Nonvoting Shares and Efficient Corporate Governance

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Abstract

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

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

This insight has several implications for law. Most important, this Article contends that recent proposals to restrict or deter companies from issuing nonvoting shares should be rejected because nonvoting stock has a beneficial function under certain circumstances. Therefore, restricting the use of nonvoting stock may impede efficient corporate structuring.

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Introduction

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

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

The success of Snap's offering, however, rallied opponents of companies that issue different classes of stock with unequal voting rights, or "dual-class companies." The typical dual class company offers low voting stock for public investors to buy, keeping the high-vote shares (with typically ten times as many votes as the low-vote shares) in the possession of the company's insiders. Opponents of dual-class company structures contend that depriving investors of voting rights serves to entrench

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

2 *See id.* (noting that the offering is structured such that the "founders' control goes away only if they die" unless they sell more than 69 percent of their stock); Snap Inc., Amendment No. 2 to Form S-1 Registration Statement at 19 (Feb. 16, 2017) ("As a result [of this structure], Mr. Spiegel and Mr. Murphy, and potentially either one of them alone, have the ability to control the outcome of all matters submitted to our stockholders for approval . . . .")

3 Snap Inc., Amendment No. 2 to Form S-1 at 40 (explaining that the company would be exempt from reporting requirements under Sections 13(d), 13(g), 14, and 16 of the Exchange Act). A subsequent prospectus claimed that Snap would nonetheless voluntarily provide those materials to stockholders. *See* Preliminary Prospectus at 40, available at: https://www.sec.gov/Archives/edgar/data/1564408/000119312517056992/d270216ds1a.htm.

4 Snap Inc., Amendment No. 2 to Form S-1.

5 *See* Solomon, *supra* note 1; Maureen Farrell, *In Snap IPO, New Investors to Get Zero Votes, While Founders Keep Control*, WALL ST. J., http://www.wsj.com/articles/in-snap-ipo-new-investors-to-get-zero-votes-while-founders-keep-control-1484568034; Paresh Dave, Big Investor T. Rowe Price Challenges Snapchat Founders' Power, LA Times (Jan 19, 2017), http://www.latimes.com/business/technology/la-fi-tn-snapchat-voting-20170119-story.html

6 Snap Inc., Amendment No. 2 to Form S-1 at 5 ("We cannot predict whether this structure and the concentrated control it affords Mr. Spiegel and Mr. Murphy will result in a lower trading price or greater fluctuations in the trading price of our Class A common stock as compared to the trading price if the Class A common stock had voting rights."); Ross Kerber and Liana Baker, *Lacking Voting Rights, Snap IPO to Test Fund Governance Talk*, REUTERS (Feb. 3, 2017) (quoting a research analyst who stated that his firm typically discounts shares by that lack of voting rights by 30%).

7 Maureen Farrell, Corrie Driebusch and Sarah Krouse, *Snapchat Shares Surge 44% in Market Debut*, WALL ST. J. (March 2, 2017), https://www.wsj.com/articles/snapchat-parent-snap-opens-higher-in-market-debut-1488471695. Since then, the shares have fallen below the IPO price. Corrie Driebusch, *Snap Shares Tumble Further Below IPO Price*, WALL ST. J. (July 11, 2017), https://www.wsj.com/articles/snap-shares-tumble-further-below-ipo-price-1499784971.

management and insulate them from the consequences of their inefficient or disloyal decisions.[8] They view the increase in dual-class offerings in the United States as a serious problem for investors.[9]

Accordingly, following Snap's IPO, the Council of Institutional Investors ("CII"), an investor advocacy group with the motto "no-vote shares have no place in public companies," ramped up lobbying efforts, contending that U.S. stock indices and exchanges should bar companies that offer nonvoting shares to the public.[10] CII also targeted companies contemplating public offerings with multiple classes of stock.[11] Large institutional investors likewise lobbied the Securities Exchange Commission ("SEC") and stock exchanges to ban nonvoting shares.[12] These efforts caught the attention of the SEC's Investor Advisory Committee, which held a meeting on dual-class stock shortly after Snap's offering.[13]

This public opposition has begun to influence stock index policy. In June 2017, FTSE Russell announced that it would not add Snap or other companies with nonvoting shares to its major U.S. stock benchmarks.[14] Soon after, S&P Dow Jones Indices stated that it would exclude companies that issue multiple classes of shares from a number of its indices.[15] These decisions dealt a major blow to Snap and provide a powerful deterrent to other companies planning to issue nonvoting stock in their public offerings. That is because index funds, which make up a significant percentage of demand for

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[8] *See generally* Blair Nicholas & Brandon Marsh, *The Consequences of Depriving Institutional Investors of Corporate Voting Rights*, The Harv. L. School Forum on Corporate Gov. & Fin. Reg (May 17, 2017), https://corpgov.law.harvard.edu/2017/05/17/dual-class-the-consequences-of-depriving-institutional-investors-of-corporate-voting-rights/; Council of Institutional Investors, Dual-Class Stock, https://www.cii.org/dualclass_stock.

[9] *See* Council of Institutional Investors, *Dual-Class Stock*, https://www.cii.org/dualclass_stock.

[10] *See* Council of Institutional Investors, *Dual-Class Stock*, available at: http://www.cii.org/dualclass_stock. The CII has also directed its advocacy overseas, lobbying the Singapore stock exchange to preserve its listing standards that exclude companies with nonvoting stock. *See* Council of Institutional Investors, *Letter to the Singapore Stock Exchange* (March 29, 2017), available at: http://www.cii.org/files/issues_and_advocacy/correspondence/2017/03_29_17_letter_to_SGX.pdf.

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

[12] *See, e.g.*, Madison Marriage, *State Street Asks SEC To Ban Nonvoting Shares*, FIN. T. (June 17, 2017), available at: https://www.ft.com/content/9595e5c4-51db-11e7-bfb8-997009366969.
Of course, institutional investor hostility toward the issuance of nonvoting shares complicates the claim that such structures offer efficiency benefits. For a detailed discussion of their arguments against nonvoting shares and my theory that these arguments may themselves be the product of agency costs, see Section III.B.

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

[14] Specifically, the index provider announced that it would bar companies from inclusion unless at least 5% of the voting rights are in the hands of public shareholders. In other words, the index provider did not ban companies with nonvoting shares outright, and instead prohibited companies that excluded the vast majority of public company owners from voting. *FTSE Russell Voting Rights Consultation – Next Steps* (July 2017), available at: http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf. As will be discussed, this is a more sensible policy than that adopted by S&P Dow Jones. See Part IV B. infra.

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

company shares,[16] will generally not buy stock that is not included on an index.[17] As such, these policy changes impose a high financial penalty on dual-class companies that will likely deter companies from utilizing such a structure in the future.[18]

Hostility to dual-class companies, however, is not new. Indeed, academics and regulators have debated whether to restrict or otherwise regulate the use of dual-class structures for at least a century.[19] Yet even after so many years, the arguments on both sides remain the same. Critics of dual-class structures argue that issuing low-voting or nonvoting shares increases agency costs and results in sub-optimal decision-making.[20] That is because the corporate insiders retain voting control even as their equity stake falls below fifty percent.[21] Because of the wedge between financial interest and control, the insiders' incentives to slack or otherwise misbehave are heightened, while outside investors who bear the brunt of the consequences have limited options to exercise influence.[22] A newer version of this critique emphasizes that dual-class structures allow the insiders to maintain control into perpetuity, even after it becomes clear that the structure is no longer efficient.[23]

By contrast, proponents of dual-class structures have consistently claimed that nonvoting or low-voting stock has valuable uses.[24] Most importantly, they contend that dual-class structures allow those who control the company—whether it be the family in a family-owned business or the visionary founders of a successful technology company—to retain control without having to bear excessive risk.[25] Although dual-class structures may lead to increased agency costs—investors will have to

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

17 *Cf.* Ari I. Weinberg, Why Index Funds Have a Limited Presence in the IPO Market, Wall St. J (Sept. 4, 2017), https://www.wsj.com/articles/why-index-funds-have-a-limited-presence-in-the-ipo-market-1504577040?ns=prod/accounts-wsj.

18 *See* Andrei Shleifer, *Do Demand Curves for Stocks Slope Down*, 41 J. FIN. 579, 580 (1986).

19 *See* Douglas C. Ashton, *Revisiting Dual Class Stock*, 68 ST. JOHN'S L. REV. 863, 890-97 (1994).

20 *See* Lucian Bebchuk, Reinier Kraakman, & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, CONCENTRATED CORPORATE OWNERSHIP 296 (2000); Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1, 4, 18 (1988); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 73 (1991).

21 Lucian Bebchuk, Reinier Kraakman, & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, CONCENTRATED CORPORATE OWNERSHIP 298.

22 Id.

23 Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 589-90 (2017).

24 *See, e.g.*, Ashton, *supra* n. 19 at 870-72; David J. Berger, Steven Davidoff Solomon, and Aaron J. Benjamin, *Tenure Voting and the U.S. Public Company*, 72 BUS. LAWYER 295, 296 (2017).

25 If founders could not issue nonvoting or low-voting shares, they would often be forced to hold all or most of their wealth in the company to maintain control, which would subject them to substantial risk. It might also cause them to forego attractive investment opportunities because the new financing would dilute their voting control, or push them to choose debt rather than equity financing even when debt financing would be less beneficial. By issuing nonvoting stock, however, the founders can secure new capital without diluting the founders' stake. This allows founders to diversify their private wealth, as well as secure outside financing, without losing control of the company. *See* Ashton, *supra* n. 19 at 870 ("Since the vote attached to the share under such a regulatory framework is not restricted in terms of exchangeability, the ultimate destination of the rights attached to the vote will be determined by the initial arrangements made between the

monitor management more closely, and when problems emerge, they will have limited recourse—the benefits of encouraging controlled companies to access capital markets, and of protecting the company from the influence of shareholders with short-term interests, exceed the costs.[26] Moreover, these proponents further claim that pressure from capital markets will discourage founders from using dual-class structures when the costs exceed the benefits.[27]

This Article posits that these arguments for and against dual-class structures ignore the fact that the world has changed dramatically in the past fifty years. Beginning in the 1970s, the shareholder base of U.S. public companies has consolidated in the hands of large institutional investors.[28] And in this new world of concentrated institutional investor ownership, nonvoting stock has a previously unrecognized but valuable function. Specifically, corporate issuance of nonvoting shares need not increase management agency costs in all cases, but can be used to *lessen* agency and transaction costs by transferring power between investors. And this theoretical observation may have something to do with nonvoting stock's recent surge in popularity: a company that offers two share classes to the public—one voting and one nonvoting—can lower its cost of capital, not because the structure protects the founding group from interference, but because it reduces inefficiencies associated with voting.

Not all shareholders value their votes equally. Some, including retail shareholders, value their vote so little that they rarely exercise it.[29] Others, such as hedge fund activists, accumulate shares with the purpose of using their voting power to agitate for changes that would increase the value of their investment.[30] And yet, the law generally prohibits shareholders from severing their voting rights from their right to receive corporate cash flows.[31] This means that rationally apathetic investors must either

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

[26] *See generally* Bernard Sharfman, *A Private Ordering Defense of a Company's Right to Use Dual Class Structures in IPOs*, 63 VILLANOVA L. REV. 1 (2018). Of course, companies also have the option to finance using debt, but this paper focuses on equity offerings, and takes the company's level of debt as given.

In defending dual class structures, Sharfman contends that although dual class companies increase agency costs, those costs are not the only costs that need to be minimized when a company goes public. Instead, as Zohar Goshen and Richard Squire have observed, companies and investors seek to minimize total control costs, which include "principal costs," or the costs that accompany investor control, such as the cost of becoming informed about a company for purposes of discipling management. *Id.* at 26-27 (citing Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 767 (2017)). This paper takes Sharfman's observation one step further and shows that dual class shares can be used by management to entice informed investors to buy voting stock, thus *reducing* agency costs; put differently, the tradeoff between minimizing agency costs and minimizing principal costs may not always exist when companies issue nonvoting stock.

[27] *See id.* at 11.

[28] *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 879-886 (2013).

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

[30] *See* Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 Penn. L. Rev. 1021, 1069 (2007).

[31] *See* Crown Emak Partners, LLC v. Kurz, 992 A.2d 377, 388 (Del. 2010).

incur costs associated with voting or let their rights go unused, which dilutes the influence of other investors' votes.[32] In a better world, shareholders who did not value their votes could sell them to shareholders who do (controlling for gamesmanship by wealthy shareholders with idiosyncratic interests),[33] but the law generally prohibits shareholders from selling their votes independent of their shares.[34] This means that voting rights are rarely optimally distributed across shareholders, which leads to inefficiencies that depress the total value of the company.

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

Likewise, funneling nonvoting shares to uninformed and "weakly motivated" shareholders will also make those shareholders better off. That's because these shareholders—whether they be retail shareholders or passively managed mutual funds ("passive funds")—would prefer not to incur expenses associated with voting and instead free ride off of other investors.[35]

Take the example of passive funds, which include index funds and exchange traded funds ("ETFs"). Passive funds often qualify as weakly motivated voters because of their investment strategy: they seek only to replicate the performance of a market index, not outperform it.[36] For this reason, these funds will not benefit from incurring expenditures to monitor and improve the performance of the companies in their large portfolios. In fact, any investment in stewardship or voting is guaranteed to harm a passive fund's relative performance—all rival funds will benefit from the investment, while

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32 Problems are likely to arise regardless of whether the company utilizes a majority or plurality voting regime. For example, under a plurality voting rule, a director will be elected so long as she receives more votes than any other. This means that unexercised votes won't dilute the influence of informed voters, although uninformed votes will. Under a majority voting regime, which requires the director or proposition to get more votes for than against, the impact is greater. Not only will uninformed votes dilute the voting power of the informed voters, but also, the decision to abstain makes it harder for proposals to pass, regardless of their merits.

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

34 *Cf. Commonwealth Assocs. v. Providence Health Care, Inc.*, 641 A.2d 155, 158 (Del. Ch. 1993) (expressing doubt that, "in a post record-date sale of corporate stock, a negotiated provision in which a beneficial owner/seller specifically retained the 'dangling' right to vote as of the record date, would be a legal, valid and enforceable provision, unless the seller maintained an interest sufficient to support the granting of an irrevocable proxy with respect to the shares"). Developments in financial instruments, however, have made it possible for investors to decouple economic ownership of shares and voting rights. *See* Henry Hu & Bernard Black, *The New Vote Buying*, *supra* n. 33 at 852. In other words, it is possible for investors to use financial instruments to "buy" votes without increasing their economic ownership of a company. This decoupling could allow votes to move to better informed hands and therefore enhance the effectiveness of shareholder oversight. *See id.* at 852. But "empty voting" can also harm the company when an investor with a neutral or negative financial interest in the company nonetheless controls the outcome of a shareholder vote. *See id.* at 820. By contrast, the controller of a dual-class company's controller must maintain a financial interest in that company, even though her voting rights may exceed her economic stake.

35 *See, e.g.*, Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting*, 43 J. OF CORP. L. 493, 495 (2018).

36 *Id.*

only the activist fund will bear the costs.[37] And because passive fund investors are particularly fee sensitive, any increase in fees will drive investors to rival funds.[38]

Because of collective action problems, weakly motivated voters should rarely vote in shareholder elections. And when they do vote, their lack of information, coupled with pro-management biases and other conflicts of interest, make it unlikely that their vote will be value-enhancing for the company.[39]

And yet, when a company has only a single class of shares, informed shareholders who highly value their right to vote end up with the same investment as weakly motivated voters who do not. When this happens, weakly motivated voters impose a deadweight loss on corporate governance in three main ways. First and most important, agency costs increase when weakly motivated voters dilute the voice of the informed voters because it will be more costly and difficult for informed voters to discipline management. Second, the company experiences higher transaction costs when it must manage voting for a larger group. And third, when the weakly motivated voters have a large enough segment of the voting power and choose to exercise it,[40] the risk that they will move the company in the wrong direction increases.

Issuing nonvoting stock can enable a company to avoid these costs and therefore minimize the firm's cost of capital. By issuing two classes of stock—one with voting rights, one without[41]—a company can reduce agency costs by making management more accountable to its informed investors while minimizing the transaction costs associated with voting. In this way, nonvoting stock can function as a bonding mechanism by signaling to potential investors that management would be especially attuned to the interests of its informed voting shareholders. The strategy is simply to channel uninformed investors to nonvoting stock.

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[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] Although retail shareholders do not vote very often, passive funds do, either out of a mistaken sense of their fiduciary obligations to investors, or to benefit their other investments. *See id.* at 134. And the rapid growth of passive investment vehicles means that their influence is growing quickly. Already, some S&P 500 companies have passive fund ownership in excess of 20%. *Id.* at 496. In addition, the growth of passive investing has given the institutional investors that dominate the passive fund market a substantial voice in corporate governance: together, Vanguard, BlackRock, and State Street Global Advisers, whose portfolios primarily consist of passive funds, constitute the largest shareholder of 88% of major U.S. companies. *See id.*; Eric A. Posner, Fiona M. Scott Morton, & E. Glen Weyl, *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST L. J. 669, 673 n.14 (2017) (quoting Jan Fichtner, Eelke Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 Bus. & Pol. 298, 313 (2017)).

[41] Although this Article focuses on nonvoting stock, low-voting stock can also be used to promote efficient corporate governance. However, there are a few reasons to believe that nonvoting stock is actually a superior tool. Most important, nonvoting stock more often trades at a significant discount to voting stock, which reflects the absence of any control rights (and the desirability of the tool for one category of voter— those that are weakly motivated). *See Price Differentials Between Voting and Nonvoting Stock,* Stout Risius Ross, available at: https://www.stout.com/insights/article/price-differentials-between-voting-and-nonvoting-stock. The discount for low-voting stock should be less pronounced, if it exists at all. Accordingly, the use of low-voting stock should result in less beneficial sorting between informed and weakly motivated voters.

And happily, market forces should accomplish much of this channeling because nonvoting stock generally trades at a discount to voting stock, despite having the same rights to dividends and cash flows.[42] Therefore, weakly motivated voters, who by definition do not value their vote, should gravitate toward the discounted stock. Likewise, informed investors will generally pay a premium to buy the voting stock, especially because they will be able to acquire influence more cheaply without weakly motivated voters diluting the votes. From an agency cost perspective, therefore, management can be understood as attracting capital at low cost with this capital structure, which will entice informed outside investors to purchase voting shares.

There are, of course, complications. Not all weakly motivated voters will gravitate toward nonvoting stock—for example, some weakly motivated passive funds may purchase voting stock because their indexing strategy requires them to do so. But even minimal dilution of weakly motivated shareholder voting power should increase the value of the firm by reducing agency and transaction costs; in other words, imperfect channeling is better than none at all.

A more confounding problem is that, thus far, the effect of issuing nonvoting stock has generally been to keep voting control with company insiders, rather than empower outside investors. Why have capital market participants not caught on? It may be that innovation in dual-class company structuring is relatively recent; fifteen years ago, typically only family-owned or media companies dared to offer low-voting stock, and nonvoting stock was even rarer.[43] As such, benefits of using nonvoting stock to sort between informed and weakly motivated investors may have yet to be realized. Over time, the growing concentration of wealth, and thus, voting power, in passive funds should increase the attractiveness of company structures that concentrate voting power with informed investors. In turn, the growing availability of discounted nonvoting shares should entice passive funds and retail investors to favor them.

A more cynical response is that managers cannot be trusted to use nonvoting shares to empower informed investors, and will instead use them only to entrench themselves. Snapchat, the source of renewed opposition to nonvoting stock, did not issue nonvoting stock to render its founders more accountable to investor pressure. Indeed, the goal appears to have been to silence outside investors. The same is true of the tech firms that have utilized dual class structuring, and the prospect of entrenchment could perhaps explain the relative unavailability of high-voting common stock in dual class companies. But this explanation ignores the fact that IPO structure is determined by a variety of actors—founders, banks, and early investors—all of whom are motivated to realize the highest price they can for their shares. We have reason to believe, therefore, that insulation can be value-enhancing under certain circumstances. And in others, the prospect of a higher stock price should incentivize beneficial experimentation in dual class structuring to promote accountability, rather than entrenchment. Management teams regularly use bonding mechanisms, such as incorporating in a jurisdiction

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[42] *See id.*

[43] See *What's With All the Non-Voting Tech Shares*?, The Motley Fool (March 6, 2017), https://www.fool.com/investing/2018/03/06/listener-question-whats-with-all-the-non-voting-te.aspx. Even today, few companies have issued or authorized nonvoting stock, and these tend to be media companies, technology companies, or family-owned. For a list of dual class companies, *see* CII Dual Class Companies List, https://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf.

with shareholder friendly law,[44] to signal their quality to investors.[45] There is no reason to think that nonvoting stock could not be part of this toolkit.

The key implication of this analysis is that the use of nonvoting stock should not be discouraged. When issued alongside high-voting stock, nonvoting stock can make corporate governance more efficient. Therefore, blanket proposals to restrict or deter companies from issuing nonvoting stock should be rejected. Such restrictions could cut off beneficial innovation in dual class structuring, increasing a company's cost of capital and worsening its performance and competitiveness. These costs will only increase as investors continue to flock to passive investment vehicles, as weakly motivated voters will control larger and larger voting blocks.[46]

That does not mean, however, that all uses of nonvoting stock are beneficial, and regulators and investors should continue to be skeptical of companies like Snap that issue *only* nonvoting stock to the public. With only one class of stock available, investors will not be able to sort based on their information and motivation. Nonetheless, such structures may be efficient at the time of the offering. But over time, the prospect for agency costs and other inefficiencies increases because the benefits of the dual-class structure likely recede over time.[47] Moreover, most dual-class structures enable the controllers to continue to reduce their equity ownership without relinquishing control, further weakening their incentives to maximize shareholder value.[48] And yet, without votes, the outside shareholders will lack important legal mechanisms to influence the direction of the company, such as the right to nominate directors or vote against them. In addition, the company's outside shareholders will lack information about what the company's insiders are doing. Therefore, if regulation is inevitable, limiting companies from offering only nonvoting shares to the public is the better course of action.

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

[44] *See, e.g.*, Ofer Eldar & Lorenzo Magnolfi, Regulatory Competition and the Market for Corporate Law at 4, Yale Law and Economics Research Paper No. 528, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2685969.

[45] For evidence that corporate governance changes may be used as mechanism to signal management quality, see Merritt B. Fox, Ronald J. Gilson, & Darius Palia, Corporate Governance Changes as Signal: Contextualizing the Performance Link, ECGI Law Working Paper No. 323/2016 (July 11, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2807926.

[46] *See, e.g.* McGinty, Krouse & Bentley, *supra* note 16; Jason Zweig, *Are Index Funds Eating the World?*, Wall St. J. (Aug. 26, 2016); John Authers & Chris Newlands, *Exchange Traded Funds: Taking Over the Markets*, FIN. TIMES (Dec. 5. 2016).

[47] *See generally* Bebchuk & Kastiel, *supra* note 23; Hyunseob Kim & Roni Michaely, *Sticking Around Too Long? Dynamics of the Benefits of Dual-Class Structures* (June 2018), https://ssrn.com/abstract=3145209; Martijn Cremers, Beni Lauterbach, & Anete Pajuste, *The Life-Cycle of Dual Class Firms*, European Corporate Governance Institute (ECGI) - Finance Working Paper No. 550/2018 (January 1, 2018), https://ssrn.com/abstract=3062895.

[48] Bebchuk & Kastiel, supra note 23 at 607.

nonvoting stock and informed voters will be willing to pay a premium for the right to influence the direction of the company. Part IV discusses implications for law. Part V concludes.

I. Dual-Class Shares: Past and Present Regulation

Academics and regulators have debated whether and how to regulate dual-class shares for the past hundred years. In the sections that follow, I map the history of dual-class companies and somewhat cyclical patterns of regulation: for the past century, as the number of dual class companies has risen, those companies have met with regulatory backlash from stock exchanges, the federal government, and now, stock indices.[49]

A. A Brief History of Dual-Class Company Regulation

Dual-class companies depart from the "one-share, one-vote" rule by issuing different classes of common shares with unequal voting rights, but equal or similar entitlements to earnings.[50] Although one-share, one-vote is the default under state corporate law, it has never been mandatory.[51] In fact, in the mid-1800s, before the adoption of general incorporation statutes, the common law rule was that corporations would follow a system of per capita voting, which required one vote per *person*.[52] Eventually, the common law rule became irrelevant as state legislatures took control over corporate charters. These legislative charters varied: some embraced one-share-one-vote, others limited the voting rights of large shareholders, such as by capping the number of votes that any one shareholder could cast.[53]

But by the 1900s, in the face of evidence that mandatory limits on a shareholder's ability to accumulate voting power made it difficult for companies to attract capital, states began to converge on a one-share, one-vote default.[54] This left corporations free to deviate from the statutory standard, and many did.[55] The growing prevalence of dual-class companies led to opposition from the public,

[49] The Article focuses on dual class structures in the United States, although such structures are more common in other parts of the world. For instance, in European countries where family-owned businesses are prevalent, such as France and Italy, the dual class structure is more common. *See* Kate Bentel & Gabriel Walter, *Comparative Corporate Governance and Financial Regulation* at 17 (2016), available at: http://scholarship.law.upenn.edu/fisch_2016/217. Some countries take a more restrictive approach, requiring that corporate structures follow the one-share-one-vote system, including Russia, India, and South Korea. *Id.*

[50] Typically, in the United States, high vote shares have ten times the votes as low vote shares, but other structures are possible, such as when the high vote class elects the majority of the board and the low vote class elects a minority of the board. *See, e.g.*, Landon Thomas, Jr., *Morgan Stanley Criticizes Stock Structure of Times Co.*, N.Y. TIMES, (Nov. 4, 2006), available at: http://www.nytimes.com/2006/11/04/business/04times.html (explaining that the structure of the New York Times Company has been in place since before the company went public in 1969 and was intended to protect the newsroom from interference).

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

[52] Ashton, *supra* note 19 at 890.

[53] Bainbridge, *SEC's Authority*, *supra* note 51 at 3.

[54] *See id.* at 5.

[55] A variety of reasons have been noted for the preference for nonvoting stock during those years, including "(1) the investor-speculator's dual demand for a share in the huge profits earned by industry during the period and the appearance

as well as prominent academics.[56] The stock exchanges also took notice, and in 1926, the NYSE refused to list a company that issued nonvoting stock for the first time.[57] This ad hoc decision-making materialized into a formal rule by 1940, when the NYSE adopted a listing requirement that excluded dual-class companies.[58] The requirement remained for four decades, until General Motors was permitted to issue restricted shares in conjunction with its acquisition of Electronic Data Systems Corporation in 1984.[59]

Around the same time that the exception was made for General Motors, the NYSE designated a subcommittee to recommend a policy regarding dual-class listings.[60] The result was a policy requiring two-thirds of shareholders to approve the creation of a second class of stock, in addition to approval by a majority of independent directors, the maintenance of a 10:1 ratio of voting rights between the enhanced shares and the second class of shares, and a requirement that all other rights between the shares be substantially the same.[61] If these conditions were met, the NYSE would list the shares.[62]

This new policy, as well as a resurgence in the use of dual-class offerings brought on by the 1980s takeover wave, triggered scrutiny from the SEC.[63] In 1988, the SEC promulgated Rule 19c-4, which restricted the NYSE, the AMEX, and NASDAQ from listing or continuing to list companies that departed from the one-share, one-vote default unless certain circumstances were met.[64] Specifically, the rule permitted issuers to offer new classes of nonvoting stock, or a special class with limited voting rights, provided the issuance did not dilute the voting power of existing shareholders.[65] Rule

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of security greater than that offered by the common share; (2) the desire of management to raise additional capital when it was easy to do so while retaining full control of the corporation; and (3) a vaguely felt or implied desire on the part of bankers and investors to have something new." Jeffrey Kerbel, *An Examination of Nonvoting and Limited Voting Common Shares-Their History, Legality, and Validity*, 15 SEC. REG. L. J. 37, 47-50 (1987). And as the use of nonvoting stock became increasingly prevalent, courts generally acquiesced to its use on the basis of freedom to contract. *See* Ashton, *supra* note 19, at 892 (collecting cases).

56 William Ripley, a professor of political economics at Harvard, was the most prominent proponent of equal voting rights and wrote many articles and speeches designed to stop transactions that "disenfranchised" shareholders. His efforts eventually attracted the attention of President Coolidge. The public, too, grew increasingly hostile toward the use of nonvoting stock, especially after a sale by Dillon, Reed, & Company of Dodge Brothers debentures that enabled Dillon, Reed to retain voting control of the company for itself. *Id.* at 892 & n.121.

57 Bebchuk & Kastiel, *supra* note 23, at 596; *see also* Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 693–707 (1986). Nonetheless, dual class structures remained popular—in the years between 1927 and 1932, at least 288 corporations issued non-voting or limited voting rights shares (which was almost half of the total number of such issuances). Ashton, supra note 19 at 893.

58 Ashton, *supra* note 19, at 893.

59 *Id.* at 893-94. It appears that increased takeover activity may have prompted the stock exchange's decision to reconsider the policy. That, and the fact that an increasing number of family-run companies wished to access the public equity markets where share values were at record highs. Dual class structures were the only means of gaining access without diluting their control. *Id.* at 895-96. For these reasons, competitor stock exchanges with less restrictive dual class listing standards were attracting corporate listings and diluting the NYSE's market share.

60 *See* Seligman, *supra* note 57, at 700-06.

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

62 *Id.*

63 Bebchuk and Kastiel, *supra* note 23, at 596-97.

64 Bainbridge, *SEC Authority*, *supra* note 51, at 6-7.

65 Ashton, *supra* note 19, at 899.

19c-4 also permitted the issuance of a second class of stock in the context of a merger or acquisition with a bona fide business purpose.[66]

The SEC asserted that it had the authority to adopt the rule based on Securities Exchange Act § 19(c), which permits the agency to amend exchange rules provided that the action furthers the Act's purposes.[67] The SEC contended that § 14(a) of the Act embodied the purpose of protecting corporate democracy.[68] The D.C. Circuit disagreed, striking down the rule in 1990 in *Business Roundtable v. SEC*.[69] It reasoned that § 14(a) did not give the SEC power to regulate substantive aspects of shareholder voting, but only to regulate the procedures by which proxy solicitations are conducted, as well as proxy voting disclosure.[70]

Therefore, after 1990, companies were largely free to depart from the one-share, one-vote rule.[71] But before 2004, companies rarely chose to do so, with certain notable exceptions, including the New York Times and News Corp.,[72] which contended that the dual-class structure helped protect journalistic integrity;[73] closely held companies such as Berkshire Hathaway; and family-owned companies such as Ford.[74]

In 2004, Google (now, Alphabet) became the first technology company to adopt a dual-class structure for the explicit purpose of keeping control of the company in the hands of the founding group.[75] To accomplish that purpose, only the low-vote shares (which had 1/10th of the voting power as the Class B shares held by the insiders) were sold to the public. In a letter to the public, the founders explained, "After the IPO, Sergey, Eric and I will control 37.6% of the voting power of Google, and the executive management team and directors as a group will control 61.4% of the voting power. New

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66 *Id.*
67 Bainbridge, *SEC Authority*, *supra* note 51, at 7-8.
68 *Id.* at 8.
69 *Bus. Roundtable v. SEC*, 905 F.2d 406, 417 (D.C. Cir. 1990).
70 *Id.* at 410-411.
71 The NYSE and other major U.S. stock exchanges prohibit recapitalizations that reduce the voting rights of existing shareholders. Essentially, companies that wish to remain listed are permitted to issue new classes of low or nonvoting stock, but they are not able to reduce the voting rights of existing stock. *See* Stephen Bainbridge, *Revisiting the One Share/One Vote Controversy: The Exchanges' Uniform Voting Rights Policy*, 22 SEC. REG. L. J. 175, 184-86 (1994).
72 Ironically, News Corp. is the parent company of Dow Jones, the index publisher that has refused to list dual class companies. *See* Richard Perez-Pena, News Corp. Completes Takeover of Dow Jones, N.Y. Times (Dec. 14, 2007), https://www.nytimes.com/2007/12/14/business/media/14dow.html.
73 Landon Thomas, Jr., *Morgan Stanley Criticizes Stock Structure of Times Co.*, N.Y. TIMES, (Nov. 6, 2016), available at: http://www.nytimes.com/2006/11/04/business/04times.html (explaining that the structure of the New York Times Company has been in place since before the company went public in 1969 and was intended to protect the newsroom from interference). The newspaper companies usually allow the public shareholders to elect a minority of the board seats (4 in the case of the New York Times), while the insiders elect the remaining 9. *Id.*
74 *See* Edward Kamonjoh, Investor Responsibility Research Ctr. Inst., Controlled Companies in the Standard & Poor's 1500: A Follow-up Review of Performance & Risk 84–87 (Mar. 2016), https://irrcinstitute.org/wp-content/uploads/2016/03/Controlled-Companies-IRRCI-2015-FINAL-3-16-16.pdf (listing companies with dual class structures).
75 This Article refers to Google, although the company is now technically Alphabet Inc., after a 2015 corporate reorganization.

investors will fully share in Google's long term economic future but will have little ability to influence its strategic decisions through their voting rights."[76]

Since 2004, other technology companies have followed suit, either going public with dual-class structures, or engaging in stock splits to help founders maintain control. For example, in 2012, Facebook went public offering only Class A shares with a single vote per share to the public, in contrast with the Class B shares, which had ten votes and were owned exclusively by Facebook insiders.[77] This structure allowed Facebook's CEO, Mark Zuckerberg, to hold over 57% of the voting power of the company despite owning approximately 28% of the economic value.[78] "This concentrated control," the company wrote in its S-1, "will limit [the investors'] ability to influence corporate matters for the foreseeable future."[79]

More recently, in April 2016, Facebook announced that it would engage in a 3-1 stock split by issuing two Class C shares with zero voting rights for every share of Class A and B stock.[80] Unsurprisingly, a majority of shareholders ratified the plan at the company's annual meeting on June 20, 2016, but the board stalled in issuing the stock because of pending litigation in the Delaware Court of Chancery. Two groups of shareholders had filed complaints alleging that the stock split was an attempt to entrench Zuckerberg, who only last year announced that he planned to give away 99% of his Facebook equity to charity.[81] In September 2017, Facebook announced that it would abandon the stock reclassification plan, mooting the litigation.[82]

Google, too, faced shareholder litigation after it engaged in a stock split in 2012.[83] Rather than simply doubling the number of shares outstanding as is traditionally done in stock splits, Google took the opportunity to create a new class of nonvoting shares.[84] By distributing a Class C share for every outstanding Class A and Class B share, the split allowed the founders to maintain their voting control, while creating additional equity to use for compensation and acquisition purposes. Some of Google's large institutional investors objected to the arrangement and sued in the Delaware Court of Chancery.[85] The litigation eventually settled and the split went forward, but Google agreed in the settlement that

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

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

[78] J. O'Dell, Power Play: How Zuckerberg Wrested Control of Facebook From His Shareholders, VentureBeat (Feb. 1, 2012), https://venturebeat.com/2012/02/01/zuck-power-play/.

[79] *Id.* at 31.

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

[81] *See* Class Action Complaint at 12-13, 17 *McGinty v. Zuckerberg*, Delaware Court of Chancery, http://www.professorbainbridge.com/Facebook_complaints/facebookmcginty.pdf; Class Action Complaint at 12, *Levy v. Zuckerberg*, http://www.professorbainbridge.com/Facebook_complaints/facebookcomplainteric levy.pdf. That litigation is still pending before the Court of Chancery.

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

[83] *See* In re Google Inc. Class C S'holder Litig., Cons. C.A. No. 7469–CS (Del. Ch. Oct. 28, 2013).

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

[85] *See id.*

if the Class C shares traded at a discount greater than 1% of the Class A shares at the end of the first year, the shareholders would be entitled to compensation.[86] By the end of the year, the shares were trading at a discount of 1.4%, requiring Google to pay out more than $500 million to the Class C shareholders.[87]

The prospect of litigation has not deterred other technology companies from utilizing dual-class structures. Since 2004, several prominent tech companies, including Groupon, LinkedIn, Yelp, and Zynga, have gone public issuing only low-voting stock to the public.[88] Other companies, such as Under Armour and Zillow, engaged in stock splits and issued nonvoting stock as a tool to prevent the founding group's control from being diminished in the future.[89]

Despite the increasing popularity of nonvoting stock in stock splits, before 2017, no company had been willing to offer only nonvoting stock to the public in an IPO.[90] But in March of that year, Snap did just that. The company utilized a three-tiered structure, reserving its two classes of voting stock for company insiders, with the super-voting stock remaining with the company's two young co-founders.[91] As a result of this structure, the founders hold 88.5% of the company's voting power, but only 18.7% of the outstanding equity.[92]

When Snap announced its plans, many predicted that the company would pay a penalty for its unfriendly governance structure.[93] And yet, Snap closed its first day of trading up 44% from its IPO price.[94] In other words, investors, including the large institutional investors who vocally opposed the dual-class structure, were not deterred from purchasing nonvoting shares.[95]

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

[87] *See* Schwab Performance Technologies Corporate Action Instructions for Google, Inc. Class C Share Distribution: https://www.schwabpt.com/public/file/P-9059479/SPT013383.pdf.

[88] *See* Bebchuk and Kastiel, *supra* note 23 at 594 (reporting that since 2004, Facebook, Groupon, LinkedIn, Trip Advisor, and Zynga all adopted a dual class structure in their public offerings).

[89] *See* Angela Chen, *Zillow Approves Dividend, Creates C Class of Stock*, WALL. ST. J. (July 21, 2015, https://www.wsj.com/articles/zillow-approves-dividend-creates-c-class-of-stock-1437512241; Miriam Gottfried, *A Double-Digit Return is Hiding in Plain Sight at Under Armour*, Wall St. J. (Nov. 28, 2016). Under Armour was sued by its shareholders following the split and eventually settled claims that the board of directors breached its fiduciary duties in approving the issuance of non-voting Class C shares through a stock split of current Class A shareholders' shares and amending the company's charter. The judicially approved settlement order awarded a $59 million dividend to Class C shareholders, designed to account for losses as a result of the split. *See* In re: Under Armour Shareholder Litigation, Case No. 24-C-15-003240 (Circuit Court, Baltimore County MD); Under Armour, Inc., Form 10-K, at 59-60 (Feb. 19, 2016), https://www.sec.gov/Archives/edgar/data/1336917/000133691716000064/ua-20151231x10k.htm#sB757DF0B726DA0FE59E7C4E24B684F99.

[90] *See* Snap Inc., Amendment No. 2 to Form S-1 Registration Statement, at 5 (Feb. 16, 2017) ("[T]o our knowledge, no other company has completed an initial public offering of non-voting stock on a U.S. stock exchange.").

[91] *Id.* at 4.

[92] *Id.* at 9. This control only goes away when both die or if they sell off 70% of their super-voting shares. Moreover, if one of the founders were to die, a proxy arrangement specifies that voting control would transfer to the other. *Id.* at 5.

[93] *See* Kerber & Baker, supra note 6.

[94] *Id.*

[95] *See* Institutional Ownership in Snap (Sept. 5, 2017), https://seekingalpha.com/article/4104202-institutional-ownership-snap.

Although no other company has followed Snap's example, other companies utilized nonvoting stock in their public offerings in the months that followed Snap's IPO. Since March 2017, several companies—Blue Apron, Altice, and Dropbox, Inc.—have gone public with a triple-class structure, authorizing single-vote Class A shares for the public, super-voting class B shares for insiders (i.e., founders and early investors), and a reserve of Class C shares with no voting rights that could be issued in the future.[96]

B. Recent Calls for Reform

The surge in dual-class stock listings in the United States has generated heated opposition from institutional investors, lawmakers, and investor advocacy groups. Their concerns are reminiscent of complaints levied at the start of the 20th century: these critics argue that creating a wedge between an investor's economic interest in the company and their voting power not only decreases the controller's incentives to maximize the share price, but also reduces her accountability to the majority of the shareholders.[97]

In light of the SEC's limited ability to regulate dual-class listings following *Business Roundtable*,[98] these critics have directed advocacy efforts to the stock indices. Most vocally, CII, an organization of more than 140 public, union, and corporate pension funds, has petitioned the U.S. exchanges and stock indices to adopt a one-share, one-vote policy since 2012.[99] Under their favored policy, the

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[96] *See* Tom Zanki, *More Companies Authorizing Dual Class Shares Despite Resistance*, Law360 (July 12, 2017), available at: https://www.law360.com/capitalmarkets/articles/943458; Dropbox, Inc., Form S-1 Registration Statement, at 7-8 (Feb. 23, 2017), https://www.sec.gov/Archives/edgar/data/1467623/000119312518055809/d451946ds1.htm.

[97] The empirical evidence on this subject is mixed. *Compare* Paul A. Gompers et al., *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1051-54 (2010) (finding evidence that U.S. dual class companies exhibited increased agency costs and reduced value from 1995 to 2002), *with* Ronald C. Anderson et al., *The Dual Class Premium: A Family Affair* 6 (Aug. 14, 2017). Fox School of Business Research Paper No. 17-021, https://ssrn.com/abstract=3006669 (finding that dual class family firms yield excess stock returns of nearly 350 basis points per year as compared to single class non-family firms, suggesting that on average, dual class structures do not harm outside investors); Valentin Dimitrov & Prem C. Jain, *Recapitalization of One Class of Common Stock into Dual-Class: Growth and Long-Run Stock Returns*, 12 J. CORP. FIN. 342, 346-47 (2006) (suggesting that dual class structures might have some positive effects), *and* Scott W. Bauguess et al., *Large Shareholder Diversification, Corporate Risk Taking, and the Benefits of Changing to Differential Voting Rights*, 36 J. BANKING & FIN. 1244, 1244-46 (2012) (same). Indeed, a recent empirical study commissioned by CII concluded only that dual-class companies did not feature a meaningful increase in long term value relative to their single-class company peers. *See* Gabriel Morey, *Multi-Class Stock and Firm Value* (May 2017), http://www.cii.org/files/publications/misc/05_10_17_dual-class_value_summary.pdf. *Cf.* Ronald C. Anderson, *Founding Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. OF FIN. 1301, 1324 (2003) (concluding that family-owned firms performed better than firms that were not family owned). For an extensive survey of the empirical evidence evaluating dual class structures, see Renée Adams & Daniel Ferreira, *One Share–One Vote: The Empirical Evidence*, 12 REV. FIN. 51 (2008).

[98] See *supra* notes **Error! Bookmark not defined.**-**Error! Bookmark not defined.**.

[99] *See, e.g,* Letter from the Council of Institutional Investors to MSCI (May 9, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/CII%20response%20to%20MSCI%20Expanded%20Consultation%20FINAL.pdf; CII Submission to S&P Dow Jones on No-Vote Shares (April 27, 2017) https://www.cii.org/files/issues_and_advocacy/correspondence/2017/20170426%20CII%20comment%20S&P%20no%20vote%20share.pdf; CII Letter to FTSE/Russell requesting consultation on the exclusion of no-vote shares (March 24, 2017), https://www.cii.org/files/issues_and_advocacy/correspondence/2017/03_24_17_letter_ftse.pdf; Letter from the Council of Institutional Investors to NASDAQ 1-2 (Oct. 2, 2012), http://www.cii.org/files/issues_and_advocacy/correspondence/2012/10_02_12_cii_letter_to_nasdaq_dual_class_stock.pdf.

exchanges and indices would bar companies with new multi-class structures, and at the very least, prohibit companies with non-voting shares from eligibility.[100] This policy, if implemented, would be a strong deterrent for any company considering whether to issue nonvoting shares because being listed on an index creates substantial demand for a company's equity, as does inclusion on a stock exchange.[101] CII's advocacy is not limited to major stock indices and exchanges—it has also written open letters to companies, including Snap and Blue Apron, asking them to abandon their dual-class IPOs or convert all dual-class structures unless the low-voting share class votes to extend it.[102] CII has also made its case to the Securities and Exchange Commission's Investor Advisory Committee, which held a meeting centering on Snap's multi-class structure on March 9, 2017.[103]

Large and influential investors have likewise expressed opposition to dual-class structures. For example, the California Public Employees' Retirement System ("CalPERS"), the largest U.S. pension fund, has threatened to boycott any dual-class listing that allows a minority of shareholders to control a majority of the votes.[104] The Investor Stewardship Group, a collective of some of the largest U.S. institutional investors, including BlackRock, Vanguard Group, T. Rowe Price, and State Street Global Advisors, has likewise taken a position against dual-class companies in its January 2017 stewardship code. That code, called the Framework for U.S. Stewardship and Governance, states as a core corporate governance principle that "shareholders should be entitled to voting rights in proportion to their

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CII's advocacy is not confined to those IPOs with dual-class shares listed on the U.S. stock indexes. It also is attempting to persuade the Singapore, Hong Kong, and London stock exchanges not to allow dual-class share structures of any kind. *See Dual Class Stock*, COUNCIL OF INSTITUTIONAL INV'RS, available at: http://www.cii.org/dualclass_stock (last visited Oct. 4, 2018) (collecting letters). Notwithstanding these lobbying efforts, Hong Kong's stock exchange recently proposed to reverse a long-standing policy excluding dual class companies in an attempt to attract technology company listings. S*ee* Benjamin Robertson, *Hong Kong Targets Next Alibaba in Revamp of IPO Rules*, Bloomberg Markets (Dec. 15, 2017), https://www.bloomberg.com/news/articles/2017-12-15/hong-kong-moves-toward-dual-class-shares-wooing-next-alibaba.

100 *See, e.g.,* CII Letter to MSCI Responding to Consolutation on the Treatment of No-Vote Shares at 3 (Aug. 3, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/8-3-17%20CII%20response%20to%20MSCI%20Consutation.pdf.

101 *See, e.g.*, Tom McGinty et al., *Index Funds Are Taking Over The S&P 500*, WALL ST. J. (Oct. 17, 2016), http://www.wsj.com/graphics/index-funds-taking-over-sp-500/.

102 *See Dual Class Stock*, COUNCIL OF INSTITUTIONAL INV'RS, http://www.cii.org/dualclass_stock (last visited Oct. 4, 2018).

103 Minutes of the Meeting on March 9, 2017, https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac030917-minutes.htm. In that meeting, a representative of CII, as well as certain institutional investors, "urged the SEC to use its regulatory authority over the exchanges to limit the ability of companies to have dual-class structures." *See* David Berger, *Dual-Class Stock and Private Ordering: A System That Works*, Harvard Law School Forum on Corporate Governance and Financial Regulation (May 24, 2017), https://corpgov.law.harvard.edu/2017/05/24/dual-class-stock-and-private-ordering-a-system-that-works/. Kurt Schacht, the Chair of the Securities and Exchange Commission's Investor Advisory Committee, agreed, describing Snap's structure as "a significant concern" and a "troubling development from the perspective of investor protection and corporate governance" if it were to spur a new trend for tech companies going. Therese Poletti, *Potential Snap IPO Effect: More Unicorns to Wall Street, but with Horrible Terms*, MARKETWATCH (Mar. 2, 2017, 7:47 PM ET), https://www.marketwatch.com/story/potential-snap-ipo-effect-more-unicorns-to-wall-street-but-with-horrible-terms-2017-03-02/.

104 Shanny Basar, *Calpers Sets Sights on Dual-Class Stock Structures*, WALL ST. J. (Aug. 20, 2012,12:16 PM ET), https://www.wsj.com/articles/SB10000872396390443855804577601271252759472. The California State Teachers' Retirement System ("CalSTRS") and the Florida State Board of Administration ("Florida SBA") have made similar threats. Bebchuk & Kastiel, *supra* note 23, at 597-98.

economic interest."[105] Separately, T. Rowe Price, a large asset management firm, has threatened to vote against directors at dual-class companies unless they take action to reclassify the shares.[106]

Proxy advisor firms have also expressed strong opposition to dual-class structures. For example, Institutional Shareholder Services ("ISS") has denounced them as "an autocratic model of governance."[107] It has proposed to amend its voting policies to recommend that shareholders vote against director nominees at companies that have completed an IPO with a dual-class capital structure unless there is a reasonable sunset provision.[108]

This wave of advocacy has begun to have an effect. In July 2017, FTSE Russell announced that it would bar companies from inclusion in its indices unless at least 5% of the voting rights were in the possession of public shareholders.[109] As a result, both Snap and Blue Apron, which went public with less than 2% of its voting rights held by public shareholders, have been excluded from its indices.[110]

Just days later, S&P 500 Dow Jones announced that going forward, the S&P 500, S&P 600, and S&P 400 indices will no longer admit companies with multiple share class structures.[111] This meant that Snap would be excluded, although existing dual-class companies, such as Facebook and Google, would be grandfathered into the indices. And in January 2018, MSCI announced that it would reduce the weight that dual class companies occupy in its indices.[112]

These decisions dealt a major blow to Snap and provided a powerful deterrent to other companies considering whether to utilize nonvoting stock. That is because index funds, which make up a

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

106 *See* Ross Kerber, *U.S. Investor Group Urges Halt to Dual-Class Structures in IPOs*, REUTERS (Mar. 23, 2016, 6:37 AM), http://www.reuters.com/article/us-usa-ipo-votingrights-idUSKCN0WP1Q0.

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

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

109 FTSE Russell Voting Rights Consultation – Next Steps (July 2017), http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf; *see also* Richard Teitelbaum, *Index Firms Take Issue with Nonvoting Rights*, WALL ST. J. (Apr. 9, 2017, 8:00 AM ET), https://www.wsj.com/articles/index-firms-take-issue-with-nonvoting-rights-1491739227.

110 No-vote Common Stock, Sullivan & Cromwell LLP (August 4, 2017), https://scdealportal.sullcrom.com/posts/no-vote-common-stock/; Existing index constituents were given a five-year grace period to conform their voting structure. FTSE Russell Voting Rights Consultation – Next Steps (July 2017), http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf.

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

112 Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indices, MSCI, at 2 (Jan. 2018), https://www.msci.com/documents/1296102/8328554/Consultation_Voting+Rights.pdf/15d99336-9346-4e42-9cd3-a4a03ecff339. Current index participants will be given a three-year grace period before adjustments are made. *Id.*

significant percentage of demand for company shares,[113] will not buy stock that is not included on an index. As such, these policy changes impose a high financial penalty on dual-class companies that is likely to deter future dual-class listings in the United States.

In addition, the SEC has become more active in the debate over dual-class voting structures. Commissioner Robert Jackson in particular has been a vocal advocate for restrictions on perpetual dual-class structures. In a February 2018 speech, he expressed his hope that stock exchanges would require companies with dual-class structures to include sunset provisions that would phase out the unequal voting rights over time.[114] One month later, the SEC's Investor Advisory Committee recommended that the Division of Corporation Finance require more detailed disclosure by dual class issuers about some of the risks of dual-class company shares.[115] Although SEC Chairman Jay Clayton has not indicated a willingness to take immediate action, he has explained that he is "watching the space."[116]

C. Changes to the Investment Landscape

The surge in dual-class companies corresponds with a major change in the shareholder landscape. In the past fifty years, the shareholder base has consolidated in the hands of large institutional investors—mutual funds, pension funds, and hedge funds. Now, more Americans own U.S. company stock than ever before, but they do so through investment intermediaries.[117] As a result, institutional investor ownership stakes in U.S. public companies have become increasingly concentrated. For example, twenty percent of Microsoft's equity is in the hands of its five largest shareholders, and more than a third is held by its twenty largest shareholders.[118]

But that is not all. In the past ten years, another major market change has occurred: investors have been flocking to passive funds in droves. Between 2008 and 2015 investors sold approximately $800 billion of their holdings in actively managed mutual funds , while at the same time buying over $1 trillion in passive funds.[119] This past year alone, investors withdrew $340 billion from actively managed funds and invested $533 billion into passive funds, increasing the total amount of assets invested

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113 *See* Tom McGinty et al., n.100 *supra*.

114 Robert Jackson, Jr., Comm'r, Sec. & Exch. Comm'n, Perpetual Dual Class Stock: The Case Against Corporate Royalty, Speech Before Cleary Gottlieb Steen & Hamilton LLP Conference: M&A, Antitrust and the Board Room in 2018 (Feb. 15, 2018), https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty.

115 *See* SEC Recommendation of the Investor Advisory Committee–Dual Class and Other Entrenching Governance Structures in Public Companies at 5-6, https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-on-dual-class-shares.pdf.

116 Ronald Orol, *SEC's Clayton "Watching" Insider-Controlled IPOs*, THESTREET (Oct. 12, 2017, 2:51 PM EDT), https://www.thestreet.com/story/14341287/1/sec-chief-eyes-dual-class-ipo-structure.html.

117 *See* Gilson & Gordon, *supra* note 28 at 884. Changes in federal retirement policy were the biggest drivers of the growth of institutional investing. *See generally id.* at 878-84; Edward B. Rock, *Institutional Investors in Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 363, 365 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018).

118 *See* Lucian A. Bebchuk, Alma Cohen, & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. OF ECON. PERSPECTIVES 89, 92 tbl.1 (2017).

119 See Jan Fichtner et al., Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk, 19 BUS. & POL. 298, 299 (2017).

in passive funds by 9%.[120]Assets under management in passive funds now represent $4 trillion, or 34% of the U.S. mutual fund market, up from just 4% in 1995.[121] And in the past twenty years, the share of total U.S. market capitalization held by passively managed funds has quadrupled to more than 8%, or 12% of the S&P 500.[122]

This explosive growth is driven by a growing awareness of the benefits of passive funds for investors: studies have generally shown that the average actively managed mutual fund is unlikely to outperform its baseline index, despite levying much higher fees.[123] As such, investor demand for low-fee passive funds is rational. It is also predicted to continue.[124] And already, the three institutional investors that dominate the market for passive funds—Vanguard, State Street, and BlackRock—have become powerful voices in corporate governance. In 2015, together these institutions constituted "the largest owner in nearly 90 percent of public companies in the S&P 500, up from 25 percent in 2000."[125] When considering all listed companies in the U.S., together these three institutions were the single largest shareholder at least 40% of the time.[126]

Scholars have questioned whether the rise of passive investing, and institutional investing more broadly, is good for corporate governance. Some, including Einer Elhauge, Eric Posner, Glen Weyl, and Fiona Morton, have posited that the rise of institutional investing may lead to anticompetitive conduct because institutional shareholders with large horizontal investments across competitor firms in concentrated industries might induce those companies to compete less aggressively.[127] Others worry that the increase in passive investing will lead to too little oversight, as well as corporate governance distortions at public companies.[128] As the next section demonstrates, nonvoting shares may play a role in ameliorating some of these concerns.

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120 See Morningstar Direct Asset Flows Commentary: United States, MORNINGSTAR (Jan. 11, 2017), https://corporate.morningstar.com/us/documents/assetflows/assetflowsjan2017.pdf.

121 *Id.*

122 Ian Appel et al., Passive Investors, Not Passive Owners, 121 J. FIN. ECON. 111, 112 (2016).

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

124 Ernst & Young has forecasted annual growth rates for the U.S. ETF industry of between 10 and 15 percent in the next few years. EY Global ETF Survey: 2015 and Beyond (Oct. 7, 2014), http://www.ey.com/Publication/vwLUAssets/ey-global-etf-survey-2015-and-beyond/$FILE/ey-etf-survey-2015-and-beyond.pdf. Likewise, PricewaterhouseCoopers estimates that assets invested in ETFs will double by 2020. Judith Evans and Jonathan Eley, *Democratising finance: How passive funds changed investing*, FIN. T. (2015), http://www.ft.com/intl/cms/s/0/b3c0c960-a56c-11e4-bf11-00144feab7de.html.

125 Posner et al., *supra* note 40 at 674.

126 Fichtner et al., *supra* note 119 at 322.

127 *See* Posner et al., *supra* note 40 at 680-91. *Cf.* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1291-1292 (2016).

128 *See generally* Lund, *supra* note 35; Bebchuk, Cohen & Hirst, *supra* note 118. For a discussion of how the increasing concentration of control with a small number of mutual fund complexes may undermine corporate governance, see John C. Coates, The Future of Corporate Governance Part I: The Problem of Twelve, Working Paper (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337).

II. Nonvoting Shares and Efficient Corporate Governance

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

Critics of nonvoting shares argue that their use increases agency costs at corporations.[129] The agency cost problem in corporate law is familiar: Shareholders finance the company and delegate control to corporate insiders—the agents—but doing so creates a conflict of interest between the insiders who make the decisions and the investors who bear the consequences. When the insiders' voting control exceeds their equity stake in the company, the misalignment of incentives between corporate insiders and shareholders is even more pronounced—the insiders will reap a disproportionately small share of the gains and losses from their decisions,[130] and so they may use their voting power to maximize their private benefits, rather than maximize the value of the company's equity.[131] This misalignment can lead to distorted investment decisions,[132] tunneling,[133] and inefficient perquisite consumption. And when this happens, the outside shareholders that are most affected will have no recourse, aside from selling their shares.

By contrast, under a one-share-per-vote system, the corporate insiders' incentives are better aligned with the outside shareholders. To keep control, the insiders must hold a controlling equity stake, meaning that they will bear a substantial fraction of the costs and benefits of their decision-making.[134] If they sell down their ownership stake, the outside investors with the majority of the equity will be able to vote management out of office when problems arise (or sell to someone who can). This provides an important check against bad behavior—the insiders will realize that if they slack or self-deal, their jobs will be at risk.

In sum, economic theory embraces proportionate voting rights as an important mechanism to help the company minimize management agency costs. Proportionate voting also facilitates the market for corporate control—if dispersed shareholders face high coordination costs, they can sell their shares

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[129] *See, e.g.*, Bebchuk et al., *supra* note 20 at 296, 301-06 (showing how dual class structures "distort the decisions that controllers make with respect to firm size, choice of projects, and transfers of control. Our central contribution here is to highlight the potentially large agency costs that such structures involve."); Gordon, *supra* note 20 at 18 ("Dual class common gives rise to agency problems not only in merger negotiations but in the management of the firm generally."); Easterbrook and Fischel, *supra* note 20 at 73 ("Votes follow the residual interest in the firm, and unless each element of the residual interest carries an equal voting right, there will be needless agency costs of management.").

[130] Easterbrook and Fischel, *supra* note 20 at 73.

[131] *See id.*; *see also* Eugene Fama & Michael Jensen, *Separation of Ownership and Control*, 26 J. L. AND ECON. 301, 304 (1983); Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 312-313 (1976).

[132] Bebchuk et al., *supra* note 20 at 301-06.

[133] Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes, & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22 (2000). Tunneling refers to the transfer of resources from a company to its controlling shareholder. *Id.*

[134] Lucian Bebchuk, Reinier Kraakman, & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, CONCENTRATED CORPORATE OWNERSHIP 298; Jensen & Meckling, *supra* note 131 at 313.

to an outside bidder, who can use the votes to bring in new management and run the firm more efficiently.[135]

Proponents of dual-class stock do not dispute that nonvoting stock can increase agency cost problems.[136] Instead, they contend that providing some isolation from shareholder intervention may be net-beneficial because that isolation allows management to pursue their long-term vision of the company without distraction from shareholders with short-term incentives.[137] These proponents also argue that market pressures at the time of the offering ensure that dual-class structures will only be utilized when they are truly value-enhancing, *i.e.*, when the benefits from giving the insiders freedom from interference outweighs heightened agency costs.[138]

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

A. Weakly Motivated Voters and Nonvoting Stock

In 1976, Michael Jensen and William Meckling famously posited that there is an optimal proportion of debt and equity for any given level of equity owned by insiders that would minimize agency

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135 Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 140 (1987) (contending that "the cost of dual class common stock is that the effectiveness of the market for corporate control as a monitoring device is reduced."); Paul Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 11 (http://www.haas.berkeley.edu/groups/finance/dualpaper.pdf finding that the average age of companies with dual class share structures in 2001 was 12.87 years while the average age for single-class companies was 9.60 years and positing that the explanation for this difference was that the dual class companies could resist takeovers). *See generally* Stanford Grossman and Oliver Hart, *One Share-One Vote and the Market for Corporate Control*, 20 J. FIN. ECON., 175 (1988).

136 *See, e.g.*, Sharfman, *supra* note 26 at 21 (arguing that investors are willing to invest in dual class companies because of "the wealth-maximizing efficiency that results from the private ordering of corporate governance arrangements, and the understanding that agency costs are not the only costs of governance that need to be minimized."); Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L. J. 560, 577 (2016) (identifying in start-ups "a fundamental tradeoff between the entrepreneurs' pursuit of their idiosyncratic vision and investors' desire for protection from agency costs."); *cf.* Albert Choi, *Concentrated Control and Long-Term Shareholder Value*, 8 HARV. BUS. L. REV. 53, 59, 67-74 (2018) (arguing that the presence of controlling shareholders may enhance the company's long-term value by inducing commitment and investment by the controlling shareholder, despite the risk of increased agency costs).

137 *See* Goshen & Hamdani, *supra* note 136 at 577; David J. Berger, Steven Davidoff Solomon, and Aaron J, Benjamin, *supra* note **Error! Bookmark not defined.** at 296.

138 Sharfman, *supra* note 26 at 18-22; *see* Ronald Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807, 808-09 (1987); Jensen and Meckling, *supra* note 131 at 313 (contending that rational minority shareholders expect expropriation from the controllers and thus demand a lower subscription price when the controlling shareholder turns to the capital market for new capital).
Proponents of dual-class structures also contend that they encourage controllers to access the public markets. Otherwise, the controller would be forced to remain private forever—itself an inefficient outcome—or control a high percentage of the equity, making it more difficult for the controller to diversify. *See* Ashton, *supra* note 19 at 925-27.

costs.[139] Along those lines, this Article posits that there may be an optimal proportion of nonvoting and voting outside equity that likewise minimizes agency costs and improves corporate efficiency. That is because at most corporations, some fraction of shareholders are weakly motivated voters, or shareholders who suffer from collective action problems that make it irrational for them to become informed about the company or incur costs associated with voting and stewardship. When these weakly motivated shareholders do vote, their lack of information coupled with conflicts of interests make it unlikely that their input will be welfare enhancing.

The quintessential weakly motivated voter is the retail shareholder, who is likely to refrain from participating in governance because the benefits of doing so are unlikely to exceed the costs.[140] But retail shareholders make up a small fraction of the shareholder base of the modern corporation. As discussed, the majority of shares of large U.S. corporations are held by institutional investors—pension funds, mutual funds, private equity funds, and hedge funds.[141] These investors tend to have large, concentrated stakes in their portfolio companies, which somewhat reduces their incentive to free ride.[142] That is not to say that their incentives are perfect,[143] but many institutional investors have the resources and sophistication to exercise their vote intelligently, as well as a financial incentive to invest in monitoring and stewardship. For this reason, this Article refers to these institutional investors as "informed voters."[144]

There are important exceptions. Most importantly, a large (and growing) subset of institutional investors will often qualify as weakly motivated voters—passive funds.[145] Passive funds lack the

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[139] Jensen & Meckling, *supra* note 131 at 344-46. Jensen and Meckling emphasize the role of debt in facilitating greater insider ownership of firm equity. With greater ownership, insiders care more about the firm's performance. But there are agency costs when debt increases arising out of the insiders' heightened incentives to reallocate wealth from the bondholders to themselves by increasing the value of the equity claim through excessive risk taking. *Id.* at 334. Thus, there will be an optimal ratio of outside debt and equity for any level of internal equity that minimizes these agency costs. *Id.* at 344-46.

[140] *See, e.g.*, Adolf A. Berle, Jr. & Gardiner C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY 76-82; 129-31 (1932).

[141] Ronald J. Gilson and Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 875 (2013).

[142] *See* Lund, *supra* note 35 at 107-113; Bernard Black, *Shareholder Passivity Reexamined*, 89 MICHIGAN L. REV. 520, 575-91 (1990).

[143] Large mutual funds suffer from a new collective action problem as a result of the structure of the industry—because funds compete on the basis of relative performance, it diminishes their incentives to invest in improving the performance of any one firm. *See* Gilson & Gordon, *Agency Costs*, *supra* note 141 at 889-91 (discussing the collective action problem facing institutional investors). Activist hedge funds face a different incentive problem by virtue of their short investment horizon. Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 458–59 (2014) (contending that empowering investors with short-term investment horizons, such as activist hedge funds, will compromise long-term company value). Finally, pension funds, whose board members are appointed by politicians or elected, are particularly sensitive to political pressure. Rock, *supra* note 117 at 367.

[144] *See also*, Zohar Goshen and Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 723, 726 (2006) (referring to "information traders," or investors who are "willing and able to devote resources to gathering and analyzing information as a basis for its investment decisions" and "then trade to capture the value of their informational advantage.").

[145] The term "passive funds" includes index funds and ETFs, which are designed to automatically track a market index. In addition, some actively managed mutual funds may qualify as "quasi-indexers," or funds with highly diversified holdings and low portfolio turnover. *See* German Gutierrez & Thomas Philippon, *Investment-less Growth: An Empirical Investigation* 3, NBER Working Paper No. 22897 (Dec. 2017), available at: http://www.nber.org/papers/w22897. In other words,

financial incentive to invest in voting in an informed way because their indexing strategy requires that they match the performance of an index.[146] For that reason, passive funds the financial incentive to ensure that each of the companies in their very large portfolios are well run. Indeed, informed voting would almost certainly harm the passive fund's relative performance—any expenditure incurred to improve governance at one of the fund's portfolio companies will benefit all rival funds. Funds tracking the same index will benefit equally from the intervention, except they will not have to bear the costs. Active funds will likewise benefit so long as they hold stock in the company; indeed, they could reap even greater benefits by overweighting the company's stock.[149]

Not only that, informed voting is especially costly for a passive fund. A passive fund's key comparative advantage is that it does not need to hire a team of analysts or incur the costs associated with company-specific research—this is why the fund can charge such low fees.[150] But casting an informed vote would require the fund to expend additional resources to learn about the company and evaluate the proposal. And because passive funds have very large portfolios, much larger than active funds, the cost of casting an intelligent vote at each company would have to be replicated across hundreds of companies.[151] Such expenditures would eat away at the cost savings generated by the indexing strategy and would drive fee-sensitive investors to rival funds.

Therefore, like retail shareholders that suffer from collective action problems, passive funds are likely to qualify as weakly motivated voters. For both groups, their rational strategy is to remain uninformed about the company and free ride off other investors. It may be possible, therefore, for a company to improve its competitiveness and lower its cost of capital by issuing nonvoting shares for the weakly motivated voters to buy. The next sections explain why doing so would reduce management agency costs, transaction costs, and the risk of suboptimal outcomes for the company.

1. Agency Costs

This sub-part demonstrates how a company can reduce agency costs by issuing nonvoting stock for weakly motivated voters to buy. The key insight is that by channeling weakly motivated voters to the nonvoting stock, the company has amplified the voice of its informed investors and under certain circumstances, made management more accountable to them.

To see why, consider the following stylized example. Company A is a dual-class company, and sixty percent of Company A's stock is voting. The other forty percent is nonvoting. The insiders at

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although they bill themselves as actively managed, quasi-indexers essentially follow an indexing strategy and thus, are unlikely to value their vote very highly.

146 *See* Lund, *supra* note 35 at 506.

149 For further elaboration, see Lund supra note 35 at 511-512. For a contrary view about passive fund incentives, see Jill Fisch, Assaf Hamdani, Steven Davidoff Solomon, Passive Investors, U of Penn, Inst. For Law & Econ Research paper No. 18-12 (June 29, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3192069.

150 *Id.*

151 For example, a typical S&P 500 tracker fund will have investments in 500 companies. Actively managed mutual funds are much smaller. *See* David M. Smith and Hany Shawky, *Optimal Number of Stock Holdings in Mutual Fund Portfolios Based on Market Performance*, 40 FIN. REV. 481, 486-87 tbl.2 (showing that in 2000, the mean number of companies in a mutual fund portfolio was 92).

Company A hold one third of the voting stock.[152] The informed outside investors hold the remainder of the voting stock, and the weakly motivated voters hold all of the nonvoting stock. In other words, Company A's weakly motivated shareholders hold 40% of the stock—all of it nonvoting. The voting shares are unevenly split between the insiders and the informed shareholders. The insiders have 20% of the stock—a third of the voting shares, while the informed shareholders hold the remaining 40%, or two-thirds of the voting shares.

Compare Company A to Company B, a company that is identical in all respects except that has only a single class of voting stock (so the insiders hold 20% of the shares, the weakly motivated shareholders hold 40%, and the informed shareholders hold the rest). Company A's equity will be more valuable than Company B's for a few reasons. For one, Company A has reduced its agency costs by issuing nonvoting stock because doing so has made the informed investors' votes more powerful. In other words, management at Company A knows that if it fails to act in the best interests of the informed shareholders, it will face discipline in the form of shareholder proposals, no votes on executive compensation, no votes in director elections, and even proxy contests. This provides a powerful incentive for management to act in the shareholders' interests. Moreover, issuing nonvoting stock will make Company A more desirable to informed investors *ex ante*, further reducing agency costs: Informed investors that are willing to spend on monitoring and discipline will gravitate to companies that reduce the transaction costs associated with doing so.

By contrast, at Company B, management knows that if it underperforms, it has a layer of security in the form of the weakly motivated voters. For example, if threatened with a proxy contest, management need only convince thirty-one percent of the outside shareholders—informed and weakly motivated alike—that the company's current rocky situation is part of the long-term plan in order to prevail.[153] Luckily for Company B management, weakly motivated voters are much more likely to defer to management, if they participate at all.[154] Knowing this, management may be less willing to change its behavior to satisfy informed investors that are unhappy with the direction of the company.

Likewise, informed investors may be deterred from investing or intervening at Company B, even if the company would benefit from shareholder monitoring, because of the costs associated with

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[152] Note that in this example, the company insiders keep a minority of the voting stock, and use the nonvoting stock to sort between informed and weakly motivated voters. This is very different than the allocation of voting power in typical dual class companies, which issue nonvoting or low-voting stock to keep voting control with insiders. But even if the insiders were to keep control in this example, efficiency benefits would remain. Most importantly, the informed, motivated shareholders would be able to speak out against management and send strong signals of their displeasure without dilution from rationally apathetic shareholders.

[153] Indeed, companies have shown an increased willingness to lobby their largest shareholders as a defense to activism. *Cf.* Sonali Basak & Beth Jinks, *It's Getting Harder to Keep the Barbarians at the Gate—and It's This Guy's Job*, BLOOMBERG MARKETS (Feb. 1, 2017). Note that this analysis assumes that the company employs a majority-of-the-shares voting standard for director elections, as many do. *See* Stephen Choi, Jill E, Fisch, Marcel Kahan, & Edward B. Rock, *Does Majority Voting Improve Board Accountability?*, 83 U. OF CHI. L. REV. 1119, 1121 (2016).

[154] *See* Ryan Bubb & Emiliano Catan, *The Party Structure of Mutual Funds* at 3, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3124039; Choonsik Lee & Matthew Souther, *Managerial Reliance on the Retail Shareholder Vote: Evidence from Proxy Delivery Methods* 2, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2970650.

an intervention.[155] Were informed investors to bring a proxy contest at Company B, to take an extreme example, they would have to lobby and rely on uninformed voters, an expensive and risky endeavor. We can see this phenomenon being borne out more and more often. As one example, Nelson Peltz's 2017 proxy campaign against Proctor & Gamble cost his hedge fund, Trian Partners, $30 million.[156] Most of these costs were incurred in attempts to sway retail investors and passive institutions using websites, social media, television appearances, video recordings, automated messages, and marketing pamphlets.[157]

The proxy contest was also costly for Proctor & Gamble—the company's successful attempt to overcome the rational apathy of its weakly motivated investors cost it $100 million.[158] Nonvoting shares, however, can help companies avoid these costs: when Company A performs badly, management will be able to interface with a small group of informed investors who are already aware of the company's problems and will be interested in finding a solution—a much less expensive task.[159] In addition, because management will more easily be able to take the temperature of its voting investors, it will be more likely to reach an agreement with informed investors, obviating the need for those shareholders to wage expensive and disruptive proxy contests.[160]

This is not to say that informed investors will always agree about what constitutes the right course of action for the company. The informed investors may have different investment strategies or goals that cause them to disagree.[161] Indeed, it may be that a vocal minority of informed investors will agitate for a course of action to benefit its own interests. The prototypical example is that of the

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155 A recent study reveals that the presence of "activism-friendly" investors increases the likelihood that a firm will be targeted by activists. Simi Kedia et al., *Institutional Investors and Hedge Fund Activism* 7, 39 (Sept. 2017) (unpublished manuscript), https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=AFA2018&paper_id=342.

156 Hamlin Lovell*, Shareholder Activism Knows No Bounds*, SRZ THE HEDGE FUND JOURNAL (Nov.-Dec. 2017), available at: https://www.srz.com/images/content/1/5/v2/154113/The-Hedge-Fund-Journal-Shareholder-Activism-Knows-No-Bounds-Dece.pdf. For additional examples, see Ronald Orol, Retail Campaigning: Why Mom and Pop Make a Difference in Proxy Fights, (Mar. 16, 2015, 2:59 PM EDT) https://www.thestreet.com/story/13080221/1/retail-campaigning-why-mom-and-pop-make-a-difference-in-proxy-fights.html.

157 Hamlin Lovell*, Shareholder Activism Knows No Bounds*, SRZ THE HEDGE FUND JOURNAL (Dec. 2017), available at: https://www.srz.com/images/content/1/5/v2/154113/The-Hedge-Fund-Journal-Shareholder-Activism-Knows-No-Bounds-Dece.pdf. For another example, take the battle between Elliot Management and Arconic, a steel company, in which the activist hedge fund sought to install four directors at the company's annual meeting. The activist investor not only made its case to investors in presentations and meetings, it mailed thousands of mini-player devices to retail investors each with one short four-minute video explaining the activist's position at a targeted company. Ronald Orol, *Paul Singer Pulls Out All the Stops in Battle for Arconic*, THESTREET (May 12, 2017), available at: https://www.thestreet.com/story/14131164/1/paul-singer-s-activist-fund-is-sending-video-players-to-thousands-of-arconic-shareholders.html. Management, too, solicited the retail shareholders, as well as the institutional investors, for months as the activist campaign waged on. *Id.*

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

159 *See* M. Todd Henderson and Dorothy Shapiro Lund, *Index Funds Are Great for Investors, Risky for Corporate Governance*, WALL ST. J. (June 22, 2017, 6:30 PM ET), available at: https://www.wsj.com/articles/index-funds-are-great-for-investors-risky-for-corporate-governance-1498170623.

160 *See* Joseph A. McCahery, Zacharias Sautner, & Laura T. Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, J. FIN. 8 (2016), *available at*: http://onlinelibrary.wiley.com/doi/10.1111/jofi.12393/ful (providing evidence that investors only resort to the proxy machinery when informal engagement fails).

161 *See* Iman Anabtawi and Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1283 (2008).

hedge fund activist. And critics will likely contend that Company B will have higher transaction costs because empowering activist hedge funds will induce them to wage proxy contests and otherwise distract management from pursuing a course of action that benefits shareholders with longer time horizons. But just as issuing nonvoting shares amplifies the voting power of activist investors, it also empowers other informed investors, including actively managed mutual funds and pension funds. And the activist investors will have to convince informed investors that their course of action is warranted in order to prevail in a proxy contest.

Put simply, Company A management need only be responsive to the needs of the *majority* of the informed shareholders. And the majority of the informed shareholders is more likely to push the company in the right direction when it can be heard clearly than when it is drowned out by the voices of weakly motivated voters. Although there is some risk that empowering hedge fund activists will lead to short-term behavior, there are also reasons to believe that diluting the influence of weakly motivated voters will have the opposite effect. Because Company A management will have a better understanding of the wishes and preferences of their informed, engaged investors, they will be less likely to settle with an activist out of a misplaced fear that it could catalyze the voting power of a majority of shareholders. By contrast, Company B management may settle with activist investors who threaten proxy contests to avoid the expenses and risk that accompanies them.[162]

The market for corporate control should also function more efficiently in the case of Company A. In the first place, it is difficult and costly to acquire a large voting block from disparate retail shareholders. In addition, passive funds often refuse to tender their shares to hostile acquirers, even if they believe the deal is beneficial, because the gap between the offering price and closing price would interfere with the fund's ability to track the index.[163] Therefore, the greater the number of nonvoting shares in the hands of weakly motivated voters, the easier it will be to accomplish a takeover, which further reduces agency costs.[164]

In sum, a company that issues nonvoting shares reduces agency costs in a variety of ways. By issuing nonvoting shares, management bonds itself to its informed investors by making management more susceptible to shareholder influence. This increases management's incentives to look out for shareholder interests *ex ante*. Quieting uninformed shareholders likewise reduces the risk of expensive proxy contests and misguided settlements with activist investors by making it easier for management to understand the needs and wants of its informed and engaged shareholder base.

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162 *See* Ian R. Appel et al., *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism* 2, 114 (Nat'l Bureau of Econ. Research, Working Paper No. 22707, 2016), http://www.nber.org/papers/w22707 (finding that companies with a higher percentage of passive shareholders had a greater increase in settlements with activists); John C. Coffee, The Agency Costs of Activism: Information Leakage, Thwarted Majorities, and the Public Morality, (European Corporate Governance Institute, Working Paper No. 373/2017, 2017) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3058319 (describing how most negotiations with activists are settled).

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

164 *Cf.* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965) (positing that shareholder participation in governance is not necessary to ensure firm efficiency so long as a robust market for corporate control exists).

1. Transaction Costs

This second sub-part demonstrates how a company that channels weakly motivated shareholders to nonvoting stock will have reduced transaction costs for itself and for its shareholders. Again, it compares the transaction costs incurred by a company with a single class of shares with those incurred by a company that has channeled its weakly motivated shareholders to nonvoting stock.

A company that issues only voting shares must incur costs associated with managing a larger number of voting investors, including preparing and mailing voting materials[165] and tallying votes, which is itself a costly and complicated process.[166] And the company must incur these costs for all investors despite the fact that most weakly motivated investors would prefer not to be involved in governance at all.

Weakly motivated voters, too, may incur costs associated with voting when they buy voting shares. Some rationally apathetic retail investors may feel compelled to vote when lobbied by management or other investors, and may therefore spend time and money evaluating proposals and casting votes (they may also choose to vote without becoming informed, which leads to different problems described in the next sub-section). In addition, passive institutional investors almost always vote in shareholder elections, perhaps out of a mistaken view of their fiduciary obligations, even though most voting does not benefit fund investors.[167] Most of the institutions that favor passive management strategies have established corporate governance groups charged with casting votes for their rationally apathetic passive fund managers.[168] These governance groups must research issues and cast votes at thousands of companies, which imposes a large financial burden on the institution and its investors.

In sum, when weakly motivated investors buy voting shares, they pay for a right that they would prefer not to exercise. They should therefore prefer to buy Company A's nonvoting shares; not only will the company have lower agency and transaction costs, but the structure allows investors to free ride without any obligation to incur costs associated with voting.

2. Investor Agency Costs

This third sub-part demonstrates that a company that channels weakly motivated shareholders to nonvoting stock will have reduced the risk of sub-optimal voting outcomes at the company.

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165 The cost of mailing the proxy statement alone is not insignificant—in 2011, Broadridge estimated that it cost 12,000 companies $425 million to simply mail the proxies to shareholders. Maxwell Murphy, *Mailing Proxy Statements Costs Companies Big Bucks*, WALL ST. J, (Feb. 21, 2012 6:52 PM ET), available at: https://blogs.wsj.com/cfo/2012/02/21/mailing-proxy-statements-costs-companies-big-bucks/.

166 For a discussion of the complexity of the current shareholder voting system, *see* Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 Geo. L.J. 1227, 1249-70 (2008).

167 SEC regulations dictate that fund managers have a fiduciary duty to vote when doing so is in the best interests of their investors, and this mandate has been widely interpreted as requiring mutual funds to vote. *See* Lund, *supra* note 35, at 534.

168 See Lund, supra note 35, at 515-16.

As discussed, weakly motivated voters have three choices: they can choose to not exercise their vote, they can vote blindly, or they can invest in gathering the information necessary to cast an informed vote. And because weakly motivated voters suffer from collective action problems by definition, we should suspect that they pursue the second approach when they are required to vote.[169] Issuing nonvoting shares for weakly motivated investors to buy therefore reduces the risk of suboptimal voting outcomes. This is another reason why shareholders should prefer Company A equity to that of Company B: Company B faces the risk that the uninformed voters will move the company in the wrong direction.

This risk is all the more likely in a world where passive funds are major blockholders in public companies. As discussed, passive funds almost always vote in shareholder elections, and yet, their influence is unlikely to move the company in the right direction for two reasons. First, because weakly motivated passive funds lack firm-specific information and governance expertise, as well as an incentive to devote appropriate resources to governance, they are especially likely to follow preset, one-size-fits-all voting guidelines on governance questions.[170] But there is no consensus about universal governance best practices: decades of scholarship has concluded that good governance is endogenous to the particular firm and the firm's particular circumstances.[171] As such, a one-size-fits-all approach to governance imposed across vastly different firms is likely to make many firms worse off.[172]

Moreover, weakly motivated passive funds have strong conflicts of interest.[173] Passive fund managers, like other mutual fund managers, have their compensation tied to the amount of assets that flow into the fund, rather than the fund's performance.[174] And although actively managed mutual funds can attract investors based on past performance (and thus, future expectations of performance), passive fund managers have only two ways to compete: on the basis of fees or strong relationships with clients. And because corporate pension fund assets are one of the largest pools of capital invested

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169 Legally, no mutual fund is required to cast a vote, but in practice, mutual funds view their voting obligations as essentially mandatory. *See* Lund, supra note 35, at 534.

170 The three largest passive fund providers—Vanguard, BlackRock, and State Street—have very similar voting guidelines that they follow closely. Each institution articulates a preference for director independence, a relationship between long-term company performance and executive compensation, and a skepticism about anti-takeover provisions and major changes to the corporation, such as mergers, reorganizations, or changes to capital structure. *See* State Street Global Advisors, *Global Proxy Voting and Engagement Principles* at 4 (March 2016), *available at*: https://www.ssga.com/investment-topics/environmental-social-governance/2016/Global-Proxy-Voting-and-Engagement-Principles-20160301.pdf; BlackRock, Global Corporate Governance and Engagement Principles, 5-7 (2014), https://www.sec.gov/Archives/edgar/data/890393/000119312515334865/d25691dex99corpgov.htm; Vanguard, Vanguard's Four Pillars of Corporate Governance, https://about.vanguard.com/vanguard-proxy-voting/. These institutions also rely on ISS and Glass Lewis for certain issues, and those also follow one-size-fits-all voting policies. *See* Charles M. Nathan, Proxy Advisory Business: Apotheosis or Apogee?, Harv. L. Sch. F. Corp. Gov. & Fin. Reg. (Mar. 23, 2011), https://corpgov.law.harvard.edu/2011/03/23/proxy-advisory-business-apotheosis-or-apogee/. As a result, the three entities are able to achieve high consistency in voting. For example, at Vanguard in 2015, only 6 out of 100,000 proposals featured a fund voting differently than its other funds. Fichtner et al., *supra* note119, at 316-17.

171 See Lund, supra note 35, at 518.

172As just one example, a recent study found that the average risk-adjusted return for companies that followed proxy advisor recommendations when adjusting compensation was 0.44% lower than firms whose changes to compensation were unrelated to proxy advisor recommendations. *See* David F. Larcker et al., Outsourcing Shareholder Voting to Proxy Advisory Firms, 58 J. L. & ECON. 173, 173–204 (2015).

173 Sean Griffith & Dorothy Lund, Interested Institutions (Working Paper).

174 *See* WILLIAM A. BIRDTHISTLE, EMPIRE OF THE FUND: THE WAY WE SAVE NOW 52 (Oxford U.Press 2016).

in passive funds, a passive fund manager may be especially inclined to support management so as to preserve the fund's access to the company's 401(k) accounts.[175]

For these reasons, passive fund voting may lead to sub-optimal outcomes for companies. Consider the following example: suppose that a shareholder at Company B has proposed to separate the position of Chairman from CEO.[176] Recall that Company B has a single class of stock, with 20% is held by insiders and the rest split evenly between the weakly motivated and informed shareholders. The insiders vociferously oppose the proposal, arguing that splitting the position will make it harder for the board to understand business operations, which are highly technical. Sixty percent of the informed investors also disagree with the proposal for the same reasons (the others, for idiosyncratic reasons, support the proposal[177]). Eighty-six percent of the weakly motivated voters support the proposal because it aligns with their internal governance guidelines, which identify good governance standards to be applied across all portfolio companies. The other weakly motivated voters follow advice from their active fund counterparts and vote against the proposal or simply abstain. In this example, the proposal will narrowly pass, even though the clear majority of informed investors disagree with it.[178]

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These examples demonstrate why all investors should prefer Company A to Company B. In the first place, informed investors will understand that the Company A managers are more likely to be attuned to their interests, which will reduce monitoring costs and costs of intervention when problems emerge. Likewise, weakly motivated voters will more highly value an investment that does not require them to incur costs in becoming informed, evaluating proposals from other shareholders, and casting a vote.[179] And both informed and uninformed shareholders will benefit from a reduced risk of

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175 *See, e.g.*, Simon C. Y. Wong, *How Conflicts of Interest Thwart Institutional Investor Stewardship*, 8 BUTTERWORTHS J. INTERNATIONAL BANKING & FIN. L. 481 (Sept. 2011), available at: http://ssrn.com/abstract=1925485.

176 Whether to separate the CEO and chairman positions is a hotly contested issue in corporate governance. In recent years, the trend has consistently moved toward separation in spite of the fact that the literature does not consider it to be unambiguously positive. David F. Larcker & Brian Tayan, *Chairman and CEO: The Controversy Over Board Leadership Structure,* Stanford Closer Look Series (June 24, 2016), at 1, available at: https://ssrn.com/abstract=2800244. In fact, there is little research that separating the two positions improves firm performance or governance quality, and a recent study has found that forced separation due to shareholder pressure is associated with a decrease in market valuation and lower future operating performance. *See* Aiyesha Dey, Ellen Engel, & Xiaohui Liu, *CEO And Board Chair Roles: To Split or Not to Split?*, 17 J. CORP. FIN. 1595 (2011).

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

178 Although this is a simplified example for explanatory purposes, this is not an uncommon occurrence. In light of the growing market share of passive institutional investors and their largely uniform preferences regarding governance, passive funds begun already influenced voting outcomes. A recent empirical study has shown that an increase in passive fund ownership is correlated with the successful implementation of controversial shareholder governance proposals, including proposals that remove poison pills and other takeover defenses, and eliminate dual class structures. Gormley et al., *Passive Investors*, *supra* n. 121 at 4-5. In addition, passive institutional investors are usually viewed as the tie breakers for close proxy contests and regularly support management even when the majority of active investors support the dissident slate. *See, e.g.*, Henderson & Lund, *Index Funds Are Great For Investors, Risky for Corporate Governance*, *supra* note 159.

179 The "empty voting" literature reveals that derivative products have the potential to enable shareholders to efficiently decouple voting rights from economic interest, which could generate similar governance benefits. *See* Black & Hu, *supra* note **Error! Bookmark not defined.** at 823, 852; Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty*

bad voting outcomes that occur when uninformed shareholders weigh in. For these reasons, a company that provides nonvoting stock for weakly motivated voters to purchase will make all shareholders better off.

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

Consider also the example of a limited partnership, which includes a general partner, as well as limited partners.[180] The general partner is tasked with managing the company's day-to-day affairs; the limited partners provides equity but are uninvolved in company operations.[181] For this reason, the partners often agree to restrict the limited partners' voting privileges to specific issues, such as amendments to the partnership agreement.[182] The parties may also depart from proportional voting to allocate fewer voting rights to the limited partners.[183] In other words, the parties designing the limited partnership's structure often depart from a proportional voting system to put control in the hands of people with expertise and better information.[184]

Voting II: Importance and Extensions, 156 U. PENN. L. REV. 625, 642 (2008). And there is evidence that passively managed funds broadly lend out their shares, which suggests that they do trade voting power for a fee. *See* Simon Moore, *How Securities Lending Makes Some ETFs Free*, FORBES (Aug. 29, 2014), at https://www.forbes.com/sites/simonmoore/2014/08/29/securities-lending-makes-some-etfs-free/#451d39483d6f; Susan E.K. Christofferson, Christopher C. Geczy, David K. Musto, & Adam V. Reed, *Vote Trading and Information Aggregation*, 62 J. OF FIN. 2897, 2901 (2007). But the problem with the decoupling solution is that there is no way for companies or investors to know whether it will be used to improve corporate governance. Indeed, derivative products have instead been used by hedge funds to neutralize their economic interest in a company and then use their voting power to benefit other investments. *See* Black and Hu, *supra* note **Error! Bookmark not defined.** at 852. By contrast, using nonvoting shares to improve governance avoids this risk: companies that offer nonvoting stock will continue to be controlled by shareholders with a financial interest in the company. Moreover, the dual class structure will be apparent to investors *ex ante*, who can therefore account for structure when purchasing shares. Equity decoupling, by contrast, presents a hidden risk for investors. Although this paper assumes for the sake of simplicity that equity decoupling is not possible, it is worth noting that the continued availability of nonvoting shares could ameliorate problems associated with empty voting: Weakly motivated voters are the most likely to part with their votes. If weakly motivated voters purchase nonvoting stock, they can continue to lend their shares, but there will be less of a risk that their voting power will be used in ways that could harm the company.

180 Some limited partnerships, such as the master limited partnership, are publicly traded. In a master limited partnership, the limited partners have no voting rights at all. The general partner runs the firm, which produces a return on the limited partners' investment. *See* Paul Hastings, Master Limited Partnership Overview (August 2013), https://www.paulhastings.com/docs/default-source/PDFs/mlp-primer.pdf.

181 *See generally*, Limited Partner, Investopedia, https://www.investopedia.com/terms/l/limited-partner.asp.

182 *See* Rod Howell, Voting Rights in a Limited Partnership, Chron, https://smallbusiness.chron.com/voting-rights-limited-partnership-61097.html.

183 *Id.*

184 Note that the analysis in this paper does not extend beyond shareholder democracy to civic democracy. First and most importantly, shareholder democracy is not really a democracy at all—votes are allocated on a per-share basis, meaning that the larger the investment, the larger the investor's voting power. That is because voting is a means to an end—efficient corporate governance. By contrast, there are important sociological justifications for voting in civic elections that are not present in the corporate context. Citizen voting is thought to further self-actualization and educate the public about

Likewise, vote buying markets provide a mechanism for votes to transfer from weakly motivated to informed public company shareholders. Although Delaware courts tend to view strict vote buying arrangements with suspicion,[185] derivatives and other equity markets could enable informed voters to accumulate voting power under the right circumstances.[186] And there is some evidence that securities lending markets result in the sorting of votes along these lines,[187] in spite of the fact that the institutional investors that lend shares are supposed to get the proxies back before a material voting event.[188] But voting markets may create more problems than efficiencies for shareholders. Most importantly, the vote buyer is able to accumulate voting power even when she has a negative financial interest in the company, which may result in those votes being cast in a way that does not maximize shareholder value.[189] The issuance of nonvoting stock largely avoids this problem: the holder of voting stock may have larger voting power relative to their financial stake, but they must maintain some economic stake in the company. Therefore, the issuance of nonvoting stock better aligns the incentives of the voting shareholders with those of the nonvoting shareholders and avoids the "empty voting" problem.

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

B. Nonvoting Shares: Demand-Side Issues

Companies seeking to reduce agency costs and transaction costs associated with voting need only take one step: offer two classes of stock, one nonvoting and one voting, to the public. When this happens, market forces should drive beneficial sorting because nonvoting shares generally trade at a discount, generally observed to be around 3-5%, to voting shares.[190] They are otherwise identical

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important issues, among other things. Second, democratic control is more important for a civic democracy, in which legislators have substantial power over the lives of citizens, than it is for a corporate democracy. Finally, shareholders have other accountability mechanisms available to them: they can exit, sue, or rely on external and internal employment markets, capital markets, and the market for corporate control to discipline management. Citizens, by contrast, generally lack the ability to exit when displeased with government, as well as the other accountability mechanisms listed above.

185 *Cf. Commonwealth Assocs. v. Providence Health Care, Inc.*, 641 A.2d 155, 158 (Del. Ch. 1993); Schreiber v. Carney , 447 A.2d 17, 23 (Del. Ch. 1982).

186 *See* Hu & Black, supra note **Error! Bookmark not defined.** at 823.

187 *See generally* Susan E.K. Christofferson et al., supra note 179.

188 *See* SEC, Securities Lending by Open-End and Closed-End Investment Companies (last modified Feb. 27, 2014), https://www.sec.gov/divisions/investment/securities-lending-open-closed-end-investment-companies.htm; *see also* Reena Agarwal et al., Does Proxy Voting Affect the Supply and/or Demand for Securities Lending? At 1, Working Paper, http://leeds-faculty.colorado.edu/bhagat/ProxyVoting-SecuritiesLending.pdf (finding evidence of a significant reduction in the supply of shares available to lend at the time of a proxy vote because institutions restrict and/or call back their loaned shares prior to a vote).

189 See Hu & Black, supra note **Error! Bookmark not defined.**, at 823.

190 *See* Aaron Stumpf & Andrew Cline, Price Differentials Between Voting and Nonvoting Stock, Stout, available at: https://www.stoutadvisory.com/insights/article/price-differentials-between-voting-and-nonvoting-stock. The presence of a voting premium is somewhat surprising. Most often, nonvoting shares are treated exactly the same as voting shares for cash flow purposes. They receive the same dividends, the same rights in repurchase, and the same treatment in any reorganization. And yet, investors pay a premium for voting stock for two reasons. First, in the event that the company

investments, with the same rights to dividends and cash flows. This makes them especially appealing investments for weakly motivated voters, who by definition, do not value their vote very much (if at all).[191]

In other words, companies like Zillow, Google, and Under Armour—all companies that offer investors the choice between nonvoting and high-voting shares—may increase the value of their companies by virtue of their dual-class structure, and not just for the reasons that those companies typically espouse. As discussed, if the weakly motivated voters buy the company's nonvoting stock, and the informed voters buy voting stock, the company will have made its governance more efficient.[192] And the weakly motivated voters have two additional reasons to gravitate toward the nonvoting stock: it is cheaper and allows them to reduce or eliminate costs associated with voting.

In theory, therefore, weakly motivated voters should always favor nonvoting shares. But reality, of course, is more complicated. Take Google as an example. Recall that Google split its stock in 2014, creating nonvoting shares (Class C).[193] The Class A voting shares have consistently traded at a premium (ranging from 1 to 5%) to the C shares in spite of an equal treatment clause providing that in the event of a change of control, the Class C shares will be eligible for the same rights and privileges as the A shares.[194] And despite this non-negligible voting premium, the three institutional investors that primarily invest in passive investment vehicles—BlackRock, Vanguard, and State Street—hold nearly identical amounts of voting and nonvoting stock.[195] Why are these institutional investors that primarily invest in passive investment vehicles not gravitating to nonvoting stock?

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becomes a takeover target, the value of the vote will become more valuable. Second, if a firm is underperforming, the vote will rise in value because the right to influence management will be perceived as being more valuable. For example, the market may perceive that the voting shareholders have a greater ability to use their voting power to advocate for their interests. For these reasons, the voting premium is rarely static; it varies based on the market's view of the quality of management and other circumstances facing the firm.

191 Some dual class companies that offer low-voting stock instead of nonvoting stock may also reduce agency costs associated with voting, although the smaller premium may reduce the incidence of beneficial sorting. *See* Warren Buffet, Memo: Comparative Rights and Relative prices of Berkshire Class A and Class B Stock (last updated Jan. 20, 2010), available at: http://www.berkshirehathaway.com/compab.pdf (positing that the low-voting stock would be a better value only at discounts above 1% to the voting stock).

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

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

194 Jesse Emspak, GOOG or GOOL: Which Stock Do You Buy?, Investopedia (June 28, 2018), https://www.investopedia.com/articles/markets/052215/goog-or-googl-which-google-should-you-buy.asp; Steven Davidoff Solomon, *Google's Stock Settlement May Not Do Much for Shareholders*, N.Y. TIMES (Sept. 11, 2013), available at: https://dealbook.nytimes.com/2013/09/11/googles-stock-settlement-may-not-do-much-for-shareholders/?_r=0 (discussing the terms of the settlement).

195 Holders of Alphabet Inc. (GOOGL), Yahoo Finance, available at: https://finance.yahoo.com/quote/GOOGL/holders?p=GOOGL (showing that Vanguard held 21.2 million shares as of December 30, 2017); Holders of Alphabet Inc. (GOOG), Yahoo Finance, available at: https://finance.yahoo.com/quote/GOOG/holders?p=GOOG (showing that Vanguard holds 21.4 million shares as of December 30, 2017). Retail shareholders, however, make up a much smaller percentage of the owners of the voting shares: Google A has about 11 percent of its shares held by retail investors, versus 18 percent of Google C. *Id.* And this is likely because

One answer that the CII—which represents Vanguard, Blackrock, and State Street—emphasizes is that so long as nonvoting stocks are included on an index, passive funds will be forced to buy them.[196] That may explain why a company like Vanguard owns the same number of Google A and Google C shares—if both are weighted equally on the index, as they are on the S&P 500,[197] the S&P 500 tracker funds will be forced to buy both share classes in equal quantities. In the case of Vanguard, therefore, we have imperfect sorting. But imperfect sorting is better than none at all. If a weakly motivated passive fund has 50% less voting power, the voice of other informed investors will be somewhat stronger, and accordingly, agency costs, as well as the risk of suboptimal outcomes, will be somewhat lower. Not only that, the passive funds will benefit from purchasing the discounted stock, which increases the fund's returns.[198] Therefore, passive funds that buy nonvoting shares should have better relative performance than those that do not and they should welcome the issuance of nonvoting stock. Why then are passive funds among the investors lobbying stock indices to exclude companies that issue nonvoting stock?

Their opposition is grounded in the same simple argument that has motivated calls to prohibit dual class company structuring for years—dual class structures are tools for entrenchment. And because passive funds are forced to buy stock that is included on a market index, they will not be able to demonstrate their opposition by refusing to purchase nonvoting shares. Not only that, they contend that a market solution—reduced investor demand, and thus, a lower price for dual-class company shares that would discourage future dual-class offerings—is unlikely to manifest and top-down restrictions are necessary.[199] Put simply, the large institutional providers of passive funds are essentially lobbying the indices to save them from themselves.[200]

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retail shareholders understand that nonvoting stock is cheaper and offers the same returns. *See* Bram de Haas, *Google: Why I Prefer the Non-Voting Shares*, SEEKING ALPHA (June 4, 2015, 2:27 PM ET), available at: https://seekingalpha.com/article/3236926-google-why-i-prefer-the-non-voting-shares.

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

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

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

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

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

But is the market solution really out of reach? If a passive fund portfolio manager believed that nonvoting shares were bad for the fund and for the company, she could easily depart from a "full replication" methodology, which requires the fund to buy every company in the index,[201] and instead purchase only voting shares. Because nonvoting shares receive the same dividends, the same rights in repurchase, and the same treatment in a reorganization as voting shares, scrubbing nonvoting shares from the index fund's portfolio would not be a difficult task (that is, so long as both share classes were available to purchase). Indeed, many funds modify their baseline indices to purchase a representative basket of companies, which is much more likely to introduce tracking error than simply substituting voting shares for nonvoting shares of the same company.[202] And funds are increasingly taking steps to modify their indices, not just for ease of management, but also to promote environmental, social, and good governance goals.[203] There is no reason why a passive fund couldn't follow this same approach to purchase nonvoting, rather than voting, stock.

There may be another reason bolstering their opposition to dual class stock: the institution that houses passive funds may benefit from enhanced voting power, even if it does not always benefit passive fund investors. For example, the institution might hold on to voting power to benefit the institution's political interests or appease clients. As an example, CalPERS and other public pensions are vocal proponents of good governance and are bound to consider governance expertise when selecting outside asset managers.[206] For that reason, the institution may believe that voting power will help its funds attract assets from these investors. Retail investors, too, may seek investment vehicles that advertise themselves as being active players in governance; perhaps they would be less likely to invest in funds that admit to being weakly motivated.[207] In addition, voting power can be used to appease another key client: company management, which is an important source of corporate 401(k) assets invested in passive funds.[208]

James Rufus Koren & Paresh Dave, *Snap won't give shareholders voting rights. For that, it's being shunned by a major stock index*, L.A. Times (July 28, 2017), available at: http://www.latimes.com/business/la-fi-snap-russell-indices-20170727-story.html.

201 RBC Global Asset Management, Understanding Index Tracking Methodologies (July, 2017), http://funds.rbcgam.com/pdf/etfs/index-tracking-methodologies.pdf.

202 *See* Investor Bulletin: Index Funds (Aug. 6, 2018), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_index-funds.

203 *See, e.g.*, Rachel Siegel, *BlackRock Unveils Gun-Free Investment Options*, Washington Post (April 2, 2018), available at: https://www.washingtonpost.com/news/business/wp/2018/04/06/blackrock-unveils-gun-free-investment-options/?utm_term=.564f7a5c8a24.

206 *See* CalPERS Global Governance Principles (2015) at 6-7, available at: https://www.calpers.ca.gov/docs/forms-publications/global-principles-corporate-governance.pdf (explaining that improving corporate governance is at the core of the pension's investment strategy).

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

208 In 2015, 401(k) assets under management totaled $4.7 trillion, with 60% held in mutual funds. Sean Collins et al., *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses*, ICI Research Perspective 2 (2016), *available at*: http://www.ici.org/pdf/per22-04.pdf. The desire to keep management happy to secure 401(k) assets is a strong conflict of interest. *See generally* Griffith & Lund, supra note []; Simon C. Y. Wong, *How Conflicts of Interest Thwart Institutional Investor Stewardship*, BUTTERWORTHS J. INT'L BANKING & FIN. L. 481 (Sept. 2011), *available at*: http://ssrn.com/abstract=1925485.

A less cynical perspective is that the passive fund complex wants to hold on to voting power for the benefit of the institution's active fund managers so they will be more effective when they intervene in governance. For evidence that beneficial information sharing occurs across large institutional investors, *see* Michelle Lowry and Peter Iliev, *Are Mutual Funds*

For these reasons, it is unlikely that weakly motivated voters will always purchase nonvoting stock, even when it is discounted. But even imperfect sorting will lower agency and transaction costs. And over time, the prospect of discounted stock and saving on voting expenses should increase the appeal of nonvoting shares to weakly motivated voters. In fact, market forces should eventually push index fund providers to modify their indices to purchase nonvoting, rather than voting stock. Passive funds that purchase nonvoting shares will improve their relative performance; investors, in turn, should gravitate to those passive funds, which would promise stable returns for even lower fees.

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

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

By contrast, when the company is well run and the market is optimistic about management, the voting premium may be small, perhaps as little as one percent.[209] In that case, the informed voters are likely to view the premium as a small price to pay for the ability to exercise control at some future date and purchase the voting stock for its option value. Even if the informed voters do decide to free ride and purchase nonvoting stock during this calm period, they will have the ability and incentive to purchase voting shares at some future point, when problems at the company manifest.

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

C. Nonvoting Shares: Supply-Side Issues

Although weakly motivated voters should have incentives to buy nonvoting shares, the question of whether companies can be counted on to supply them in the right numbers and for the right

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Active Voters?, 28 REV. OF FIN. STUDIES 446, 453-55 (2015). Assuming that passive fund and active fund investors share the same goals, such information sharing across funds is less problematic.

[209] *See* Stout Advisory Services Report, *supra* n. **Error! Bookmark not defined.**.

reasons is more complicated. In theory, so long as market participants are not restricted or deterred from issuing nonvoting equity, market pressure should encourage certain companies to issue nonvoting stock to some, but likely not all, outside investors. In other words, because the company wants to get the highest price for its shares in an IPO or secondary offering, it should issue nonvoting stock not for entrenchment purposes, but rather to amplify the voice of informed investors, which would increase the value of the company's equity.

But there are reasons to believe that management might not always use nonvoting stock in this way. The first reason is technical—it would be difficult for the company to ascertain how much nonvoting stock to issue *ex ante* because that number depends on the composition of the shareholder base, which is always changing.[210]

Second and more importantly, the insiders may issue nonvoting stock for the opposite purpose: to silence outside investors so that the insiders can reap private benefits of control. Indeed, nonvoting shares have generally been used to keep control with insiders, rather than empower informed investors. And even though this arrangement may be efficient, the prospect of entrenchment has motivated much of the backlash against nonvoting shares.

What can we infer from the fact that nonvoting shares have not been used to sort between informed and weakly motivated voters? It is possible that management cannot ever be counted on to use nonvoting shares for this purpose. It may be that the prospect of entrenchment is too alluring, or that the possibility of outside interference too risky, to support the issuance of nonvoting shares. The main casualty of efficient corporate governance is inept management, who will be more vulnerable to scrutiny and displacement.[211] Not only that, fears of investor-driven short-term thinking may deter even high quality management teams from amplifying the voice of the investor base.

Ultimately, however, there are many high quality management teams that would benefit from using nonvoting stock as a bonding mechanism and to signal their quality to outside investors.[212] In addition, struggling management teams could use nonvoting stock to lure smart, engaged investors—the Warren Buffetts of the world—to invest. Other insiders (including the banks, venture capitalists, and other early investors that cash out after a company's IPO) should also demand the issuance of nonvoting stock that would maximize the company's share price. It is therefore puzzling that we have not yet seen nonvoting stock used for this purpose.

It is possible that the market is currently in disequilibrium, and that the potential of nonvoting stock has yet to be unlocked. True, the existence of nonvoting stock is as old as the corporate form itself, but innovation in dual-class structuring is relatively recent.[213] In addition, trends in corporate governance and changes in financial markets have increased the appeal of nonvoting stock only

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[210] The amount of insider stock is continually in flux as well—often, employees are paid in stock options that can be exercised at any time, making it more difficult to ascertain the level of insider ownership.
[211] *See generally* Thomas Keusch, *Hedge Fund Activists and CEO Contracting*, Working Paper (March 6, 2017), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2746135.
[212] See generally Merritt Fox et al., supra note [].
[213] *See* Lindsay Baran et al., Dual Class Structure and Innovation 1, Working Paper, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3183517 ("While only a mere 1% of firms conducting their IPOs in 2005 went public with a dual class equity structure, the proportion of such firms increased to 15% in 2014 and 24% in 2015.").

recently. In the past ten years, shareholder power has grown dramatically.[214] Shareholders now have the ability to directly intervene and weigh in on a variety of corporate issues, from executive compensation to decisions about corporate strategy. At the same time, the shareholder base has become increasingly concentrated in the hands of institutional investors with agency problems of their own, as well as conflicts of interests.[215] To protect against distortions that occur when large, passive institutional investors wield substantial voting power, companies may find the benefits of nonvoting stock to be too great to ignore. That is, so long as companies that seek to issue nonvoting stock do not face legal or market barriers, which would deter further innovation.

III. Implications for Law

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

A. Misguided Policies

As discussed, the recent controversy over dual-class stock has motivated investors and investor advocacy groups to lobby against dual-class structures and the use of nonvoting shares. Their actions have not fallen on deaf ears: both Dow Jones S&P 500 and Russell FTSE will not list companies with nonvoting stock in their U.S. benchmarks.[216] Those indices are the biggest drivers of passive fund demand for U.S. stocks, and so their decisions are likely to substantially deter dual-class IPOs in the United States.[217] Moreover, the stock indices' decision to eschew companies with nonvoting stock will undo much of the beneficial sorting that had already occurred: instead of being channeled toward purchasing nonvoting stock, weakly motivated passive funds will purchase voting shares, as companies like Zillow will be excluded from their baseline indices.

These policy changes ignore the fact that nonvoting stock can play an important role in improving firm efficiency by reducing agency costs and transaction costs associated with voting.[218] And these benefits will only grow as assets continue to flow into passive investment vehicles.[219] And

[214] *See* Paul Edelman et. al., *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. Cal. L. Rev. 1358, 1359-60 (2014).

[215] *See generally* Lund, *supra* n. 35 at 506-520; Bebchuk, Cohen, & Hirst, *supra* n. 118 at 89-91.

[216] *See* notes **Error! Bookmark not defined.**-**Error! Bookmark not defined.** and accompanying text.

[217] *Id.*

[218] Indeed, it is incongruous that the indexes are willing to list companies with other characteristics that could be deemed entrenching, such as poison pills. That may be because the scholarly consensus is that these pills can be welfare enhancing when used correctly. *See generally* Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845-47 (2002). But this paper reveals that nonvoting stock, like poison pills, has a beneficial function in certain cases, and thus, should not be subject to a blanket prohibition.

[219] *See generally* Lund, supra n. 35 at 506 (describing the rapid rise of passive funds and their growing influence over corporate governance).

although very few U.S. companies offer voting and nonvoting stock to the public,[220] it is likely that market pressure would push more and more companies in this direction, as it has already done. By deterring companies from issuing nonvoting stock, however, the indices impede beneficial experimentation in company structuring.[221]

The recent wave of advocacy for mandatory sunset provisions for dual-class companies is similarly wrongheaded.[222] Sunset provisions ensure that dual-class structures sunset after a pre-determined period of time, such as three to five years, unless their extension is approved by shareholders unaffiliated with the controller.[223] These provisions are just one of many tools available to companies that seek to reduce agency costs associated with dual-class structures.[224] Requiring them, however, is a crude solution, as it is unclear *ex ante* when the dual-class structure will become inefficient. In addition, the solution is too extreme because nonvoting shares may provide important efficiency benefits for the company, and therefore, the sunset provision would undo those benefits at an arbitrary point in time. Providing shareholders an opportunity to extend the dual-class structure lessens this concern, but many of the shareholders tasked with approving the extension will be the same weakly motivated voters that warranted the use of nonvoting shares in the first place.[225]

B. Possible Restrictions

Even with a greater understanding of the benefits provided by dual-class structures, it is likely that calls for regulation will continue. And if securities regulators, stock exchanges, or stock indices are compelled to take a stance against nonvoting stock, they should favor a more moderate approach: prohibiting or deterring companies from offering *only* nonvoting stock to the public. In other words, rather than a total prohibition on dual-class company structures, the law (or indices adopting standards for inclusion) could require a company that issues nonvoting stock to also issue a non-negligible

220 Although there are very few companies that issue both high and low voting stock to the public in the U.S., the structure is more common in Europe and in Canada. In fact, a recent trend in Europe is the "loyalty" share, or shares that accumulate voting rights the longer that they are held. For example, in France, shares that are registered for two years automatically receive double voting rights under the Florange Act. *See* David J. Berger, et. al., *Tenure Voting* at 297 & n.4; Michael Stothard, French Companies Fight Back Against Florange Double-Vote Law, Financial Times (April 16, 2015, https://www.ft.com/content/05314dfe-e27d-11e4-ba33-00144feab7de. Italy has also allowed companies to grant two votes for every share held for at least two years. *See* ISS Analysis: Differentiated Voting Rights In Europe, https://www.issgovernance.com/analysis-differentiated-voting-rights-in-europe/.

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

222 *See generally* Bebchuk & Kastiel, *supra* note 23 at 618 (advocating for sunset provisions that would end a company's dual-class structure after a certain point in time).

223 *Id.*

224 Indeed, Google and Facebook both have sunset provisions for the dual class structure that are triggered by certain events. In the case of Google, the classes would combine upon a liquidation of the company. *See* Google Form S-1, https://www.sec.gov/Archives/edgar/data/1288776/000119312504073639/ds1.htm.

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

amount of voting stock to the public.[226] FTSE Russell has adopted a rule of this kind—it requires companies to have at least 5% of their voting rights across all share classes in the hands of outside shareholders to be eligible for inclusion in its indices.[227]

It is possible that offering only nonvoting stock to the public might be the most efficient structure for certain companies at a certain moment in time. If investors were extremely confident in the leadership of the company, perhaps they would pay the highest price for shares that minimized outside shareholder interference and gave the visionary management team room to breathe. It is therefore possible that the Snap IPO was structured optimally at the time of the offering.

But even if it were optimal to issue only nonvoting stock at the time of issuance, it is unlikely to be optimal for an extended period. Over time, the advantages of such a structure likely decrease, especially for dynamic companies in which disruptive innovations and a quick pace of change are expected.[229] The costs of such a structure are also likely to increase over time—insiders are likely to dilute their economic position in the company in order to diversify risk, which will only increase agency cost problems. And even when the company's structure has become patently inefficient, insiders who reap private benefits of control could have an incentive to maintain it.[230] When this happens, the informed investors will lack important mechanisms that could accelerate change, such as the ability to nominate directors and cast votes at annual meetings.[231]

By contrast, when informed investors have voting shares, even when they are in the minority, they will have some ability to influence the direction of the company, including whether to maintain dual-class structure. If the outside investors believe that management is entrenched and insufficiently attuned to shareholder interests, they have several legal tools at their disposal as a result of their voting

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[226] This means that if the company issued only a handful of voting shares, it would qualify as an issuer of nonvoting shares. The right number of voting shares will depend on each company, but ideally, the number would sufficiently substantial that it would give the outside investors leverage over management and potentially a path toward unseating management in the future. *See* Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. L. BUS. R. 61, 90 (2016) (discussing mechanisms available to activist investors who wage successful campaigns at controlled companies, most of which require the power to vote).

[227] FTSE Russell Voting Rights Consultation – Next Steps (July 2017), http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf. Whether 5% is a large enough number remains to be seen; future research should address the question of the optimal amount of voting participation by outside investors in dual class companies.

[229] *See generally* Bebchuk & Kastiel *supra* n. 23 at 590 (explaining how the benefits of dual class structures are likely to recede over time).

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

[231] Holders of nonvoting stock can drum up negative publicity about the company as leverage for its demands. *See generally* John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151, 2175 (2001) (claiming that social norms matter and constrain controlling shareholders). However, without some legal bargaining chip, such as the ability to veto an M&A transaction or nominate a minority director, the insiders are much more likely to ignore the demands of a minority shareholder. *See* Kobi Kastiel, *supra* note 226 at 110 (reviewing activist campaigns waged against controlled companies and finding that only 11% of those campaigns without a bargaining mechanism other than the threat of a reputational penalty were successful). In addition, the likelihood of securing media coverage for an activist campaign is strongly correlated with the decision to wage a proxy battle. *See id.* at 115. Lawsuits against the company, too, are more successful when the minority shareholders can point out that the company ignored its demands that were clearly articulated in a shareholder vote.

rights. Those outside shareholders can submit a shareholder proposal requesting reclassification of the company's stock.[232] They can vote against board nominees or executive compensation at the annual meeting.[233] They can nominate a director candidate to the board and encourage other voting shareholders to support her,[234] or they can threaten to veto M&A transactions initiated by the controlling shareholder.[235] They can even form coalitions with insiders in an attempt to unseat some of the incumbents.

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

If it seems implausible that a company would pay attention to a shareholder without power to threaten management's control, consider this example. In 2016, Forest City Realty Trust Inc. agreed to abandon its dual-class structure that had allocated voting control to a single family for the past hundred years.[236] Forest City reclassified its shares because of pressure from an activist investor, Scopia Capital Management, that had a 7.4% stake in the company.[237] Scopia had no chance of acquiring control—even if the insiders had parted with their stock, the high vote shares would convert to low vote shares upon the transfer—and thus lacked the ability to threaten a proxy contest or engineer a takeover. Nonetheless, Scopia's persistent public campaign, coupled with threats to call for a non-binding vote on the company's equity structure, eventually moved the needle.[238]

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

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

234 Ronald Orol, *Activist Investors Target Snapchat Parent Snap Over Non-voting IPO Shares*, THESTREET (Feb. 8, 2017), available at: https://www.thestreet.com/story/13993165/1/insurgents-rail-against-snap-over-non-voting-ipo-shares.html ("Activist hedge funds can still target dual-class companies with unequal voting structures by nominating director candidates in the hopes that a large vote of the noninsider shareholders will back their nominees, sending an embarrassing message to the company that change is needed."). For companies that allow the right to nominate and elect minority directors, this tool is even more powerful. *See* Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. L. BUS. R. 61, 90 (2016). For example, an activist campaign targeting Dillard's, Inc., which had a dual class structure but allowed the minority shareholders to nominate a director, was able to secure major changes, including compensation cuts, by using the ability to nominate a director as a bargaining chip. *See id.* at 93.

235 In Delaware, companies are not required to get the approval of a majority of the minority voting shareholders before consummating a conflicted going-private transaction, but courts incentivize companies to secure such approval. *See Kahn v. M & F Worldwide Corp.*, 88 A.3d 635, 644 (Del. 2014) (holding that a controlling stockholder's related party transaction will be subject to the business judgment rule if a proposed transaction receives both the affirmative recommendation of a functioning special committee and approval by a majority of the minority stockholders). This provides another important channel of activism at companies for minority shareholders. See Kastiel, *Against All Odds*, *supra* n. 226 at 101.

236 David Benoit, *Activist Pressures Ratner Family to Relax Control of Forest City*, WALL ST. J. (Aug. 10, 2016), available at: https://www.wsj.com/articles/activist-pressures-ratner-family-to-relax-control-of-forest-city-1470801603; Ethan Kingsberg, Index Eligibility as Governance Battlefield: Why the System is Not Broken and We Can Live With Dual Class Issuers), Harv. Law School F. on Corp. Gov. and Fin. Reg. (July 5, 2017), https://corpgov.law.harvard.edu/2017/07/05/index-eligibility-as-governance-battlefield-why-the-system-is-not-broken-and-we-can-live-with-dual-class-issuers/.

237 *Id.*

238 *Id.*

Likewise, in the case of Reader's Digest, pressure from an activist investor sped up the unwinding of the publisher's dual-class structure. Since the company's stock started trading on the NYSE in 1990, it has offered voting and nonvoting shares to the public, but voting control remained with an entity created by the founders.[239] In the early 2000s, outside investors became increasingly unhappy with the company's structure and strategy and began to pressure the company for changes. Most prominently, Highfields Capital Management, an investment firm that owned about 10% of the non-voting stock and a small fraction of the voting stock, made an offer to buy the voting shares with the explicit purpose of eliminating the dual-class structure.[240] The company rejected the offer, but the investor pressure accelerated discussions to reclassify the company's shares.[241] Shortly after rejecting the offer, the company agreed to replace its two classes of shares with a single voting class.[242]

There are other examples in which a dual-class company has bent to the wishes of a minority investor with some voting power. In 2006, activist investor Morgan Stanley Investment Management put pressure on the New York Times to eliminate its dual-class structure. That structure permitted the low-vote Class A shareholders to elect a minority (four out of thirteen) of the company's directors.[243] The company resisted this pressure for two years, even after 42% of the Class A shareholders withheld their votes for directors at the company's 2007 annual meeting.[244] Eventually, Morgan Stanley exited the investment, but the campaign attracted the attention of another group of activist investors, the hedge funds Harbinger Capital Partners and Firebrand Partners. These funds eventually secured a settlement with the company that allowed them to appoint their nominees to the board.[245] And in the years following the campaign, the company implemented the activists' proposed policy changes, reducing spending, lowering its operating costs, and divesting underperforming assets.[246]

These examples demonstrate how shareholders with voting rights are able to influence management even when they are not able to credibly threaten their control.[247] And although the founder's

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239 Matthew Rose, *Reader's Digest's Shareholders To Give Up Control of Publisher*, WALL ST. J. (Apr. 15, 2002), available at: https://www.wsj.com/articles/SB1018822198298046520.
240 *Id.*
241 *Id.* (noting that "pressure from Highfields accelerated their planning" to move to a single class structure).
242 *Id.*
243 Joshua Chaffin, *Hedge Fund Lashes Out at NYT Board*, FIN. T. (Jan. 28, 2008), http://www.ft.com/intl/cms/s/0/5eae7fba-cd3a-11dc-9b2b- 000077b07658.html#axzz42LvTOajM.
244 Merissa Marr, *New York Times Co. Relents on Board Seats*, WALL. ST. J. (Mar. 18, 2008), http://www.wsj.com/articles/SB120577291969142019
245 *Id.*
246 Kastiel, *supra* note 226 at 63.
247 Advisory shareholder votes on executive compensation have also proven to be influential. For example, in 2012, a strong showing of investor disapproval in the form of an advisory say-on-pay vote by Citigroup shareholders against CEO Vikram Pandit's pay package led to his departure and substantial changes to executive compensation. 55% of Citigroup shareholders voted against the pay package, which was taken as a strong signal of displeasure. *See* Jessica Silver-Greenberg & Nelson D. Schwartz, *Citigroup's Chief Rebuffed on Pay by Shareholders*, N.Y. TIMES (Apr. 17, 2012), available at http://dealbook.nytimes.com/2012/04/17/citigroup-shareholders-reject- executive-pay-plan/; Tom Braithwaite, Dan McCrum & Kara Scannell, *Citigroup Sees Off Shareholder Revolt on Executive Pay*, FIN. T. (Apr. 24, 2013), available at: http://www.ft.com/intl/cms/s/0/ef667544-ace1-11e2-b27f- 00144feabdc0.html#axzz2dOEJ6hvL. One analyst described the vote as follows: "This is a milestone for corporate America. When shareholders speak up about issues on which they've been complacent, it's definitely a wake-up call." Silver-Greenberg & Schwartz, *supra*. That was so even though the vote was non-binding. Empirical evidence has generally revealed that Dodd-Frank's mandatory say-on-pay vote for public companies has influenced compensation practices, in spite of the fact that the vote is nonbinding. *See, e.g.*, Yonca Ertimur,

grip on the company may be tight at the time of the offering, that grip may loosen over time, providing even greater opportunity for the voting shareholders to influence or even unseat management.[248]

By contrast, a company that issues only nonvoting shares to the ensures that the insiders will be able to ignore influence from outside investors into perpetuity. For some companies, the benefits provided by insulation may outweigh the risks, but this is unlikely to occur very often, and even when it does, will unlikely to remain efficient into perpetuity. Therefore, a requirement that companies make a non-negligible amount of voting shares available to the public when issuing nonvoting shares would be least likely to impede efficient structuring, while also protecting shareholders from future inefficiencies.

Conclusion

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

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

Fabrizio Ferri & David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay* at 4 (Working Paper 2013), available at: http://ssrn.com/abstract=2019239.

248 There is another reason why regulators might wish to prohibit companies from issuing only nonvoting shares to the public: doing so may allow companies to avoid certain disclosure requirements under securities law. For example, without issuing voting securities, a company need not hold an annual meeting, nor provide a proxy statement to shareholders, which would otherwise be required under Section 14(a) of the Securities and Exchange Act of 1934. *See* Snap Inc., Amendment No. 2 to Form S-1. Those proxy statements include financial statements, background information about the company's directors including potential conflicts of interest, board compensation, executive compensation, and the composition of the audit committee. *See* Exchange Act Rule, 17 C.F.R. Section 240.14a. This information would be of particular interest to outside shareholders of a company that has such a high potential for agency costs. Moreover, those disclosure requirements are also important to regulators who monitor the company.