foundational component of sound corporate governance."[100] Therefore, in addition to adversely affecting disclosure requirements, issuing nonvoting, rather than low-voting, common stock adversely affects corporate governance as well. Holders of nonvoting stock are deprived of important governance mechanisms. These mechanisms will be discussed below.

First, unlike holders of low-voting stock, holders of nonvoting stock cannot vote on significant issues at a shareholder meeting.[101] For example, they are not allowed to elect directors to the board or

97. Securities and Exchange Act of 1934, ch. 404, 48 Stat. 896; 15 U.S.C. § 78p(b) (2012).

98. *See* 17 C.F.R § 240.16a.

99. *See* Snap Prospectus, *supra* note 34, at 40.

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

101. *See* Steven M. Haas & Charles Brewer, *What's the Deal with Nonvoting Shares? An Overview of the Legal Differences Between Voting and Nonvoting Stock*, INSIGHTS, Oct. 2017, at 8.

remove them from office.[102] Moreover, they cannot approve extraordinary transactions of the company,[103] such as mergers,[104] significant asset sales,[105] or dissolution.[106] Finally, they are not able to make amendments to the company's certificate of incorporation.[107] Furthermore, according to the Dodd–Frank Wall Street Reform and Consumer Protection Act, the majority of publicly traded companies are required to offer shareholders an advisory (but nonbinding) vote on executive compensation, known as a "say-on-pay" vote.[108] When shareholders have no voting rights at all, however, they are denied any opportunity to cast say-on-pay votes.[109]

Second, holders of nonvoting stock are deprived of certain notice rights under Delaware corporate law. In contrast to low-voting shareholders, nonvoting shareholders are not entitled to receive a written notice of a shareholder meeting in which they are not entitled to vote,[110] unless the meeting is being held to vote on a merger or consolidation[111] or to ratify a defective corporate act.[112]

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102. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 141(k), 216(3) (2019).

103. However, under Delaware corporate law, holders of nonvoting stock are entitled to vote on the conversion of a domestic corporation into other entities and the transfer, domestication, or continuance of domestic corporations. *See id.* §§ 266(b), 390(b).

104. *See, e.g.*, *id.* § 251(c).

105. *See, e.g.*, *id.* § 271(a).

106. *See, e.g.*, *id.* § 275(b).

107. *See, e.g.*, *id.* § 242(b)(1). However, holders of a class of nonvoting shares are entitled to vote as a class on a proposed amendment:

> if the amendment would increase or decrease the aggregate number of authorized shares of such class, increase or decrease the par value of the shares of such class, or alter or change the powers, preferences, or special rights of the shares of such class so as to affect them adversely.

Id. § 242(b)(2).

108. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899 (2010). Section 951 amended the Securities Exchange Act of 1934 by adding Section 14A (codified as amended at 15 U.S.C. § 78n-1).

109. For more examples of significant corporate issues that holders of nonvoting stock cannot vote on at shareholder meetings, see Haas & Brewer, *supra* note 101. *But see* Dorothy S. Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. 687 (2019) (arguing that some shareholders are weakly motivated voters who do not value voting rights at a shareholder meeting and thus prefer purchasing discounted nonvoting stock).

110. *See* DEL. CODE ANN. tit. 8, § 222(b) (2019) (requiring that each shareholder entitled to vote at the meeting receive written notice of a shareholder meeting).

111. *See id.* § 251(c).

112. *See id.* § 204(d). Nonvoting shareholders are also entitled to receive a written notice if the board of directors ratifies a defective corporate act that does not require shareholder approval or if shareholders ratify a defective act by written consent. *See id.* § 204(g).

Moreover, holders of nonvoting shares are not entitled to receive a notice that a corporate action has been taken by written consent in lieu of a shareholder meeting.[113]

Third, nonvoting shareholders cannot express their voice on a company's key issues. In order to be eligible to submit a proposal for inclusion in a proxy statement, Rule 14a-8 of the Securities Exchange Act of 1934 requires a shareholder to hold "at least $2,000 in market value, or one percent, of the *company's securities entitled to be voted* on the proposal at the meeting."[114] Holders of nonvoting common stock, therefore, are unable to raise shareholder proposals under Rule 14a-8.

Furthermore, the absence of even a highly diluted shareholder vote raises an interesting question about the implementation of state corporate law mechanisms for cleansing conflict-of-interest transactions.[115] A recent Delaware case strengthened the power of minority shareholder voting in going-private mergers.[116] In the *M&F Worldwide* (*MFW*) decision,[117] the Delaware Supreme Court held that freeze-out mergers structured with a dual procedure of shareholder protections,[118] which require approval of the majority of the minority shareholders, should be reviewed under the highly deferential business judgment standard instead of the highest level of scrutiny—the entire fairness review.[119] In later cases, the Delaware Court of Chancery extended the application of the analytical framework articulated in *MFW* to govern not only going-private mergers, but also other forms of controlling transactions.[120]

113. *See id.* § 228(e).

114. *See* 17 C.F.R. § 240.14a-8(b)(1) (2011) (emphasis added).

115. Given the concentrated ownership structure of dual-class firms, the possibility of conflict-of-interest transactions is more significant than in widely held companies. *See* James Moloney et al., *Non-Voting Shares and Judicial Scrutiny*, INSIGHTS, May 2017, at 10, 12.

116. In a going-private merger, a corporation's controlling shareholder attempts to buy the remainder of the corporation's widely held shares from minority shareholders using the mechanism of a "statutory merger." *See* DEL. CODE ANN. tit. 8, § 251(a)–(c) (2019).

117. Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014).

118. This dual procedure of shareholder protections is a negotiation of the terms of the freeze-out merger by a well-functioning special committee of independent directors and approval of the transaction by a majority of the minority shareholders.

119. *Kahn*, 88 A.3d at 635, 644.

120. *See* IRA Trust FBO Bobbie Ahmed v. Crane, C.A. No. 12742-CB (Del. Ch. Dec. 11, 2017); *In re* Martha Stewart Living Omnimedia, Inc. Stockholder Litig., C.A. No. 11202-VCS (Del. Ch. Aug. 18, 2017); *In re* Ezcorp Inc. Consulting Agreement Derivative Litig., C.A. No. 9962-VCL, 2016 WL 301245 (Del. Ch. Jan. 25, 2016).

Therefore, the desire to mitigate the judicial standard of review provides a strong incentive to get controlling transactions approved by a fully informed majority-of-the-minority vote.[121] It might seem that the *MFW* procedure would not be available when minority shareholders have no voting rights, but that does not seem to be the case. A controlling shareholder who wished to rely on the *MFW* procedure to mitigate the standard of review could condition the transaction on the approval of a majority of the holders of (nonvoting) common stock, even if those shareholders were not generally entitled to vote.

This section shows that holders of nonvoting common stock are deprived of important governance mechanisms. After identifying the serious consequences of issuing shares with no voting rights for disclosure and corporate governance, the next Part will suggest addressing them through SEC regulation and stock exchange rules.

VI. Policy Implications

A. The Need for Regulatory Intervention

The discussion so far has analyzed the agency costs of dual-class structures and the serious consequences of nonvoting common stock for disclosure and corporate governance. In light of this analysis, the important question is whether nonvoting shares justify regulatory intervention to protect their holders. Some may argue that to the extent that the negative effects of nonvoting stock on investors can be assessed in advance, the stock price should reflect the decline in investor protection and thus would compensate nonvoting stockholders.[122] If investors can freely choose whether to buy nonvoting shares that are accurately priced by the market, there is no apparent need for external regulatory intervention.

However, there are several reasons for questioning this argument. First, it is doubtful that the IPO markets reflect the high

121. See also the decision in this case at the Delaware Court of Chancery, *In re* MFW S'holders Litig., 67 A.3d 496, 528 (Del. Ch. 2013).

122. Even if fewer than all investors can assess the effects of nonvoting stock on investor protection, insofar as a sufficient number of sophisticated investors are able to do so, the effects will be reflected in stock prices and compensate *all* of the nonvoting stockholders. *See* Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 123–25 (1987).

degree of efficiency that this argument demands.[123] Second, not all investors are able to protect themselves from the negative implications of nonvoting stock for disclosure and corporate governance. This argument is especially important given the substantial share of passive investors in the capital markets. Passively managed funds have significantly increased their ownership share of the U.S. stock market in recent years.[124] Moreover, a large proportion of all mutual funds and exchange-traded funds (ETFs) are index-tracking funds. Essentially, index funds buy and hold stock in an underlying index, such as the S&P 500, and consequently own certain shares irrespective of their performance and prospects. As opposed to actively managed funds, they are unable to exercise the "Wall Street Walk"[125] and to simply sell their shares if they are dissatisfied. Therefore, passive investors are forced to invest in nonvoting common shares despite their effects regarding eroding investor protection.

The Council of Institutional Investors (CII) has approached major index providers to explore the exclusion of share classes with no voting rights from core indices.[126] Indeed, global index providers have recently initiated market consultations to determine whether to revise their policies regarding multiclass shares in general, nonvoting shares in particular. Following its consultation, S&P Dow Jones announced that, effective immediately, companies

123. *See* Robert J. Jackson Jr., Comm'r, Perpetual Dual-Class Stock: The Case Against Corporate Royalty, Speech at University of California, Berkeley, School of Law (Feb. 15, 2018), https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty. For the general argument that capital markets do not usually price each and every corporate provision, see Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 55–70 (John W. Pratt & Richard J. Zeckhauser eds., 1991); Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1410–14 (1989); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1411–27 (1985).

124. *See* Ian R. Appel et al., *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111, 112 (2016) (showing that the share of equity mutual fund assets held in passively managed funds tripled over the 1998–2014 period to 33.5%, and the share of total U.S. market capitalization held by passively managed funds quadrupled to more than 8%).

125. *See* MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 35 (1995) (explaining the "Wall Street Walk" as the "ability to sell out at any time"); *see also* Solomon, *supra* note 47, at 755–56.

126. *See* Ken Bertsch, Exec. Dir., Council of Institutional Inv'rs, Unequal Voting Rights in Common Stock, Remarks to the SEC Investor Advisory Committee (Mar. 9, 2017), https://www.sec.gov/spotlight/investor-advisory-committee-2012/bertsch-remarks-iac-030917.pdf.

with multiple share classes would no longer be eligible for inclusion in the indices comprising the S&P Composite 1500, including the S&P 500, S&P MidCap 400 and S&P SmallCap 600.[127] However, to minimize turnover, the change would not affect existing S&P Composite 1500 index constituents, who would be grandfathered.[128]

According to FTSE Russell, its market consultation indicated broad support for the imposition of a minimum hurdle for the percentage of voting rights in public hands.[129] Therefore, it proposed that more than five percent of a company's voting rights be required to be held by non-restricted ("free float") shareholders, as defined by FTSE Russell, in order to be eligible for inclusion in all FTSE Russell indices.[130] The policy would apply to new index constituents from the September 2017 quarterly and semiannual index reviews.[131] An indicative analysis performed by FTSE Russell has shown that thirty-seven current index companies would not meet the five percent hurdle.[132] Under FTSE Russell's grandfathering rule, these companies would have five years to change their capital structure (e.g., increase the voting power of their free float or reduce the voting power of their high-voting stock) to avoid expulsion from the index.[133]

FTSE Russell's decision not to include in its indices companies that offer only nonvoting common stock, but to require a minimum threshold for voting rights, is consistent with the thesis of this

127. *See S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rules*, S&P DOW JONES INDICES (July 31, 2017), https://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjimulti-classsharesandvotingrulesannouncement7.31.17.pdf?force_download=true. S&P Dow Jones also announced that the S&P Global BMI Indices, S&P Total Market Index, and other S&P and Dow Jones-branded indices would not be affected by this change. *Id.*

128. *Id.* A newly public company spun off from a current S&P Composite 1500 index constituent would not need to meet the criteria for new additions to the index, and so would effectively benefit from its parent's grandfathering. *See* Joseph A. Hall & Michael Kaplan, *Snap Decision: Leading Index Providers Nix Multi-Class Shares*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 2, 2017), https://corpgov.law.harvard.edu/2017/08/02/snap-decision-leading-index-providers-nix-multi-class-shares/#more-100537.

129. *See* FTSE RUSSELL, FTSE RUSSELL VOTING RIGHTS CONSULTATION RESULTS 2 (2017), http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Results.pdf.

130. *See* FTSE RUSSELL PROPOSAL, *supra* note 10.

131. *Id*. at 6.

132. *See* Hall & Kaplan, *supra* note 128.

133. *See* FTSE RUSSELL PROPOSAL, *supra* note 10.

Article. The above analysis has shown that shareholder low-voting rights are important to investor protection, even though they are disproportionately much lower than the high-voting rights of the insiders. In the absence of even a highly diluted vote in public hands, the firm does not have to abide by certain types of disclosure rules and corporate governance standards.[134] It seems that the importance of voting rights has led FTSE Russell to impose a minimum hurdle for the percentage of voting rights in public hands. This new policy of index eligibility may disincentivize companies from offering only nonvoting shares to the public.[135]

However, these decisions by the S&P Dow Jones and the FTSE Russell have far-reaching implications that cannot be ignored. The exclusion of the stock of some of the most-innovative companies would prevent the indices from being as expansive and diverse as the underlying industries and economies whose performance they seek to capture.[136] The indices then may no longer reflect the investable universe of public companies or represent the wealth-creating power of the U.S. economy.[137] As a result, the access to the investment marketplace of Main Street investors, who often own stock in U.S. public companies through an index, would become limited.[138]

This Article suggests different ways to address the consequences of nonvoting common stock for disclosure and

134. *See supra* Part V.

135. Research has consistently established that inclusion of a company's stock in a major index increases (and exclusion decreases) the liquidity and value of that stock. *See, e.g.*, Messod D. Beneish & Robert E. Whaley, *An Anatomy of the "S&P Game": The Effects of Changing the Rules*, 51 J. FIN. 1909 (1996); Yen-Cheng Chang, Harrison Hong & Inessa Liskovich, *Regression Discontinuity and the Price Effects of Stock Market Indexing*, 28 REV. FIN. STUD. 212 (2015); Lawrence Harris & Eitan Gurel, *Price and Volume Effects Associated with Changes in the S&P 500 List: New Evidence for the Existence of Price Pressures*, 41 J. FIN. 815 (1986); Anthony W. Lynch & Richard R. Mendenhall, *New Evidence on Stock Price Effects Associated with Changes in the S&P 500 Index*, 70 J. BUS. 351 (1997); Andrei Shleifer, *Do Demand Curves for Stocks Slope Down?*, 41 J. FIN. 579 (1986).

136. *See A Potential Solution for Voting Rights and Index Inclusion Issues*, BLACKROCK, https://www.blackrock.com/corporate/literature/publication/blk-a-potential-solution-for-voting-rights-and-index-inclusion-issues-october2017.pdf (last visited Oct.. 11, 2019).

137. *See* Bernard S. Sharfman, *The S&P and FTSE Russell Should Reverse Course on Dual Class Shares*, OXFORD L. FAC.: BUS. L. BLOG (Nov. 8, 2017), https://www.law.ox.ac.uk/business-law-blog/blog/2017/11/sp-and-ftse-russell-should-reverse-course-dual-class-shares.

138. *See* Jackson, *supra* note 123.

corporate governance, which are not limited to the indices' inclusion policy, but reflect a broader perspective of the issue. Instead of addressing these consequences incidentally by means of the index providers and thus creating a gap between the indices and the economy, the Article suggests addressing them directly through SEC regulation and stock exchange rules.[139] These proposals will be discussed in the next two sections.

B. SEC Regulation

Protecting investors is one of the three key statutory mandates of the U.S. Securities and Exchange Commission.[140] To achieve this goal, the SEC set disclosure requirements for public companies designed to ensure transparency. The SEC's disclosure regime relies on fully informed investors to hold boards and management accountable through the exercise of the shareholder franchise.

The above analysis has shown, however, that issuing public shares with no voting rights at all has negative effects on investor protection.[141] This is because some of the disclosure requirements of public companies are linked to public shares with voting rights. To protect nonvoting shareholders, therefore, the SEC should revisit the linkage between voting rights and disclosure, requiring the same level of disclosure for the issuance of both voting and nonvoting stock.

Some may question the SEC's authority to regulate shareholder voting rights, which traditionally have been the exclusive province of state corporate law. Indeed, in 1990 a federal court discussed this issue while examining Rule 19c-4 of the SEC.[142] This rule barred national securities exchanges from listing the stock of any issuer that took any action with "the effect of nullifying, restricting, or disparately reducing the per share voting rights" of existing

139. *See* Matt Levine, *Listing Standards and Dividend Shares*, BLOOMBERG: VIEW (Apr. 13, 2017, 9:25 AM), https://www.bloomberg.com/view/articles/2017-04-13/listing-standards-and-dividend-shares (arguing that excluding companies on the basis of governance characteristics is a "weird role" for stock indices, as opposed to the "long tradition of corporate governance standards being imposed by stock exchanges, as 'listing standards,' a sort of seal of approval that listed companies have been screened by the exchange and found to be plausible investments").

140. The mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. *See* 15 U.S.C. § 78c(f) (2012).

141. *See supra* Section V.A.

142. *See* Voting Rights Listing Standards, *supra* note 21.

common stock shareholders of the company.[143] In its *Business Roundtable* decision, the U.S. Court of Appeals for the D.C. Circuit struck down the rule as being beyond the SEC's delegated authority under the Securities Exchange Act of 1934. The court found that "the Exchange Act cannot be understood to include regulation of an issue that is so far beyond matters of disclosure . . . and that is concededly a part of corporate governance traditionally left to the states."[144]

It should be noted that the SEC based its authority to adopt Rule 19c-4 on its powers under Section 19(c) of the Securities Exchange Act,[145] which permits it to amend exchange rules provided that the Commission's action furthers the purposes of the Act. The D.C. Circuit determined, however, that the attempt to regulate corporate voting rights furthered none of the Securities Exchange Act's purposes. In striking down Rule 19c-4, the court adopted a narrow view of the Act's purposes. According to the court, the primary purpose of the federal proxy regulation under Section 14 of the Securities Exchange Act is disclosure.[146]

However, even under this narrow view of the Securities Exchange Act, it plainly delegates authority to the SEC to regulate nonvoting common stock. There is a significant difference between issuing shares with inferior voting rights—as was in the case of the *Business Roundtable* decision—and issuing shares with no voting rights at all. Issuing nonvoting shares is not just a matter of allocation of powers among classes of shareholders, which may be governed by state corporate law. In contrast, it has direct negative implications for disclosure and investor protection, which are subject to the SEC's delegated authority under the Securities Exchange Act: The Commission has a statutory mandate to protect investors, and therefore it should act to protect holders of nonvoting common stock by expanding disclosure requirements.

The linkage between voting rights and disclosure requirements should be severed in order to ensure the same high degree of information and transparency when nonvoting stock is issued as is required when voting stock is issued. For example, since annual

143. *Id.*
144. *See* Bus. Roundtable v. SEC, 905 F.2d 406, 408 (D.C. Cir. 1990).
145. *See* 15 U.S.C. § 78s(c) (2012).
146. *See Bus. Roundtable*, 905 F.2d at 410–11.

reports on Form 10-K and quarterly reports on Form 10-Q do not include all the information included in proxy statements and required under Section 14 of the Securities Exchange Act of 1934, nonvoting shareholders are provided with lower level of disclosure and transparency than voting shareholders.[147] The SEC should consider adding disclosure requirements to Form 10-K and Form 10-Q that would provide nonvoting shareholders with all information equivalent to that ordinarily included in proxy statements.[148]

C. Stock Exchange Rules

Important goals of stock exchange rules are to ensure the quality of the markets and protect investors.[149] To fulfill these goals, stock exchanges promulgate rules for listed firms governing financial disclosure, annual meetings, or corporate structure. The exchange rules should impose requirements for listed firms aimed at protecting holders of nonvoting stock by expanding their disclosure and governance rights.

A possible challenge to imposing strict requirements for listed firms is that the competition to attract new listings may put "race to the bottom" pressure on listing standards. This pressure may lead stock exchanges to adopt pro-management and anti-shareholder rules. Since corporate managers decide whether and where to list, they may base their decision on which exchange offers them the greatest opportunity to benefit at the expense of investors. If one exchange relaxes its rules and allows managers to exploit investors, other exchanges may be forced to follow suit to avoid losing their listings to the first exchange. The competition among stock exchanges will result in a "race to the bottom" in

147. *See supra* notes 92–93 and accompanying text.

148. *See* Recommendation of the Investor as Owner Subcommittee: Dual Class and Other Entrenching Governance Structures in Public Companies, SEC (Feb. 27, 2018) at 7, https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac030818-investor-as-owner-subcommittee-recommendation.pdf.

149. *See, e.g.*, Nasdaq Listing Rules, *supra* note 24, § 5101 ("Nasdaq is entrusted with the authority to preserve and strengthen the quality of and public confidence in its market.").

which all exchanges end up with similar lax rules to the detriment of investors.[150]

However, stock exchanges have strong incentives to maintain good reputations.[151] The long-run profitability of an exchange is highly dependent on trading volume, which will fall if investors doubt its integrity. The listing rules chosen by a particular exchange are a matter of public record, and thus observable by investors. If the rules allowed by an exchange were to produce systematic exploitation of investors, investors would lose confidence in the exchange, and the exchange would lose trading volume as investors took their business elsewhere. It is clearly in the interest of exchanges, therefore, to adopt listing rules that protect investors. Moreover, maintaining a good reputation is most important when repeat transactions are contemplated. Repeat business is essential to the success of a stock exchange, and thus the costs of losing it through damage to reputation are high. Therefore, the "race to the bottom" argument loses some of its merit.

The listing standards adopted by the main stock exchanges following the *Business Roundtable* decision[152] in 1990 may illustrate the incentives of the exchanges to maintain good reputations in the present context. Even though the District of Columbia Court of Appeals overturned Rule 19c-4 of the SEC,[153] both the NYSE and the Nasdaq voluntarily decided to adopt a policy similar to this rule in their listing standards.[154]

Indeed, stock exchange rules grant nonvoting shareholders of listed companies governance rights they do not otherwise have under state law. For example, under Delaware corporate law no annual shareholder meeting is required if the directors are elected

150. The "race to the bottom" argument was developed in connection to the consequences of the competition among states to attract incorporations. *See, e.g.*, Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179 (1985); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663 (1974); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

151. Fischel, *supra* note 122, at 124.

152. *See* Bus. Roundtable v. SEC, 905 F.2d 406, 408 (D.C. Cir. 1990).

153. *Id.*

154. *See* NYSE Listed Company Manual, *supra* note 14, § 313.00(A) & (B); Nasdaq Listing Rules, *supra* note 24, § 5640.

by unanimous written consent.[155] Therefore, companies may be able to avoid holding annual meetings by issuing nonvoting common stock to the public and concentrating all of the voting rights in the hands of insiders, who elect directors by unanimous written consent. However, stock exchange rules strengthen nonvoting shareholders' rights by requiring companies to hold an annual shareholder meeting even if the only listed shares are nonvoting common stock.[156]

Moreover, the NYSE rules also grant nonvoting shareholders of listed companies certain disclosure rights they do not otherwise have under federal law. These rules are aimed at ensuring holders of nonvoting common stock the same degree of transparency as holders of voting common stock. Therefore, they require that any materials sent to voting shareholders, including proxy material, also be sent to nonvoting shareholders.[157]

Although current stock exchange rules already grant nonvoting shareholders certain disclosure and governance rights they do not otherwise have under federal or state law, these rules are limited and far from addressing all the serious consequences of nonvoting common stock for investor protection analyzed in Part V. For example, a company that has registered only nonvoting securities under Section 12 of the Securities Exchange Act of 1934 may evade the NYSE requirement to send nonvoting shareholders all proxy statements sent to voting shareholders—it would just not provide any proxy statements to voting shareholders in the first place.[158] Moreover, even if the company voluntarily provides proxy

155. *See* DEL. CODE ANN. tit. 8, § 211(b) (2019).

156. *See* NASDAQ, Frequently Asked Questions, No. 82, https://listingcenter.nasdaq.com/Material_Search.aspx?cid=1,22,45,52,108,71,69&mcd=LQ (last visited Aug. 31, 2019) ("A company that lists only non-voting common stock on Nasdaq is required to hold an annual meeting."); *see also* Nasdaq Listing Rules, *supra* note 24, § 5620(a) ("Each Company listing common stock or voting preferred stock, and their equivalents, shall hold an annual meeting of Shareholders no later than one year after the end of the Company's fiscal year-end . . . ."); NYSE Listed Company Manual, *supra* note 14, § 302.00 ("Listed companies are required to hold an annual shareholders' meeting during each fiscal year.").

157. *See* NYSE Listed Company Manual, *supra* note 14, § 313.00(B)(2) ("[H]olders of any listed non-voting common stock must receive all communications, including proxy material, sent generally to the holders of the voting securities of the listed company.").

158. When voting securities are not registered under Section 12 of the Securities Exchange Act, the company is not required to distribute proxy statements under federal securities law. *See* 15 U.S.C. § 78n (2012) (governing the solicitation of proxies in respect of registered securities).

statements for its shareholders, it may not include all the information under Section 14 of the Securities Exchange Act that a company with voting securities registered under Section 12 would be required to provide to its shareholders. Therefore, this Article calls for expanding disclosure rights of nonvoting shareholders. Stock exchange rules should impose a broader requirement for delivering proxy statements to holders of nonvoting shares registered under Section 12 regardless of sending them to voting shareholders. In addition, they should require that any proxy statements sent to nonvoting shareholders include all the information under Section 14 of the Securities Exchange Act that a company with voting securities registered under Section 12 would be required to provide to its shareholders.

VII. CONCLUSION

A dual-class capital structure enables founders to entrench their control of the company even after it goes public. The debate over the pros and cons of this structure divides continents and legal systems.[159] On the one hand, supporters argue that it allows the company's founders to pursue their idiosyncratic vision for producing above-market returns and insulates management from short-term market pressures. On the other hand, opponents argue that the combination of founders' weak ownership incentives and entrenchment results in agency problems that may lead to a distortion of various business choices, such as the extraction of private benefits of control. The analysis in this Article has shown, however, that regardless of one's position on dual-class structures in general, having at least some voting rights in public hands is important for investor protection. So long as shareholders have even inferior voting rights, they are protected by important disclosure and governance requirements for listed firms. Nonvoting shareholders, however, are deprived of these significant components of investor protection. Therefore, it should be plainly apparent, even to advocates of multiple classes of common stock with unequal voting rights, that it is necessary to expand the disclosure and governance rights of nonvoting shareholders.

159. *See, e.g.*, Bebchuk & Kastiel, *supra* note 42, at 599–601.

The Article suggests two ways to address the serious consequences of nonvoting common stock for investor protection. First, the SEC should act to protect nonvoting shareholders by requiring the same level of disclosure when nonvoting stock is issued as is required when voting stock is issued. Second, stock exchange rules should protect holders of nonvoting stock by granting them certain disclosure and governance rights they do not otherwise have under federal or state law. These proposals directly address the implications of nonvoting stock for disclosure and corporate governance, and therefore are preferable to the current incidental reaction of major index providers to Snap's recent IPO.