CORPORATE GOVERNANCE BY INDEX EXCLUSION

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ABSTRACT

Investors have long been unhappy with certain governance arrangements adopted by companies undertaking initial public offerings ("IPOs"), such as dual-class voting structures. Traditional sources of corporate governance rules—the Securities and Exchange Commission, state law, and exchange listing rules—do not constrain these arrangements. As a result, investors have turned to a new source of governance rules: index providers.

This Article provides a comprehensive analysis of index exclusion rules and their likely effects on insiders' decision-making. We show that efforts to portray index providers as the new sheriffs of the U.S. capital markets are overstated. Index providers face complex and conflicting interests, which make them reluctant regulators, at best. We put forward an analysis of insider incentives in light of index exclusions and apply it to one of the most important applications of index exclusion rules to date, the recent decision by index providers to exclude from their indexes certain companies with dual-class share structures. We conclude that the efficacy of index exclusions in preventing disfavored arrangements such as dual-class structures is likely to be limited, but not zero.

Index exclusions are a corporate governance experiment, one that has important lessons. We examine these lessons, and the way forward for corporate governance. These lessons are all the more important because of the central place of index funds, and therefore index providers, in our capital markets.

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INTRODUCTION

On March 2, 2017, Snap Inc. went public in a highly anticipated initial public offering ("IPO").[1] Snap's IPO valued the company at $24 billion, making it one of the largest "unicorn" companies to go public.[2] But to many investors, Snap's IPO was controversial for another reason: Snap proposed a multi-class capital structure, where insiders and some pre-IPO investors had the right to vote but other shareholders did not.[3] Shareholders buying Snap's shares in the IPO were completely disenfranchised. While the number of companies going public with different classes of voting rights has increased in recent years, none of these IPOs had previously issued common stock with *no voting rights* at all.[4] Investors expressed strong complaints about being forced to invest in shares without any voting rights.[5] Snap, as some investors argue, had crossed "a line in the sand."[6]

Snap's actions provoked the creation of a new source of governance rules. Investors who opposed Snap's structure were met with indifference from Snap itself. None of the traditional sources of governance rules that constrain firm structuring decisions—the Securities and Exchange Commission ("SEC"), state law, or exchanges' listing rules—were effective to prevent Snap or others like it from choosing extreme dual-class structures that disenfranchised shareholders.

The rise of index investing adds another dimension to this problem. Over the past two decades there has been a substantial shift from active management to index management.[7] Mutual funds are the largest investors in U.S. corporations, and index funds—particularly those managed by the "Big Three" investment managers, BlackRock, Vanguard, and State Street Global Advisors ("SSGA")—are the largest mutual funds managers and are growing rapidly.[8] Index investors

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[1] Snap Inc., Prospectus (Form 424B4) (Mar. 3, 2017).

[2] Portia Crowe, *Snap Is Going Public at a $24 Billion Valuation*, BUS. INSIDER (Mar. 1, 2017), https://www.businessinsider.com/snapchat-ipo-price-2017-3 [https://perma. cc/A9SD-FZFH].

[3] Snap Inc., *supra* note 1, at 4-6.

[4] Kaitlin Descovich et al., *Voting Rights Gone in a Snap – Unequal Voting Rights Back in the Spotlight*, WEIL, GOTSHAL & MANGES LLP (Apr. 3, 2017), https://governance.weil.com/whats-new/voting-rights-gone-in-a-snap-unequal-shareholder-voting-rights-back-in-the-spotlight/ [https://perma.cc/6A3J-WAC6].

[5] *See infra* Section III.A (discussing investor opposition to dual-class shares).

[6] *See* Hazel Bradford, *Snap IPO Igniting Furor; Institutions Not Pleased*, PENSIONS & INVS. (Mar. 20, 2017), https://www.pionline.com/article/20170320/PRINT/303209977/snap-ipo-igniting-furor-institutions-not-pleased [https://perma.cc/UYC4-W2GQ].

[7] *See, e.g.*, Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721 (2019).

[8] *See* Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, J. ECON. PERSPECTIVES, Summer 2017, at 89, 94; Jan Fichtner, Eelke M. 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, 299 (2017).

make their investments according to an index: a benchmark portfolio listing securities and their weightings in the portfolio. Once a company with a disfavored governance structure is included in an index, index investors are essentially required to invest in the company.[9] Even though many of these investors oppose the use of dual-class structures, they cannot avoid investing in companies with those structures once they are included in the index. Left without other means to influence Snap and future companies like it, investors advocated for a new source of corporate governance constraints: index composition rules.[10]

At the end of July 2017, S&P Dow Jones, a prominent index provider, announced that the S&P Composite 1500 and its component indexes, including the S&P 500, would no longer add companies with multi-class structures.[11] It adopted a strict flat exclusion, but grandfathered existing multi-class companies.[12] Around the same time, another leading index provider, FTSE Russell decided to exclude companies with extremely low, or non-voting, rights from its indexes.[13] After the adoption of the new exclusion rules, companies seeking inclusion in FTSE Russell's indexes will need to have at least 5% of voting rights held by unaffiliated public shareholders.[14]

Market participants view these new exclusion rules as an important shift in the governance landscape. The Council of Institutional Investors ("CII") has claimed that "[i]ndex providers' action responds to a void left by years of inaction from stock exchanges, regulators and global regulatory coordinators."[15] One commentator remarked that the key governance debate of the modern market regarding the use of dual-class shares "was fought and decided, not at

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[9] Many "closet indexers" that follow the index closely may also feel pressure to invest in the company.

[10] *See infra* Section I.A (discussing limitations on investors' ability to affect change).

[11] *See* 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?force_download=true [https://perma.cc/T7YV-ZTD6]. Index providers differ as to whether they use the term "indices" (e.g., S&P Global) or "indexes" (e.g., FTSE Russell, MSCI). For consistency we use the term "indexes" throughout this Article.

[12] *Id.*

[13] *See* FTSE RUSSELL, FTSE RUSSELL VOTING RIGHTS CONSULTATION RESULTS – NEXT STEPS (July 2017), https://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf [https://perma.cc/BN5U-3X6A].

[14] *Id.*

[15] Ken Bertsch, Council of Institutional Inv'rs, *CII Comment Letter to MSCI On Unequal Voting Structures,* HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 16, 2018), https://corpgov.law.harvard.edu/2018/05/16/cii-comment-letter-to-msci-on-unequal-voting-structures/ [https://perma.cc/TX54-SQNX].

the Securities and Exchange Commission or in Congress . . . but by a couple of for-profit index providers."[16]

In the same vein, other market participants have focused on the growing clout of index providers. Howard Marks, co-founder of Oaktree Capital Management LP, observed that "the people who create the indices are deciding which stocks will be invested in."[17] A memorandum issued by one of the leading Silicon Valley law firms anticipated that the new exclusions will likely have "a significant impact" on technology companies that contemplate whether to implement a dual-class structure in connection with their IPO.[18] Similarly, Professor Jay Ritter, a well-known economist who has researched IPOs for decades anticipated that "the moves by the index firms will discourage companies from adopting the structure."[19] And a recent *Bloomberg* article, entitled *Index Providers Rule the World—For Now, at Least*, explained, "In a market increasingly characterized by passive investing, these players can direct billions of dollars of investment flows by reclassifying a single country or company . . . ."[20]

Index exclusions are thus a new and important tool in the corporate governance landscape. They respond to governance arrangements that outside investors disfavor, but that insiders nonetheless put in place at the time of IPOs. This Article provides a comprehensive analysis of index exclusion rules and their likely effects on insider decision-making. We apply this analysis to evaluate the use of index exclusion rules with respect to dual-class structures. We also consider the lessons that can be drawn from this important corporate governance experiment.

Our analysis first considers the political economy of index exclusions. We consider why disfavored arrangements are not constrained at the IPO stage, or by other sources of corporate governance rules, and why index providers were the last resort of the investors that oppose those arrangements. Whether the IPO process results in corporate governance arrangements that are collectively optimal for IPO companies is an enduring source of debate. We note that many

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[16] Matt Levine, *Index Rules and Analyst Fatigue*, BLOOMBERG (Aug. 1, 2017), https://www.bloomberg.com/view/articles/2017-08-01/index-rules-and-analyst-fatigue.

[17] Tracy Alloway, Dani Burger & Rachel Evans, *Index Providers Rule the World—For Now, at Least*, BLOOMBERG (Nov. 27, 2017), https://www.bloomberg.com/news/articles/2017-11-27/index-providers-rule-the-world-for-now-at-least.

[18] Ran Ben-Tzur, *New Index Rules Likely to Significantly Impact Tech Companies with Multi-Class Capital Structures*, FENWICK & WEST LLP (Aug. 4, 2017), https://www.fenwick.com/publications/Pages/New-Index-Rules-Likely-to-Significantly-Impact-Tech-Companies-with-Multi-Class-Capital-Structures.aspx [https://perma.cc/NM6F-CUED].

[19] Andrea Tan & Benjamin Robertson, *Dual-Class Shares Are Coming Under Fire—Again*, BLOOMBERG (Sept. 28, 2017), www.bloomberg.com/news/articles/2017-09-27/can-democracy-stage-a-comeback-at-stock-exchanges.

[20] Alloway, Burger & Evans, *supra* note 17.

IPOs result in companies with arrangements that outside investors broadly disfavor, such as dual-class share structures. These arrangements are not limited by traditional sources of corporate governance constraints, such as state corporate law, exchange listing rules, and federal securities laws. Competitive pressures lead these institutions to choose rules that cater to the preferences of corporate insiders rather than outside investors. These structural incentives are weakest for the SEC; however it is hamstrung by a D.C. Circuit decision that rejected the SEC's prior attempt to constrain dual-class share structures.[21] This leaves index providers as the last resort of investors.

We next consider the position of these index providers. Index providers face a complex set of conflicted interests and incentives. On one hand, where particular arrangements are strongly disfavored by their clients, index providers have an incentive to respond to those preferences by adopting an exclusion rule. On the other hand, there are numerous factors that make index providers reluctant regulators, at best. First, index providers have reason to be concerned about federal regulation if they intervene too strongly in the corporate governance choices of their constituents. Second, the exclusion tool does not fit well with the business model of index providers and their preference not to limit their clients' access to the investable universe of public companies. Third, index providers face a divergence in the views of their clients regarding exclusion rules, making them reluctant to adopt strong exclusion rules. Fourth, index providers also prefer to avoid sudden extreme changes in the composition of their indexes that would require substantial and costly portfolio rebalancing by their clients. Finally, index providers face some (albeit mild) competitive pressures that may reduce their inclination to adopt very restrictive exclusions.

Our political economy analysis also considers the surprising opposition that prominent index fund managers raised against the index exclusions. BlackRock, for example, issued a statement publicly opposing the index exclusions.[22] The other two largest index fund managers, Vanguard and SSGA, echoed this view.[23] Opponents to the index exclusion expressed the view that "broad market indexes should be as expansive and diverse as the underlying industries and economies

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[21] Bus. Roundtable v. Sec. Exch. Comm'n, 905 F.2d 406, 416-17 (D.C. Cir. 1990) (striking down SEC's decision to bar self-regulatory organizations from listing dual-class stock).

[22] *See* Letter from Barbara Novick, Vice Chairman, BlackRock to Baer Pettit, President, MSCI, Inc. 1 (Apr. 19, 2018), https://www.blackrock.com/corporate/literature/publication/open-letter-treatment-of-unequal-voting-structures-msci-equity-indexes-041918.pdf [https://perma.cc/NA39-7Q5F].

[23] *See* James Rufus Koren & Paresh Dave, *Index Firm Shunning Snap over Vote Rights*, L.A. TIMES (July 28, 2017), http://www.latimes.com/business/la-fi-snap-russell-indices-20170727-story.html ("Portfolio managers at State Street recently wrote that excluding companies such as Snap ruins the whole point of indexes, which is to reflect the stock market. . . . Vanguard, the world's largest provider of mutual funds, also said it was disappointed with the exclusion even though it favors every share having a vote.").

whose performance they seek to capture."[24] This objection may be also motivated by the fear that the exclusions would reduce the performance of passive index funds compared to other active fund managers, with whom the passive managers compete.[25] We doubt any of these reasons for passive managers' opposition to the index exclusions is based on valid reasoning. This excessive deference of index funds to the preferences and positions of corporate managers is also consistent with recent work co-authored by one of us showing that index fund managers have incentives to be excessively deferential to the managers of their portfolio companies.[26] The divergence among investors, however, is likely to decrease the tendency of index providers to use the exclusion tools in the future, or to tighten existing dual-class exclusions.[27]

We next consider the likely effects of index exclusions on insiders' decision-making. Even if index providers were able to serve as investors' new gatekeepers, their exclusions are unlikely to fully prevent disfavored governance arrangements from emerging for several reasons. First, the financial effect of index exclusions on the firm stock price may be more limited than initially assumed, and empirical evidence on the existence of such an effect is mixed. Second, inclusion in indexes would, in any case, happen at some point in the future, so the impact of index exclusions must be discounted to reflect the time value of money. Third, because S&P Global exercises discretion regarding which companies it includes in the S&P Composite Indexes, including the S&P 500, index inclusion is not assured. Thus, the effect of the index exclusion must be discounted by the probability that the company would not be included in the index even if it were eligible. Fourth, that index inclusion is generally delayed for some time provides insiders with a "free option" to have their company go public with the disfavored arrangement and maintain it until the company would otherwise become eligible for index inclusion, at which point they can remove the arrangement. Given the limited impact of index exclusion rules, the likelihood that they would deter insiders from adopting certain governance arrangements they find valuable is also limited. This is especially the case for post-IPO companies because the costs of index exclusions are shared among all

[24] *See* Letter from Barbara Novick, to Baer Pettit, *supra* note 22, at 1.

[25] Traditionally, investment managers invested in the securities of particular companies that they thought presented good investment opportunities, referred to as "active management." *See* Bebchuk, Cohen & Hirst, *supra* note 8, at 89-102.

[26] Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, COLUM. L. REV. (forthcoming 2019) (manuscript at 21-28), https://ssrn.com/abstract=3282794.

[27] Although we use the term "dual-class," in recent years a number of companies have adopted structures with more than two classes of shares. These are more accurately described as "multi-class" structures. However, because of the historical prevalence of two-class structures, the term "dual-class" is much more widely used in the literature. We therefore adopt this term, but also intend for it to refer to companies that have more than two classes of shares.

shareholders in the company, whereas the private benefits of control from disfavored arrangements accrue exclusively to insiders.

Does this mean that the index exclusions were meaningless and should be eliminated as some have argued? We cannot agree. At the very least, the index exclusions can represent a symbolic win for investors against the use of non-voting shares. In addition, even weak index exclusions may have some effects on the choice of governance arrangements by IPO companies.

We evaluate our theory of index exclusions by analyzing a case study of a significant use of index exclusions for policy purposes: the exclusion of dual-class stock from the major indexes. Dual-class structures are broadly disfavored by outside investors.[28] In particular, leading mutual funds and public pension funds, such as Fidelity, Vanguard, California Public Employees' Retirement System ("CalPERS"), and California Teachers Retirements System ("CalSTRS"), have committed to corporate governance guidelines that oppose all dual-class structures.[29] In addition, those investors regularly vote against proposals for issuing additional classes of shares, and in favor of unification of multiple classes of shares into one class with equal voting rights.[30] However, state law and listing exchanges have failed to constrain the use of dual-class structures, and the SEC has been hamstrung from intervening. For investors seeking to limit the use of dual-class structures, index providers were thus the last resort.

Index providers' reluctance to regulate is clearly reflected in the dual-class exclusion rules they adopted or, in the case of MSCI, failed to adopt.[31] Where the index providers did adopt dual-class exclusion rules, those exclusions contained important loopholes and limitations. The S&P dual-class exclusion

[28] For example, in summer 2016, a group of leaders of asset managers as well as operating companies issued a set of consensus governance principles including a statement that "dual-class voting is not a best practice." *See* Margaret Popper, Sard Verbinnen & Co., *Commonsense Principles of Corporate Governance*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (July 22, 2016), https://corpgov.law.harvard.edu/2016/07/22/commonsense-principles-of-corporate-governance [https://perma.cc/US7E-AFZD]. Additionally, the CII, an organization of more than 140 public, union, and corporate pension funds, has declared the structure to be "fundamentally flawed as a long-term capital model." *See Dual-Class Stock: Governance at the Edge*, DIRECTORS & BOARDS, Third Quarter 2012, AT 37, 38, http://sites.udel.edu/wccg/files/2012/10/Dual-Shares-Q3-20121.pdf [https://perma.cc/4BL9-WR9Q] (quoting Ann Yerger, then Executive Director of the CII).

[29] For statements reflecting the opposition of major institutional investors to dual-class structures, see CALPERS, GOVERNANCE & SUSTAINABILITY PRINCIPLES 12 (2018), https://www.calpers.ca.gov/docs/forms-publications/governance-and-sustainability-principles.pdf [https://perma.cc/3GFN-428X]; *Proxy Voting*, FIDELITY INVESTMENTS, https://www.fidelity.com/about-fidelity/fidelity-by-numbers/fmr/proxy-guidelines [perma.cc/NUV3-7C2U] (last visited Apr. 13, 2019); *Policies and Guidelines*, VANGUARD (2016), [https://perma.cc/W7PA-LTRP].

[30] *See infra* Section III.A.

[31] *See infra* Section III.C.3.

applies only to new IPO companies, and may not be relevant to many dual-class companies for years following an IPO.[32] The Russell exclusion can be circumvented by ensuring that public investors hold slightly more than five percent of voting rights and thus still enables the inclusion of companies with extreme separation between controllers' equity and voting rights.[33]

Data that we collected on the incidence of dual-class IPOs before and after the adoption of the dual-class exclusions confirms our theory that index exclusions are likely to have limited but non-zero effects. Index exclusions were not effective enough to substantially eliminate the use of dual-class shares. Lyft, Inc.'s recent and high-profile decision to go public with a dual-class structure illustrates this desire to maintain company control, notwithstanding the potential adverse consequence of being excluded from certain indexes.[34] However, on the margin, insiders seem to have reduced their use of dual-class structures at the IPO stage.[35]

In addition, the details of the dual-class arrangements that have been adopted since the Snap IPO suggest other patterns. A limited but increasing proportion of dual-class companies are choosing to go public with time-based sunset provisions incorporated into their charters, which automatically unify the share structure after a number of years.[36] Further, since the Snap IPO, no companies have issued non-voting shares in their IPOs.[37] While it may be too early to draw definite conclusions, this initial data seems to suggest some effects on IPO arrangements since the dual-class exclusion rules came into effect.

The dual-class exclusions also represent an important symbolic victory for certain investors. The Snap IPO represented the high-water mark in a long trend towards more frequent and more unequal dual-class structures. Investors were concerned that if the Snap IPO went unchallenged, it would set a new and dangerous precedent for future companies going public.[38] The ability of these investors to influence index providers to exclude dual-class companies, even in a limited fashion, reaffirms the power of those investors.

A number of important lessons can be drawn from our analysis. Chief among them is that the effort to portray index providers as the new sheriffs of the U.S. capital markets is likely to be an overstatement. The nature of the index provider business is to mimic existing broad markets. This limits the extent to which

[32] *See infra* notes 125-126 and accompanying text.

[33] *See infra* Section III.C.2.

[34] Lyft, Inc., Registration Statement (Form S-1), at 13 (Mar. 18, 2019).

[35] *See infra* Section III.E.1 (graphing dual-class share IPOs).

[36] *See* Letter from Council of Institutional Inv'rs to Elizabeth King, Chief Regulatory Officer, Intercontinental Exch. Inc. 2-5 (Oct. 24, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NYSE%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf [https://perma.cc/BH5U-9ZGP].

[37] Four multi-class companies have gone public with non-voting shares authorized in their charter. However, all four have left those shares "on the shelf," rather than issuing them in their IPO. *See infra* note 152 and accompanying text.

[38] *See infra* notes 157-159 and accompanying text.

index providers can implement index exclusions. Were index providers to implement profligate exclusion rules, their indexes would no longer reflect the investable marketplace. Other concerns relate to index providers' role as reluctant regulators, to the delayed impact of the index exclusion rules, and to the disagreement among investors regarding whether index exclusions should be used to achieve their common goals. At any rate, we believe that the recent calls to eliminate index exclusions are premature, and investors, index providers, and policy-makers would be better served by pausing to observe the impact of the index exclusions.

In the meantime, outside investors should consider whether there are alternative, viable, and effective mechanisms to discourage insiders from adopting disfavored arrangements at the IPO stage. To that end, we consider the effectiveness of three alternative approaches: coordinated cooperative action of exchanges, providing index investors with a menu of investment index options with indexes that include and exclude the disfavored arrangement, and collective action by investors themselves.

Before proceeding we wish to identify and address an important assumption on which this Article is based. This Article focuses on companies that have governance arrangements in place, such as dual-class structures, that their investors, taken as a whole, would prefer that they not have. At face value this assumption would seem to be justified; in Section III.A we describe how a broad group of investors have expressed their opposition to dual-class structures, through their statements, policies, and voting behavior.

An argument that has often been advanced in corporate governance holds that there are no disfavored governance arrangements, as long as these terms are accurately priced. That is, if insiders put in place governance arrangements that are unfavorable to outside investors, then those investors will reduce the price they are willing to pay for the shares accordingly. Insiders will receive a lesser amount in the IPO and consequently will have reduced incentives to go public with governance terms that outside investors disfavor.[39] By this argument, if a company has a disfavored governance arrangement, outside investors (or their predecessors) have received a discount when they invested in the company at the IPO, and any readjustment of those arrangements after the fact entails a wealth transfer between the insiders and outsiders.

This argument, however, is predicated on the efficiency of the IPO pricing mechanism, a matter which has been subject to vigorous debate.[40] In this Article

[39] For a general formulation of the argument that IPO pricing reflects the quality of offered governance, see Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 123-25 (1987); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2366-68 (1998).

[40] For studies contesting the efficiency of the IPO pricing mechanism, see, for example, Lucian Arye Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713, 726-28 (2003); Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 83-86 (2001). For a well-known

we do not attempt to solve this long-standing debate, though we do wish to note three points that we believe leave room for the existence of disfavored governance arrangements.

First, for the IPO pricing mechanism to result in optimal corporate governance arrangements requires a very high degree of market efficiency. This is because the pricing of the future potential decrease in firm value due to the use of unfavorable governance terms depends on numerous factors and contingencies, some of which will come into effect only many years after the IPO.

Second, the pricing argument is not just an objection to the theory of index exclusions, but also to any (unpriced) restriction on the terms that insiders may choose to offer when going public. Those who fully believe in the efficiency of the IPO pricing mechanism should not only reject the need for index exclusions, but should also regard most of the restrictions on corporate governance arrangements that have been implemented through regulation, legislation, or judicial action as unnecessary, since the IPO market should result in optimal governance terms without any need for adjustment by outside rule-makers. We take as given that the majority of our readers accept that investors should be able to limit certain arrangements that they disfavor at the IPO stage, or to adjust post IPO, and are interested in the most efficient way of doing so.

Finally, regardless of one's view on the efficiency of the pricing mechanism at the IPO stage, it is important to emphasize that investors *do* manifest a strong preference against the use of certain governance terms, such as dual-class structures, and this preference is not contingent on the pricing of those arrangements. If investors' major concern was that these arrangements were inappropriately priced, then those investors could refine their guidelines or voting decisions accordingly and would support dual-class shares if they believed that their cost to the company had been properly incorporated into the price of the company's shares. However, this is not observed in investor opposition to dual-class structures. Instead, investors express strong opposition to dual-class structures, and do so consistently across different companies, regardless of how the shares of those companies are priced.

Our Article proceeds as follows. Part I considers the political economy of index exclusions. Part II puts forward a theory of the effects of index exclusions and why their effects are likely to be limited but non-zero. Part III applies our analytical framework to the most important case of index exclusions: the dual-class exclusion rules. Part IV considers the lessons from our analysis and a number of ways forward.

I. THE POLITICAL ECONOMY OF INDEX EXCLUSIONS

In this Part we examine the forces and incentives shaping the index exclusions and the responses to them. Section I.A explains why investor preferences

collection of articles expressing different views on the subject, see Symposium, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

regarding corporate governance constraints are often not satisfied by traditional sources of governance rules, leaving index providers as a last resort. Section I.B describes the forces acting on index providers themselves, which make them reluctant regulators. Section I.C explains the divergence in views among index investors regarding index exclusions and why index fund managers may oppose index exclusions.

A. *The Demand for Index Exclusions: Index Providers as a Last Resort*

The story of the Snap IPO raises an important question: if certain arrangements are disfavored by investors, why are they not constrained by corporate governance rules? Corporate governance arrangements are subject to constraints from several sources. While the shareholders of a potential IPO company are generally free to determine the voting arrangements and other important rules that apply to corporations, certain mandatory requirements of state law constrain the scope of these arrangements.[41] Once the company goes public, the mandatory provisions of exchange listing requirements[42] and securities laws[43] constrain the company's arrangements. As this Part explains, state law and exchanges have structural incentives to favor insiders over outside investors and therefore to not constrain arrangements favored by insiders but not outsiders. The SEC has a mix of historical and incentive problems that limits its ability to intervene in order to protect outside investors from disfavored arrangements. Structural incentives also explain why index providers have been more willing to intervene to constrain disfavored arrangements: they have structural incentives to favor investors over insiders.

State law and exchange listing rules have not constrained the use of arrangements favorable to inside shareholders and unfavorable to outside investors. That is because the interests of state legislatures and exchanges are more closely aligned with the interests of insiders than those of outside investors.

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[41] *See* Scott Hirst, *The Case for Investor Ordering*, 8 HARV. BUS. L. REV. 227, 289 (2018). For example, Delaware corporations are required to hold shareholder meetings each year, DEL. CODE ANN. tit. 8, § 211(b) (2019), and may not opt-out of the fiduciary duty of loyalty that is incumbent on directors. *Id.* § 102(b)(7). For a longer list of mandatory provisions in Delaware corporate law, see Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1553-54 (1989).

[42] For instance, the New York Stock Exchange and Nasdaq listing rules require their listed companies to have a majority of independent directors, NYSE Listing Rule 303A.01; Nasdaq Listing Rule 5605(b)(1), and to have audit and compensation committees with only independent directors, NYSE Listing Rule 303A.06; Nasdaq Listing Rule 5605(c)(2).

[43] Most obviously, these constraints include the comprehensive disclosure requirements applicable to public companies. *See, e.g.*, 15 U.S.C. § 78m (2012) (periodic and other disclosure); *id.* § 78n(c) (disclosure relating to proxy solicitations). Additional constraints are imposed through the SEC's oversight of the exchanges, whereby the SEC is required to approve changes in exchange listing rules, and can require exchanges to take certain actions. *See id.* § 78s(b)(1) (regulating self-regulatory organizations).

States and exchanges compete with other states and exchanges for incorporations and listings. The insiders of the corporation prior to the IPO decide where corporations incorporate and list. Were a state or exchange to limit the ability of corporations to adopt terms favorable to insiders, they could choose to incorporate in another state or to list on another exchange. As a result, states and exchanges prefer not to constrain arrangements that insiders favor because permitting more discretion attracts companies to incorporate or list in higher numbers. A long debate regarding state competition for incorporations has shown that competition for incorporations and listings will lead states and exchanges to follow the preferences of those that make incorporation and listing decisions—in this case corporate insiders.[44] Because those insiders prefer the freedom to use arrangements that outsiders may nonetheless disfavor, states and exchanges will refrain from limiting those choices.

Because of the political nature of the SEC, it is also subject to competing influence from outside investors, which counterbalance the influence of insiders.[45] One of the SEC's primary responsibilities is to protect investors, which may lead it to constrain arrangements that unduly favor insiders at the expense of outside investors. However, in some cases, such as that of dual-class shares, the SEC is constrained from acting for constitutional or institutional reasons. After the New York Stock Exchange ("NYSE") relaxed its rules to permit dual-class shares in 1986, the SEC adopted Rule 19c-4, which had the effect of requiring exchange listing rules to prohibit dual-class shares.[46] In *Business Roundtable v. Securities & Exchange Commission*,[47] the Court of Appeals for the D.C. Circuit struck down the SEC's rule, on the grounds that the rule exceeded the SEC's authority under section 19 of the Securities Exchange Act, which did not extend to SEC regulation of corporate governance matters.[48] Although the SEC persuaded the main stock exchanges to prohibit dual-class recapitalizations under their listing standards, the practical effect of the *Business Roundtable* decision has been to tie the SEC's hands and prevent it from direct involvement in constraining many corporate governance arrangements.

[44] For a discussion of state law competition, see, for example, Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1444-46 (1992); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 685-86 (1974). For a discussion of competition for listings, and among securities laws, see Romano, *supra* note 39, at 2365-72; Frederick Tung, *Lost in Translation: From U.S. Corporate Charter Competition to Issuer Choice in International Securities Regulation*, 39 GA. L. REV. 525, 530-31 (2005).

[45] *See, e.g.*, Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2509-10 (2005) (describing possibility of federal response if Delaware policy became excessively pro-manager).

[46] Governing Certain Listing or Authorization Determinations by National Securities Exchanges and Associations, 17 C.F.R. § 240.19c-4 (2018).

[47] 905 F.2d 406 (D.C. Cir. 1990).

[48] *Id.* at 408.

Even in cases where the SEC is not limited by constitutional factors, it also faces two competing pressures. As with state corporate law and listing rules, the SEC faces some competitive pressure from other jurisdictions. Just as insiders can choose which corporate laws apply to them by their decision where to incorporate, so too can they choose which securities laws apply to them by deciding where they incorporate and list. Corporations headquartered in the United States can choose to incorporate and list abroad and not in the United States (for instance in Frankfurt, Hong Kong, or London), so that they would be subject to another country's securities laws.[49] Corporations incorporated abroad can choose to list on U.S. exchanges, making them subject to U.S. securities laws. This competitive pressure may also limit the willingness of the SEC to constrain arrangements that insiders favor, such as unequal voting structures.

The competitive value for the U.S. capital markets of allowing unequal shares has been raised as an argument against limiting those rules. In 2014, Chinese-headquartered Ali Baba chose to list on the NYSE rather than the Hong Kong Stock Exchange, in large part because Hong Kong securities laws would have prevented it from using the unequal voting structure its insiders preferred. As with states and exchanges, this makes the SEC more susceptible to follow the preferences of insiders and not constrain arrangements even though they may be disfavored by outside investors. Since 1996, the SEC has been required to consider the effects of its rules on "efficiency, competition, and capital formation."[50] In addition to considering the threat of losing listings to foreign capital markets, this may require the SEC to consider whether its rules might lead insiders not to go public at all. If the SEC were to unduly constrain the ability of insiders to put in place governance arrangements they favor at the IPO stage, then the argument goes, those insiders might choose to have the company remain private rather than going public.[51]

Index providers are driven by a different set of incentives. They have been willing to intervene in constraining terms that outside investors disfavor where other corporate governance rule makers were not because their structure incentivized them to follow the interests of outside investors over insiders. Index providers generate income from index fund managers and other investors that license their indexes. Index providers compete to attract assets from those investors. As a result, they have a structural incentive to follow the preferences of investors. In this sense they are unique among potential sources of corporate governance constraints, the others of which have incentives to follow the preferences of insiders. For instance, with respect to the dual-class exclusion,

[49] Tung, *supra* note 44, 561-78

[50] Securities Act of 1933, 15 U.S.C. § 77a-aa (2012); Securities and Exchange Act of 1934, 15 U.S.C. § 78a-qq.

[51] For a discussion of this argument and its limitations, see Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 625-26 (2017).

the CII has stated that "[i]ndex providers' action responds to a void left by years of inaction from stock exchanges, regulators and global regulatory coordinators."[52]

B. *Index Providers as Reluctant Regulators*

The rise of index exclusions as a new source of corporate governance rules has created a new promise among investors in favor of more robust constraints on disfavored governance arrangements. At the same time, it has also generated considerable opposition among insiders, and—as discussed in Section I.C—among index fund managers. Both camps view the rise of index providers as regulators as an important shift in the corporate governance landscape. Discussing dual-class arrangements, one commentator stated that the key governance debate of the modern market regarding the use of dual-class shares "was fought and decided, not at the Securities and Exchange Commission or in Congress . . . but by a couple of for-profit index providers."[53]

However, as we will discuss in this Section, index providers are far from ruling the world, or even from being a primary source of corporate governance regulation. They are motivated by a complex set of conflicted interests and incentives and are subject to several significant constraints, which makes them reluctant regulators at best. What constrains index providers?

To begin, index providers are not ordinary regulators. They face an important structural limitation by the very nature of their business: broad market indexes have to be as expansive and diverse as the underlying industries and economies whose performance they seek to capture. Therefore, in constructing indexes, index providers are limited in their ability to regulate governance terms of public companies by using the exclusion tool too often. Were they to do so, the indexes they produce would no longer reflect the investable marketplace. For instance, imagine that socially conscious investors pushed index providers to exclude from the index gun manufacturers; tobacco companies; companies that inadequately disclose their carbon emissions; companies without women directors; and companies that adopt other governance terms that investors generally disfavor, such as classified boards, dual-class shares, and plurality voting. If that were the case, the list of excluded companies would be so large that indexes would no longer serve their business purpose of reflecting the performance of the industries and economies whose performance they seek to capture.

This imposes a natural limit on the extent to which index providers can exclude companies from their indexes. It explains why index providers intervene *only* as a matter of last resort, when other sources of governance regulation have not. A preference for broad coverage makes index exclusions a nuclear option, to be reserved for extreme situations. The effort to portray index providers as the new sheriffs of the U.S. capital markets is therefore an overstatement. At most,

52 Bertsch, *supra* note 15.
53 Levine, *supra* note 16.

they may intervene in one or two governance arrangements, most likely those that investors are unable to amend midstream through private ordering.

Even taking this natural limitation into account, there remains an open question whether index providers could act as determined and effective regulators on the few matters in which they would be willing to intervene. As we will show in the remainder of this Part, index providers face a complex set of conflicted interests and incentives, which limit their willingness to constrain corporate governance arrangements, and make them, at best, reluctant regulators.

The role of index providers as reluctant regulators has a number of explanations. First, index providers are likely to be concerned about the threat of federal intervention in their operations, which would make them subject to more stringent regulations.[54] Once index providers start acting as regulators by making specific governance characteristics part of the criteria for inclusion, they subject themselves to a greater risk of being regulated in the same way as stock exchanges or credit rating providers, including S&P Global's own credit ratings department. As profit maximizing businesses, index providers are likely to be rather averse to being regulated and the additional costs and constraints that it would impose. They can therefore be expected to demonstrate self-restraint in their actions and to prefer weaker or less effective exclusion rules.

These concerns regarding federal intervention are not unfounded. Following the adoption of the index exclusions, leading market participants began to question the ability of index providers to act as regulators. SEC Chairman Jay Clayton explained that he did not think indexes should choose which stocks to include based on voting power, stating, "Governance by indexation doesn't sit really well with me."[55] SEC Commissioner Robert Jackson Jr. stated that "excluding all dual-class firms from our major market indices is a blunt tool. And it's one I'm deeply worried about."[56] Consistent with these views, BlackRock expressed its opinion that "policymakers, not index providers, should set corporate governance standards."[57]

At the same time, a number of commentators have questioned whether index providers are well suited to determine which companies should be included in

[54] For similar arguments made regarding likely concern on the part of index funds regarding greater regulation, see Bebchuk & Hirst, *supra* note 26 (manuscript at 61).

[55] Andrea Vittorio, *FTSE Russell to Revisit Voting Power One Year After Snap IPO*, BLOOMBERG LAW (Mar. 13, 2018), https://www.bna.com/ftse-russell-revisit-n57982089820/ [https://perma.cc/Y25Y-WEEF] (quoting Chairman Jay Clayton).

[56] Robert J. Jackson Jr., Comm'r, Sec. & Exch. Comm'n, Address at Berkeley Law: Perpetual Dual-Class Stock: The Case Against Corporate Royalty (Feb. 15, 2018), https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty#_ftn29 [https://perma.cc/JQ48-KC4L].

[57] *See* Letter from Barbara Novick to Baer Pettit, *supra* note 22, at 1.

the index.[58] Others criticize the lack of transparency in index providers' processes. Some have argued that "very little is known about [index providers'] internal workings."[59] Commissioner Jackson and Professor Steven Davidoff Solomon claim that index providers "face little regulatory scrutiny and can face significant conflicts of interest, which have the potential to harm American investors."[60] They argue that "we need a national conversation about how to ensure that they operate with integrity, transparency and accountability."[61] This lack of regulation over index providers "has become increasingly salient as index providers make decisions that affect the governance of companies seeking to be listed on major exchanges."[62] Continued questioning of the legitimacy of index providers as the creators of governance rules is likely to heighten the threat of regulatory oversight of index providers.

These concerns regarding a regulatory backlash could have a chilling effect on index providers, both ex ante and ex post. Ex ante, these concerns could cause index providers to adopt relatively "weak" exclusions to decrease the likelihood of a regulatory response. Ex post, the calls for regulatory intervention could decrease the likelihood that index providers will strengthen the weak index exclusions they adopted, or could even lead index providers to further weaken—or eliminate—those exclusions.

Index providers' concerns regarding regulation are likely to have influenced them to reduce the salience of their power. Index providers have repeatedly emphasized the fact that they are for-profit organizations, not regulators. For example, in a panel discussion addressing the role of index providers, David Blitzer, Chairman of the Index Committee at S&P Dow Jones Indices, "suggested that the decision on whether dual-class structures should be banned or limited should be a decision taken by legislatures, regulators, and stock

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[58] *See, e.g.*, Matt Levine, *Stocks Are Forever, and Your Future Grandchild Knows It*, BLOOMBERG (Feb. 19, 2018), https://www.bloomberg.com/view/articles/2018-02-19/sec-s-commissioner-sparks-debate-on-dual-class-stocks ("An index provider, whose job is mostly to make lists of what stocks there are, is not necessarily well suited to deciding what stocks there *should* be."); Ann Lipton, *Index as Cartel*, BUS. L. PROF BLOG (Aug. 12, 2017), http://lawprofessors.typepad.com/business_law/2017/08/index-as-cartel.html [https://perma.cc/F42T-6YQ7] ("[I]ndex investors aren't supposed to be actively picking stock characteristics . . . .").

[59] Anita Anand & Adriana Robertson, *Stock Market Indices: Inside the Black Box*, CLS BLUE SKY BLOG (Mar. 21, 2018), http://clsbluesky.law.columbia.edu/2018/03/21/the-lack-of-transparency-in-stock-market-indices [https://perma.cc/PAX2-V7BN].

[60] Robert J. Jackson Jr. & Steven Davidoff Solomon, *What's Really in Your Index Fund?*, N.Y. TIMES, Feb. 19, 2019, at A23.

[61] *Id.*

[62] *See supra* note 59. Professors Anand and Robertson also query: "Given the extent to which the market relies on the information that indices provide, should they be subject to some form of regulatory oversight, including disclosure requirements? These are pressing questions that merit urgent answers." Anand & Robertson, *supra* note 59.

exchanges, not index providers."[63] Mark Makepeace, head of FTSE Russell, emphasized the passive role of index providers, stating that "[w]e're not activists. . . . [O]ur role is to build consensus amongst that investor community as to what that minimum standard should be."[64] Similarly, MSCI Chairman and CEO Henry Fernandez stated, "We're not looking to play this role."[65]

There is also evidence that the index exclusions were "imposed" on index providers by some of their clients, and that the exclusion tool does not fit well with index providers' preference not to limit their clients' access to the investable universe of public companies. FTSE Russell, for example, emphasized the fact that its index exclusion decision came after considerable consultation with their investors and was aimed to build a consensus among those investors.[66] MSCI's Chairman and CEO said to investors, "[Y]ou push it to us."[67] Given these circumstances, it is likely that index providers' preference would be to appease those investors that oppose the use of dual-class shares, but to do so without making groundbreaking changes.

Further support for the view that index exclusions do not fit the business model and ideology of index providers comes from an S&P policy change in 2014, which cuts in the opposite direction from the index exclusions. At that time, S&P permitted Google Inc. to include both its Class A and Class C shares in the S&P 500 index.[68] S&P representatives explained that this change was due to the trend—especially among tech companies—of offering multiple share classes.[69] Were S&P to ignore the trend, it would have difficulty "properly representing major market segments while providing sufficient liquidity to accommodate trading and necessary index adjustments."[70] Building on that exception, S&P later included in their index two classes of shares of other large dual-class companies such as Comcast Corporation, Fox Corporation, and News

[63] EUROPEAN CORP. GOVERNANCE INST., HARV. L. SCH., GLOBAL CORPORATE GOVERNANCE COLLOQUIUM REPORT 5 (June 2018), https://ecgi.global/sites/default/files/events/_4th_annual_global_corporate_governance_colloquium_small.pdf [https://perma.cc/VP6Y-DESG].

[64] Matt Levine, *Index Providers Can Make or Break Passive Investors*, BLOOMBERG (Nov. 28, 2017), https://www.bloomberg.com/view/articles/2017-11-28/index-providers-can-make-or-break-passive-investors.

[65] Vittorio, *supra* note 55 (referring to comments by MSCI Chairman and CEO Henry Fernandez at CII conference in March 2018).

[66] *See* FTSE RUSSELL, *supra* note 13, at 4-6.

[67] Vittorio, *supra* note 55.

[68] Alex Rosenberg, *Why Google's Split Will Change the S&P 500 Forever*, CNBC (Apr. 2, 2014), https://www.cnbc.com/2014/03/28/why-googles-split-will-change-the-sp-500-forever.html [https://perma.cc/X3VU-876Y].

[69] *Id.*

[70] *Id.*

Corporation.[71] This policy change received significantly less attention than the recent index exclusions, but reveals index providers' true preference to mimic the market as much as possible. The index exclusions tended against this natural inclination.

Third, as we describe in Section I.C below, investors have mixed views regarding the use of index exclusions. While some investors, such as CalSTRS and the CII strongly supported the index exclusions,[72] index fund managers such as BlackRock and Vanguard opposed them.[73] Those investment managers claimed that if index funds were required to exclude certain public companies from their indexes then the index funds would become much less representative of the investment universe the index funds are trying to represent, thereby reducing their value to investors in mutual funds and exchange-traded funds ("ETFs").[74] This divergence of opinions among the clients of index providers caused the index providers to navigate carefully. On the one hand, index providers had to implement some exclusion principles to mollify the investors that opposed the use of dual-class shares and insisted on a response to the Snap IPO. On the other hand, index providers had to restrain their actions to avoid antagonizing those clients that opposed "governance by indexation." Index providers are thus caught between their fear of doing too much and their fear of doing too little.

Fourth, index providers are also likely to prefer gradual changes in the composition of their broad market indexes, rather than sudden and significant changes. Extreme changes in indexes' composition could require index investors to make very large volumes of trades to adjust to the new index composition or weightings.[75] Making more gradual changes would also allow index providers to observe market reactions to their index exclusions before strengthening those exclusions. This concern about sudden significant changes could also explain why index providers would have an incentive to exempt from their exclusion rules those companies that are already included in the index; or at the very least, to allow a "grandfathering" period during which constituent companies could change their capital structure to avoid being excluded.

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71 Joseph Ciolli, *S&P 500 to Add Second Class of Shares for Fox, Comcast, News*, BLOOMBERG (Aug. 10, 2015, 7:43 PM), https://www.bloomberg.com/news/articles/2015-08-10/s-p-500-to-add-second-class-of-shares-for-fox-comcast-news.

72 *See supra* note 29 and accompanying text.

73 *See* Letter from Barbara Novick to Baer Pettit, *supra* note 22, at 4; *infra* notes 81-82 and accompanying text.

74 *See* Koren & Dave, *supra* note 23.

75 *See* Letter from Barbara Novick to Baer Pettit, *supra* note 22, at 1; *see also* Barbara Novick, BlackRock, Inc., *Open Letter Regarding Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG (May 3, 2018), https://corpgov.law.harvard.edu/2018/05/03/open-letter-regarding-consultation-on-the-treatment-of-unequal-voting-structures-in-the-msci-equity-indexes/ [https://perma.cc/M8QS-J7EH].

Finally, the index investing market has become more competitive in recent years. Increasing competitive pressures could cause leading index providers to adopt more relaxed exclusions, so as to avoid losing clients to their competitors.[76] We believe this argument to be the least persuasive of the explanations for index provider reluctance. As we will show in Section III.B.2, there is some "stickiness" in the initial selection of an index by an index fund, and there are likely to be significant hurdles and costs associated with an index fund switching indexes. These include the need to change the index fund's constitutive documents, the loss of network effects, and the risk associated with investing in an index with less brand recognition. These reasons are likely to limit the willingness of index funds to change indexes, and therefore limit the forces of competition on index provider choices. However, collectively, the different factors that we have identified give index providers incentives to be reluctant regulators, at best.

C. *Index Fund Opposition to Index Exclusions*

In this Section we examine a revealing phenomenon: prominent index fund managers clearly disfavor certain governance arrangements such as dual-class exclusions, however they publicly oppose index exclusions aimed at curbing those arrangements.[77] This Section considers the reasons for index fund managers to oppose index exclusions and evaluates the validity of those reasons.

1. Competition for Assets

Some scholars have argued that competition for assets among investment managers influences the behavior of investment managers. Professors Jill Fisch, Assaf Hamdani, and Steven Davidoff Solomon, for example, argue that index fund managers compete for funds "not only with each other but also with active funds."[78]

Investment managers are paid a fixed percentage of their assets under management. They therefore have incentives to increase their assets under

[76] Andrew Winden & Andrew Baker, Dual-Class Index Exclusion 49 (July 24, 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3201578.

[77] *See* Letter from Barbara Novick to Baer Pettit, *supra* note 22, at 1 ("[W]e believe policymakers, not index providers, should set corporate governance standards."); *see also* Koren & Dave, *supra* note 23 (citing Vanguard and SSGA opposition).

[78] Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *Passive Investors* 11 (European Corp. Governance Inst., Working Paper No. 414, 2018). Consistent with this argument, BlackRock's statement indicates that the exclusion rules "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 1 (Oct. 2017), https://www.blackrock.com/corporate/literature/publication/blk-a-potential-solution-for-voting-rights-and-index-inclusion-issues-october2017.pdf [https://perma.cc/NV43-9L7E].

management as much as possible by attracting additional assets from investors.[79] The factors that drive investor assets to different funds have been the subject of much debate. The generally accepted view is that investors make decisions on which investment managers to invest with based on the past performance of those investment managers.[80] If this is the case, then index funds may have opposed index exclusions because they feared that the exclusions would reduce the performance of index funds compared to other fund managers, and would therefore reduce the assets under management—and the revenues—of index funds.

Concern that excluding companies with certain arrangements would reduce index fund performance will only be relevant if (1) companies with those arrangements are likely to significantly outperform other companies and (2) the proportion of the companies that outperform (net of those that underperform) are a substantial proportion of the index. The average company in the S&P 500 represents 0.2% of the index. If such a company outperforms other companies in the index by 5% in a year, having included that company would only increase the aggregate performance of the index by 0.01%, which would be unlikely to affect investor judgments. For larger indexes, such as the Russell 1000 or 2000, the effect would be only 0.005% or 0.0025%. Of course, if excluded companies underperform other companies, then the index will perform better than it would have with the excluded companies. However, if index fund managers are risk averse, they may prefer to give up the possibility of outperforming their peers in exchange for not bearing the risk of underperformance.

Competition with other index funds cannot explain the opposition of index fund managers to index exclusions. If an index excludes a set of companies with disfavored arrangements that nonetheless perform better, on average, than other companies in the index, the index will perform worse than it would have had those companies been included. However, the effect will be the same for all index funds benchmarked to that index. That is, BlackRock's S&P 500 fund will underperform exactly as much as Vanguard's S&P 500 fund, so BlackRock will not be concerned about losing investments to Vanguard. Might BlackRock be concerned about investors switching to an index fund that has not excluded companies with disfavored arrangements to the same extent? All of the "Big Three" index fund managers offer index funds that are linked to the indexes of each of the three index providers. As a result, it is unlikely that BlackRock would lose investors that preferred a Russell index to an S&P index. Instead such investors are equally or more likely to switch from BlackRock's S&P index fund to BlackRock's Russell index fund.

[79] *See, e.g.*, Bebchuk, Cohen & Hirst, *supra* note 8, at 90.

[80] *See, e.g.*, Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589, 1590 (1998) ("Mutual fund consumers chase returns, flocking to funds with the highest recent returns, though failing to flee from poor performers.").

A more plausible explanation for index fund opposition to index exclusions is a concern that, were companies with disfavored arrangements to substantially outperform other companies, index funds would underperform actively managed funds, and lose assets to them. However, concern about the underperformance of index funds will be lessened based on two factors. First, managers of index funds also manage actively managed funds. For instance, BlackRock also manages many actively managed funds.[81] As a result, any assets lost because of the underperformance of index funds that exclude companies with disfavored arrangements would be offset by funds gained by its outperforming actively managed funds.

Second, many actively managed funds are, in fact, "closet indexers"—their investment patterns overlap substantially with the indexes against which they benchmark their performance.[82] That is, a significant proportion of those actively managed follows the composition of the indexes to which they benchmark. This suggests that if companies with disfavored arrangements were to be excluded from important indexes, then many actively managed funds would also drop those companies from their indexes. Actively managed funds that did so would not outperform index funds, and would not threaten to take assets under management from index funds.

2. Ideological Preference to Cover the Market

The second stated reason for BlackRock's opposition to the index fund exclusion was their view that "broad market indexes should be as expansive and diverse as the underlying industries and economies whose performance they seek to capture."[83]

This claim rings slightly hollow, for three reasons. First, the moderate exclusionary rules of the three indexes would only exclude some dual-class shares, retaining access to those sectors of the economy. Second, the S&P Composite indexes do not reflect the investable universe by including all eligible companies in all industries.[84] Instead, a committee selects a set of companies that they believe will reflect the returns of major industries. If the index selection committee chooses poorly there may already be some parts of the investable universe that are not covered by the S&P Composite index. Following the index exclusions, the selection committee could adjust the index to ensure that all

[81] *See, e.g.*, BlackRock, Inc. Annual Report (Form 10-K), at 6 (Feb. 28, 2019) (breaking out assets under management by active and passive products).

[82] For empirical evidence on the prevalance of closet indexers, see generally K.J. Martijn Cremers & Antti Petajisto, *How Active Is Your Fund Manager? A New Measure that Predicts*, 22 REV. FIN. STUD. 3329 (2009).

[83] Letter from Barbara Novick to Baer Pettit, *supra* note 22, at 1.

[84] *See, e.g.*, S&P DOW JONES INDICES, S&P U.S. INDICES METHODOLOGY 9-12 (Jan. 2019). For recent work discussing the discretionary nature of index funds, see generally Adriana Robertson, *Passive in Name Only: Delegated Management and "Index" Investing*, YALE J. ON REG. (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3244991.

industries are adequately covered. Third, at least one part of the economy has already been excluded from major indexes. Since 2006 the SEC has required investment funds that own shares of business development companies ("BDCs")—publicly traded investment companies that invest in small- and medium-sized companies—to disclose the fees and expenses of the BDCs.[85] In 2014, following pressure from index funds, FTSE Russell and S&P Global excluded BDCs from their indexes.[86]

Additionally, the three major indexes—FTSE Russell, MSCI, and S&P—also adopted eligibility criteria stipulating that companies must have a U.S. domicile in order to be included in the index.[87] Therefore, e-commerce giant Alibaba and many other foreign firms listed on U.S. exchanges are excluded from major indexes.[88] Additional ineligible organizational structures include publicly traded limited liability companies, limited partnerships, and master limited partnerships.[89] There have been no public statements from index fund managers opposing those exclusions, even though they reduced the expansiveness and diversity in which index fund investors invest.[90]

3. Incentives to Be Deferential to Portfolio Company Managers

A third reason why index fund managers may oppose index exclusions relates to their incentives to be excessively deferential to the managers and insiders of their portfolio companies. One of us—with other co-authors—has examined the

[85] Fund of Fund Investments, Investment Company Act Release No. 33-8713, 71 Fed. Reg. 36,639, 36,640-45 (June 27, 2006) (amending Form N-1A to require disclosure of "Acquired Fund Fees and Expenses" in certain circumstances).

[86] *See, e.g.*, DOW JONES INDICES, *supra* note 84, at 6 (listing BDCs as an organizational structure that is ineligible for index inclusion) EVERSHEDS SUTHERLAND, A CLOSER LOOK: IMPACT OF THE SEC'S AFFE RULE ON BDCS, https://www.publiclytradedprivateequity.com /portalresource/WhatIsTheAFFERule.pdf [https://perma.cc/F9KZ-NDAG] (last visited Apr. 13, 2019).

[87] S&P DOW JONES INDICES, *supra* note 84, at 5 (stating that "[o]nly common stocks of U.S. companies are eligible").

[88] Dennis Hudachek, *Alibaba IPO's Huge ETF Conundrum*, ETF.COM (Sept. 15, 2014), https://www.etf.com/sections/blog/23268-alibaba-ipos-huge-etf-conundrum.html?nopaging =1 [https://perma.cc/R6XA-V35S] ("The exclusion of Alibaba from most MSCI- and FTSE-based ETFs has some big implications from the perspective of Alibaba shares and ETF investors, since the lion's share of assets in emerging market ETFs are tied to MSCI and FTSE-based indexes."); Tomi Kilgore, *Alibaba Can't Join in the S&P 500*, MARKETWATCH (Sept. 12, 2014), https://www.marketwatch.com/story/aliba ba-cant-join-in-the-sp-500-2014-09-12 [https://perma.cc/A2HH-7SDU].

[89] *See, e.g.*, S&P DOW JONES INDICES, *supra* note 84, at 6.

[90] Indeed, it is plausible to assume, at least in the case of the exclusion of BDCs, that the large index fund managers favored these exclusions, as those index fund managers would avoid having to include the fees and expenses of the BDCs in their expense ratios, which might then compare unfavorably with actively managed funds.

incentives of index fund managers.[91] Among other things, index fund managers have an incentive to be excessively deferential to the corporate managers of their portfolio companies.[92] For instance, index fund managers have a variety of business ties to public corporations, including those that they hold in their portfolios, and they may be concerned about losing those valuable ties were they to take positions that the managers of those corporations disfavored.[93] Because index fund managers hold substantial positions in many public companies, they are also particularly susceptible to regulatory intervention. Were they to frequently take positions that corporate managers disfavor, then those managers might ignite a regulatory or public backlash against index fund managers.[94] These incentives are likely to push index fund managers to generally adopt practices that are more deferential to managers. There is also evidence that these incentives influence the actions that index fund managers take with respect to regulatory and judicial matters.[95] It follows that those incentives might also influence index fund managers to take a position on index exclusions that corporate insiders are likely to prefer.

In sum, the discussion above suggests that neither of the reasons given by BlackRock for its opposition to the index exclusions—the rational objection based on competition with other funds and the principled reason based on the desire to increase the investable universe—are based on valid reasoning.

II. A THEORY OF THE EFFECTS OF INDEX EXCLUSIONS

This Part provides a comprehensive theory of index exclusion and its impact on insiders' decision-making. Section II.A sets forth a structural analysis of insiders' incentives, showing that index exclusions are likely to have a limited effect on their choices as to whether to adopt (or retain) disfavored arrangements. Section II.B sheds light on a number of reasons why, on the other hand, the index exclusions should not be expected to have zero effect, as some scholars have recently argued.[96]

A. *The Limited Effects of Index Exclusion*

The starting point for our analysis is that, unlike mandatory regulation that bans certain governance practices, the use of index exclusion would not necessarily eliminate the targeted practices. However, at least in theory, index exclusions should increase the cost of capital for excluded companies. This is because index funds who make up a significant percentage of demand for most

[91] *See generally* Bebchuk, Cohen & Hirst, *supra* note 8; Bebchuk & Hirst, *supra* note 26.
[92] Bebchuk & Hirst, *supra* note 26 (manuscript at 21).
[93] *Id.* (manuscript at 23-25).
[94] *Id.* (manuscript at 27-29).
[95] *Id.* (manuscript at 48-52).
[96] *See* Winden & Baker, *supra* note 76, at 49.

public companies, as well as the closet indexers that follow indexes to some extent, will not purchase the company's stock. And if index funds and closet indexers will not buy the stock of those companies (or will have to sell the stock of newly excluded companies that they currently hold), then the price that investors will be willing to pay for the company stock will be depressed when the exclusion comes into effect.[97] It has also been argued that inclusion in an index leads to greater liquidity, and therefore a decline in investors' required rate of return, promoting higher prices.[98]

However, as we describe below, it is unlikely that index exclusions will significantly deter disfavored arrangements, for a number of reasons: (1) the financial effect of the index exclusion on firm value is not likely to be very large in the first place; (2) in many cases the company might not be included in any case because index providers exercise some discretion with respect to certain indexes; (3) index inclusion might only occur at some time in the future, and therefore its beneficial effects need to be discounted to present value; and (4) where any index inclusion would only occur at some point in the future, insiders can go public with a disfavored arrangement at the IPO stage and retain the option to change that arrangement when the company would otherwise satisfy the preconditions for index inclusion. These factors must also be weighed against the private benefits that insiders derive from adopting the disfavored arrangements, which will often be significant and sufficient to outweigh the cost to the insiders of the index exclusions. Moreover, when the decision whether to retain a disfavored arrangement is made midstream in a company's existence, the costs from the index exclusion are divided among all shareholders, whereas the insiders fully capture private benefits of control from the disfavored governance arrangements. Below we consider each of these factors in turn.

(1) The financial effects of index inclusion on stock prices. There is considerable financial research regarding the effects of index inclusion on stock prices.[99] As noted above, the basic presumption in this literature has been that adding a stock to an index will create increased expected demand from the index funds and closet indexers tracking the index, which will in turn increase the price of the stock. Indeed, early studies by financial economists estimate that inclusion in the S&P 500 index increases firm value between 3% and 8.8%.[100]

[97] Matt Levine, *The End of Libor and Non-Voting Stock*, BLOOMBERG (July 27, 2017, 9:36 AM), https://www.bloomberg.com/view/articles/2017-07-27/the-end-of-libor-and-non-voting-stock; *see also* Anand & Robertson, *supra* note 59; Tan & Robertson, *supra* note 19 (quoting Jay Ritter).

[98] *See, e.g.*, Shantaram P. Hegde & John B. McDermott, *The Liquidity Effects of Revisions to the S&P 500 Index: An Empirical Analysis*, 6 J. FIN. MARKETS 413, 459 (2003) (noting improved liquidity expectations).

[99] For a survey of this literature, see Pyemo N. Afego, *Effects of Changes in Stock Index Compositions: A Literature Survey*, 52 INT'L FIN. ANALYSIS 228, 239 (2017).

[100] Messod D. Beneish & Robert E. Whaley, *An Anatomy of the "S&P Game": The Effect of Changing the Rules*, 51 J. FIN. 1909, 1924-25 (1996); Honghui Chen, Gregory Noronha &

More recent studies find a much more limited effect, concluding that the S&P 500 index exclusion effect has essentially disappeared in recent years and may never have been a real source of long-term lower capital costs.[101] We note, however, that these studies are limited to inclusion in the S&P 500 index. It well may be inclusion in the S&P 500 index brings limited benefit, because the newly included company was previously included in other indexes, such as the S&P 400 or the Russell 1000. In other words, these studies cannot be taken as evidence that exclusion from all of these indexes would have no effect.

Early studies on the S&P 500 index inclusion effect were extended to other indexes in the 1990s and early 2000s. These studies show positive price effects, similarly to the findings that were found in earlier studies on the S&P 500 inclusion effect.[102] Most relevant for our purposes are studies that focus on the index inclusion and exclusion effect for the Russell 2000 index. One study considers index premiums from 1990 to 2005 and finds price effects for inclusions of 8.8% for the S&P 500 and 4.7% for the Russell 2000, and price effects for deletions of 15.1% for the S&P 500 and 4.6% for the Russell 2000.[103] A second study found that investors in S&P 500 funds lost between 0.03% and 0.12% annually from index changes, while investors in Russell 2000 funds lost between 1.3% and 1.84% each year from index changes.[104]

Vijay Singal, *The Price Response to S&P 500 Index Additions and Deletions: Evidence of Asymmetry and a New Explanation*, 59 J. FIN. 1901, 1908 (2004) (showing that between 1976 and 1989 gains equaled 3.17%, and between 1990 and 2000, 5.45%); Anthony W. Lynch & Richard R. Mendenhall, *New Evidence on Stock Price Effects Associated with Changes in the S&P 500 Index*, 70 J. BUS. 351, 351-52 (1997) (showing that between 1990 and 1995 gains equaled 3.80%); Antti Petajisto, *The Index Premium and Its Hidden Cost for Index Funds*, 18 J. EMPIRICAL FIN. 271, 272 (2011) (showing that between 1990 and 2005 gains equaled 8.8%, and from 2001 to 2005, 4.5%); Andrei Shleifer, *Do Demand Curves for Stocks Slope Down?*, 41 J. FIN. 579, 584 (1986) (showing that between 1976 and 1983 stocks added to the S&P 500 experienced abnormal returns of about 3% one day after the announcement); William B. Elliott et al., *What Drives the S&P 500 Inclusion Effect? An Analytical Survey*, FIN. MGMT., Winter 2006, at 31, 32 (showing that between 1993 and 2001 gains equaled 5.67%).

[101] *See* Konstantina Kappou, *The Diminished Effect of Index Rebalances*, 19 J. ASSET MGMT. 235, 243 (2018) (finding that newly added firms inflate S&P 500 index by less than ten basis points per year); Nimesh Patel & Ivo Welch, *Extended Stock Returns in Response to S&P 500 Changes*, 7 REV. ASSET PRICING STUD. 172, 208 (2017) (claiming that since 2000s, stocks no longer experience permanent shifts in investor demand when they are added or removed from the S&P 500); Jan Schitzler, *S&P 500 Inclusions and Stock Supply*, 48 J. EMPIRICAL FIN. 341, 356 (2016) (showing that index inclusion effect based on stock demand and supply has disappeared); Chan Wung Kim, Xiao Li & Timothy T. Perry, *Adaptation of the S&P 500 Index Effect*, J. INDEX INVESTING, Summer 2017, at 29, 36 (finding no evidence of positive price drift between announcement date and effective date for newly added stocks from 2010 to 2013). For a review of this literature, see Winden & Baker, *supra* note 76, at 50.

[102] For a list of these studies, see Winden & Baker, *supra* note 76, at 19 nn.52-53.

[103] Petajisto, *supra* note 100, at 272.

[104] Honghui Chen, Gregory Noronha & Vijay Singal, *Index Changes and Losses to Index Fund Investors*, FIN. ANALYSTS J., July/Aug. 2006, at 31, 47.

While this empirical evidence regarding the financial benefits of index exclusion is mixed, it appears to show that index inclusion has relatively limited benefit. If one follows the later studies on the S&P 500 effect to conclude that index inclusion has no price impact, then index exclusions should have no impact on insiders' decisions whether to adopt disfavored corporate governance arrangements. While we believe there are reasons to be cautious about applying these studies to conclude that exclusion from *all* indexes would have no effect, at best these studies would suggest that the financial benefits from index inclusion are limited.

(2) Delayed impact of the index exclusion penalty. Most indexes have minimum market capitalization levels for inclusion, and many IPO companies will be too small to be immediately eligible for inclusion. Instead, they will need to wait some time until their market capitalization has grown sufficiently to be eligible for inclusion. As a result, the costs to those companies from an index exclusion must be discounted by the time value of money for the period until they would otherwise be eligible for inclusion. The longer the delay, the lower the costs to insiders from an index exclusion. In contrast, the benefits to insiders from the disfavored governance arrangement will accrue immediately, from the time of the IPO. The delay until an IPO company becomes eligible for index inclusion also increases the likelihood that, by the time it is eligible, index providers may have amended their policies to remove or weaken the index exclusion, thereby allowing the company to be included despite having the disfavored arrangement.

(3) Conditionality. As noted earlier, inclusion in S&P composite indexes, including the S&P 500, is discretionary.[105] Since S&P exercises discretion regarding which companies are included in those indexes, a company may not be included whether or not it has the disfavored governance arrangement. The reduced likelihood of being included in these indexes further reduces the relative cost of index exclusions.

(4) Optionality. The delayed impact of the index exclusion rules also allows insiders that go public with a disfavored governance arrangement to have the option to remove that arrangement immediately before they would otherwise become eligible for index inclusion. As a result, even if insiders do wish to be included in the index at some point in the future, they have no reason to avoid the disfavored governance arrangement when they go public. They have a "free option."[106] The availability of that option further reduces the cost to insiders of index exclusions.

Putting these factors together, the expected reduction in firm value due to index exclusions can be thought of as the cost of being excluded from the index,

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[105] *See supra* note 84 and accompanying text.

[106] Anita Balakrishnan, *Start-Ups Go Public to Get Your Money — Your Input on How It's Spent Is Now Optional*, CNBC (Aug. 5, 2017), https://www.cnbc.com/2017/ 08/05/snap-exclusion-from-sp-500-wont-stop-multiple-share-classes.html [https://perma.cc/YK37-94 KY].

multiplied by the probability of the company not being discretionarily excluded in any case, discounted by the time it would otherwise take for the company to enter the index.

Insiders will weigh their costs against the benefit they receive from the disfavored governance arrangement. In contrast to the index exclusion effects, these private benefits will accrue from the time of the IPO, so are not subject to a time-value discount. These benefits are also certain, rather than conditional. And the insider has the free option to trade those benefits for index inclusion by eliminating the disfavored arrangement when the company would otherwise become eligible for inclusion in the index. As a result, all else being equal, we predict that index exclusions will give insiders limited incentives to avoid disfavored arrangements that the insiders prefer.

B. *The Non-Zero Effect of Index Exclusions*

So far, we have explained why index exclusions are likely to have limited effect on insiders' incentives to go public with disfavored arrangements. Does this mean that index exclusions have no effect and should be eliminated as some have argued? We do not believe so. In this Section, we describe several reasons why people should not expect index exclusions to have zero effect.

1. Reduced Demand for Excluded Stock

First, the index exclusion will reduce the demand for excluded stocks among a number of different groups. Most obviously, index funds benchmarked to those indexes will no longer purchase shares in the excluded companies. However, the reduced demand will also affect a number of other groups of investors.[107]

As discussed above, many actively managed funds are actually closet indexers.[108] Once a company is excluded from an index there may be a domino effect that pushes closet indexers to also divest from that company. This will further decrease the demand for the shares of companies excluded from the index. While some active funds that have investment beliefs about excluded companies may still buy the excluded companies' shares, those actively managed funds that do not have particular views on excluded companies are likely to follow the index, and would therefore also exclude those companies from their portfolios.

A number of other active managers that oppose the particular governance arrangement may have nonetheless bought shares of dual-class companies in the past because they wished to reduce the "tracking error" of their portfolio when measured against baseline indexes. Those funds will no longer have an incentive to invest in dual-class companies, so they can exercise their preferences against investing.

[107] John C. Coates IV, The Future of Corporate Governance Part I: The Problem of Twelve 20 (Sept. 20, 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337.

[108] *See* Cremers & Petajisto, *supra* note 82, at 3331.

As a result, there is likely to be reduced demand for those companies that are excluded from the index. That reduced demand, in turn, is likely to have some effect on the price of their stock. Whether this effect will be strong enough to deter founders from taking their companies public with a disfavored governance structure is a separate question that depends on the size of the reduced demands, the private benefits that the founder derives from the dual-class structure, as well as other factors mentioned in Section III.A.

2. Stickiness

It could be possible that excluding certain companies from an index might cause investment managers that prefer to invest in dual-class stock to instead link their index funds to an index that does include companies with the disfavored governance arrangement. Alternatively, investors in index funds that no longer include dual-class stock might switch to another index fund that does. However, both of these decisions are likely to display significant "stickiness," which is likely to limit the extent to which the market adjusts to the exclusion of those companies, for several reasons.

First, it will likely be difficult for investment managers to change the index to which a particular fund is benchmarked. The foundational documents of most index funds indicate that their strategy is to follow a particular index.[109] In order to change those documents, the fund would require a vote of the investors in the fund, which may be impossible; even if it were possible, it would be costly and expensive. Therefore, in order to switch indexes, a fund manager would have to set up a new fund, benchmarked to a different index, and channel its investors into that fund.

Second, investors may be resistant to switching to a new index fund, so may not follow the fund manager's channeling, and even if they have their own preference for including dual-class companies in their portfolio, they may not act on that preference by switching to a fund linked to an index that does. Index providers have spent considerable amounts marketing their brands, which is reinforced by the marketing of index fund managers that encourage investors to invest in funds that are linked to those brands. A new index provider would have considerably less brand recognition. Even if an existing provider created a new index, that index would have less brand recognition than their existing indexes.

There is also a network effect that operates with respect to existing indexes. The large number of investment funds that benchmark to that index—whether index funds or actively managed funds that compare their performance to the index—makes that index more attractive as a benchmark for a new entrant, because they can compare their performance to the same benchmark as those other funds, which will be useful for investors attempting to compare investments. Conversely, it will be much less useful for a new fund to benchmark to an index that has very few other investors benchmarked to it,

[109] *See, e.g.*, iShares Trust, iShares Core S&P 500 ETF 2018 Prospectus (Form 485) (Aug. 1, 2018) (describing investment objective of fund).

because it will not be able to compare its performance easily to competing funds. As a result, it is unlikely that market forces would nullify the index exclusion.

3. Symbolic significance

At the very least, the index exclusion represents a symbolic win for investors in the battle on the future U.S. IPO market. Professors Marcel Kahan and Ed Rock have considered the possibility that many corporate governance debates contain a significant symbolic element.[110] That investors were able to convince index providers to exclude disfavored arrangements suggests that investors have some power, even if this exclusion does not substantially reduce the number of companies going public with such governance arrangement.

III. THE DUAL-CLASS INDEX EXCLUSION

In this Part, we apply our general analysis to one of the most important applications of index exclusion rules to date: the case of the dual-class exclusions.

A. *Opposition to Dual-Class Structures*

Institutional investors have long expressed opposition to dual-class share structures.[111] As Professor Lucian Bebchuk and one of us analyzed, dual-class share structures generate significant governance risks because they feature a unique combination of entrenchment and incentive misalignment.[112] Controllers of dual-class companies own only a small fraction of the company's equity capital and thus bear only a small (and sometimes extremely small) share of the costs that their actions may inflict on the company's value. Despite this, they exercise effective control over decision-making and can capture the full private benefits of that control. This means that they may tolerate underperformance by the company where their private benefits from control offset the effect of the underperformance on their relatively small shareholdings. More importantly, these dual-class structures fully insulate minority controllers from market disciplinary forces. There is no threat that shareholders may remove them no matter how poor their performance as managers or how harmful the effects of their management on the interests of other public investors. This combination of entrenchment and weak ownership incentives could well lead to a wide range of distorted choices by the controller.

For these reasons, a broad group of investors appear to disfavor dual-class voting structures. Most large investment managers and asset owners have

[110] Marcel Kahan & Edward Rock, *Symbolic Corporate Governance Politics*, 94 B.U. L. REV. 1997, 1998 (2014).

[111] *See supra* notes 28-29 and accompanying text.

[112] Lucian A. Bebchuk & Kobi Kastiel, *The Perils of Small-Minority Controllers*, GEO. L.J. (forthcoming 2019) (manuscript at 8-10), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3128375.

policies in favor of equal voting rights.[113] In addition, when shareholders at annual meetings vote on proposals requesting that companies adopt equal voting rights with dual-class voting structures, large investment managers and asset owners generally vote in favor of equal voting rights. Tables 1 and 2 below show the proportion of the votes on such shareholder proposals of each of the ten largest U.S. investment managers and five largest U.S. asset owners, respectively, that were in favor of, against, or split on proposals that went to a vote between 2013 and 2017. Tables 1 and 2 show that each of the largest investment managers and asset owners voted in favor of equal voting rights at least eighty-five percent of the time; and eight of the ten investment managers and all of the five asset owners voted in favor more than ninety percent of the time.

Table 1. Investment Manager Voting in Shareholder Proposals Requesting One-Share One-Vote, 2013-2017.

Investment Manager	***Meetings***	***For***	***Against***	***Split***
BlackRock	51	88.2	9.8	2
Vanguard	50	94	6	0
State Street Global Advisors	49	100	0	0
Fidelity Management & Research	40	85	10	5
BNY Mellon	48	100	0	0
JPMorgan Investment Management	43	90.7	4.7	4.7
Goldman Sachs Asset Management	43	100	0	0
T. Rowe Price Associates	41	100	0	0
Wellington Management Company	40	97.5	2.5	0
Northern Trust Investments	48	100	0	0

[113] *See supra* note 29; *see also* Bebchuk & Kastiel, *supra* note 51, at 597-98.

Table 2. Asset Owner Voting in Shareholder Proposals Requesting One-Share One-Vote, 2013-2017.

Asset Owner	*Meetings*	*For*	*Against*	*Split*
New York State Teachers' Retirement System	37	100	0	0
California Public Employees' Retirement System (CalPERS)	43	95.3	4.7	0
California State Teachers' Retirement System (CalSTRS)	47	100	0	0
Florida State Board of Administration	48	100	0	0
New York City Pension Funds	29	100	0	0
The New York State Common Retirement Fund	36	100	0	0

It is important to emphasize that investors' strong preference against the use of dual-class shares without time limitation—as reflected both in their guidelines and voting patterns—is not contingent on the pricing of these arrangements. If investors' major concern were that these arrangements were inappropriately priced, then those investors could refine their guidelines or voting decisions accordingly; they would support dual-class shares if they believed that they were priced appropriately. However, most outside investors do not show such support. Instead, they express strong and clear opposition to dual-class structures that do not contain sunset provisions, whereby the structures would expire after a certain period of time.[114] This opposition is consistent across different companies, regardless of how the shares of those companies are priced.

Moreover, the pricing mechanism does not assure that dual-class structures will not emerge against the preferences of outside investors; nor does it resolve the tension between outside investors' revealed preferences and the structures put in place by insiders at the IPO stage. Even if the pricing mechanism were to work perfectly—a strong assumption by itself—then at best it would cause insiders to fully internalize the costs of using dual-class structures, but it would not prevent the emergence of these structures.

[114] Bebchuk & Kastiel, *supra* note 51, at 597-98. A recent survey by Institutional Shareholder Services indicates that this view is shared among many institutional investors. The survey included 120 responses from institutional investors. Fifty-seven percent supported negative recommendations against directors at companies that go public with dual-class stock, and an additional twenty-four percent supported negative recommendations as long as there was no sunset provision on the unequal voting rights. Marc Goldstein, Institutional S'holder Servs., Inc., *2016-2017 Annual Benchmark Voting Policy Survey*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 5, 2016), https://corpgov.law.harvard.edu/2016/10/05/2016-2017-annual-benchmark-voting-policy-survey/ [https://perma.cc/2CDV-WLY2]. For CII's statement supporting the use of a sunset provision, see *supra* note 36.

B. *The Demand for Dual-Class Exclusions*

The use of dual-class structures is not a new phenomenon. Insiders taking their companies public have been using unequal voting for many years. This has spurred a similarly long-running debate regarding the overall efficiency of dual-class structures. This Section considers the factors that have triggered the recent push for index exclusion to limit dual-class structures, and the institutional background and factors that led to index exclusion rules. In particular, we highlight two main factors: the rise in the number of dual-class IPOs and the increasing concern from the use of extreme separation mechanisms and investors' willingness to avoid ratcheting. While the Snap IPO was the straw that broke the camel's back, it came against the backdrop of these two important factors that generated significant opposition among institutional investors.

1. The Increasing Frequency of Dual-Class IPOs

In recent years there has been a rise in the number of dual-class IPOs. In particular, since Google went public with a dual-class voting structure in 2004, the incidence of dual-class structures among IPO companies has increased considerably. According to recent data, 19% of U.S. companies that went public on U.S. exchanges in 2017 had at least two classes of stock with differential voting rights, up from only 1% in 2005.[115]

The use of dual-class IPOs is even more prevalent among large IPOs. The law firm Shearman & Sterling LLP wrote a comprehensive annual report which considered IPOs of companies with a market capitalization of at least $100 million. The study found that 29% of the 62 such IPOs in 2015 had a multi-class structure, 19% of the 32 IPOs in 2016 had a multi-class structure, and 39% of the 59 IPOs in 2017 had a multi-class structure.[116]

2. The Increasing Inequality of Dual-Class IPOs

In recent years there has also been a rise in the number of companies that have gone public with extreme separation mechanisms. These mechanisms provide insiders with an absolute lock on control while still allowing insiders to unload a significant fraction of their equity stake. A prominent example is, of course, Snap's issue of non-voting shares in its IPO. Altice USA, Inc. and Blue Apron Inc. are two other high-profile companies that went public with charters that

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[115] Press Release, Council of Institutional Inv'rs, Investors Petition NYSE, NASDAQ to Curb Listings of IPO Dual-Class Share Companies 3 (Oct. 24, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/FINAL%20Dual%20Class%20Petition%20Press%20Release%20Oct%2024,%202018.pdf [https://perma.cc/3PFN-E9H6].

[116] SHEARMAN & STERLING LLP, CORPORATE GOVERNANCE & EXECUTIVE COMPENSATION SURVEY 2018, at 53 (2018), http://digitsal.shearman.com/i/1019978-2018-corporate-governance-survey/0? [https://perma.cc/JUQ5-CUQ6] (stating multi-class equity share statistics). The study excluded IPOs of foreign private issuers, special purpose acquisition companies, master limited partnerships, and REITs.

authorize zero-vote shares, although the shares that both companies issued in their IPOs did have voting rights.[117] Other well-known dual-class companies, such as Google, Facebook, IAC/InterActiveCorp, NRG Yield, Inc., and Under Armour, Inc. have initiated midstream reclassifications that enabled the issuance of a third class of non-voting shares[118] (although Facebook and IAC/InterActiveCorp later abandoned these plans in the face of shareholder lawsuits).[119]

These extreme dual-class IPOs and reclassifications were met with strong opposition from investors. Why do investors care about such non-voting shares? In the typical dual-class company where investors do have voting rights, the majority—or a large minority—of the voting power of the company is held by the controller. Even though they have the right to vote, outside investors are therefore generally unable to influence voting outcomes at the company.

There are a number of reasons why non-voting shares have encountered such opposition from investors. First, the distortion of the controller's incentives becomes more severe as the gap between the controller's cash-flow rights and voting rights widens. Also, where there are extreme separation mechanisms, the controller is unlikely to lose control in the future even if the controller disposes of almost all of its cash-flow rights in the company.[120] Second, where outside shareholders lack the right to vote, the company is not required to file a proxy statement or, therefore, to disclose to investors certain important information that the proxy statement would otherwise contain.[121]

Finally, and most importantly, this process can be seen as a ratcheting interaction among insiders and investors. Insiders in a particular IPO company have the opportunity to put in place a dual-class structure with greater inequality than has been used in the past. Advisors to IPO companies observe the response of investors to these proposed structures. If investors continue to buy shares in the IPOs of such companies without significant protest, then the level of inequality becomes the new limit on the arrangements that investors are prepared to accept. The process repeats, ratcheting the inequality of voting structures to ever higher levels, until investors finally protest the increasing inequality. Google's IPO in 2004 was a test case in an IPO market that had seen almost no dual-class IPOs in the preceding years. The success of Google's IPO led to a

[117] Altice USA, Inc., Prospectus (Form 424B4), at 10 (May 24, 2018); Blue Apron Inc., Prospectus (Form 424B4), at 10-11 (June 29, 2017).

[118] Snap Inc., *supra* note 1; Bebchuk & Kastiel, *supra* note 112 (manuscript at 32-33).

[119] Bebchuk & Kastiel, *supra* note 112 (manuscript at 32).

[120] We note, however, that even with the more common 1:10 low-high vote ratio, the controller would be able to maintain control voluntarily.

[121] Dov Solomon, *The Importance of Inferior Voting Rights in Dual-Class Firms*, BYU L. REV. (forthcoming 2019) (manuscript at 21), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3179375. However, these companies could, and some of them do, disclose financial information to investors. Snap, for example, continues to publish, annually, quarterly, and immediate reports following its IPO. *Id.* (manuscript at 23).

wave of other dual-class IPOs. Since that time, most dual-class companies have gone public with a high-to-low vote ratio of 10-to-1.[122] However, Snap deviated from this practice. Snap's IPO also took place against the backdrop of a number of dual-class reclassifications that included the issuance of an additional class of non-voting stock.[123] There was a concern among investors that Snap would set a precedent, and that other companies going public would follow suit.[124] The situation was a question of who would blink first. The response of investors, and their calls for index exclusions for dual-class stock, are also partly explained by their interest in avoiding further ratcheting.

C. *The Dual-Class Exclusions as Evidence of Index Providers' Reluctance to Regulate*

This Section shows that index providers' tendency to act as reluctant regulators is clearly reflected in the dual-class exclusion rules they adopted. Since the index exclusions were very much imposed on index providers by some of their clients, the exclusion rules that index providers chose reflect a desire to appease those investors without making groundbreaking changes. As we show below, each of the index exclusions therefore contains important loopholes and limitations.

1. S&P Dow Jones

S&P will no longer add companies to those indexes if the company has a multiple share class structure. This appears to be a strict, flat exclusion rule.[125] However, existing index constituents with dual-class structures are "grandfathered" in—they are not affected by the exclusion.[126] Additionally, the exclusion applied only to the S&P Composite 1500 and its component indexes, including the S&P 500. The S&P Global BMI Indexes and S&P Total Market Index will continue to include companies with dual-class shares, including those with limited or no shareholder voting power.[127] Moreover, the methodologies of other S&P and Dow Jones branded indexes, which allow the index provider

[122] Bebchuk & Kastiel, *supra* note 112 (manuscript at 21).
[123] *See supra* note 118-119 and accompanying text.
[124] *See infra* notes 157-158.
[125] *See supra* note 11 (announcing decision regarding multi-class shares and voting rules).
[126] *See supra* note 11.
[127] *S&P Dow Jones Indices Announces Decision on Multi-Class Share and Voting Rules*, PR NEWSWIRE (July 31, 2017) [hereinafter *S&P Dow Jones Indices*], https://www.prnewswire.com/news-releases/sp-dow-jones-indices-announces-decision-on-multi-class-shares-and-voting-rules-300496954.html [https://perma.cc/8ZHV-UPLF] (publishing S&P Dow Jones Indexes' decision); *see also* S&P DOW JONES INDICES, *supra* note 84 (releasing official decision on multi-class shares and voting rules).

significant discretion regarding which companies to include in its indexes, remain unchanged by the new rules.[128]

Other details of S&P index eligibility rules mean that the S&P index exclusion is unlikely to have an immediate impact on newly public companies for some time. S&P indexes require that IPO companies be traded on an eligible exchange for at least twelve months before the index considers them for addition. Companies must also meet other requirements before being eligible for the S&P Composite 1500 and its component indexes, which further delay the time at which most IPO companies would otherwise become eligible for inclusion in S&P indexes. Most prominently, S&P requires certain minimum market capitalization levels for index inclusion: $6.1 billion for the S&P 500; $1.6 billion for the S&P MidCap 400; and $450 million for the S&P SmallCap 600.[129] In 2017, 98.5% of IPO companies were smaller than the $6.1 billion S&P 500 threshold.[130] Other eligibility requirements that IPO companies must meet include having adequate liquidity and a reasonable price; at least 50% of its equity must be held by the public (its "free float"); and financial viability, demonstrated by positive GAAP earnings in its most recent quarter and in the aggregate over its four most recent quarters.[131] Many IPO companies—especially technology companies—go public before achieving GAAP profitability, so may also need to wait for some time before becoming eligible for inclusion in the S&P Composite 1500 and its component indexes.[132] As discussed in Section II.A, the extended time before index inclusion would occur will reduce the effect of the dual-class exclusion rules, and allow those companies a longer free option to use a dual-class structure before it effectively prevents them from joining an S&P Composite 1500 index.

2. FTSE Russell

The dual-class exclusion adopted by FTSE Russell was limited in a different fashion. Companies will be excluded from the Russell 3000 indexes—including the Russell 1000 and Russell 2000—where outside shareholders have extremely low voting rights or no voting rights at all. To be included in FTSE Russell's

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[128] *S&P Dow Jones Indices*, *supra* note 127. The S&P 1500 composite only includes a sample of companies in their market cap brackets of about thirty percent.

[129] *S&P Dow Jones Indices Announces Changes to U.S. Indices and Updates to U.S. Indices Methodology and Market Cap Guidelines*, PR NEWSWIRE (Mar. 10, 2017), https://www.prnewswire.com/news-releases/sp-dow-jones-indices-announces-changes-to-us-indices-and-updates-to-us-indices-methodology-and-market-cap-guidelines-300422179.html [https://perma.cc/CGM3-7BLW].

[130] Calculated based on IPO dates from Compustat and market capitalization data from FactSet. FACTSET, https://www.factset.com/ (last visited Apr. 23, 2019).

[131] Ben-Tzur, *supra* note 18.

[132] *Id.*

indexes, companies must have at least 5% of their voting rights held by unrestricted public shareholders.[133]

FTSE Russell's index exclusions therefore capture only the most extreme structures of recent IPOs, such as the use of non-voting shares by Snap. Its exclusion will not affect most other types of dual-class structures, where insiders will be able to significantly reduce their fraction of corporate equity and still exercise control over the overwhelming majority of the firm's voting rights. The 5% eligibility standard is significantly lower than the threshold favored by the majority of investors who participated in FTSE Russell's consultation process and thought that higher minimum voting rights hurdle was sensible. Of the investors participating in the process, 23% believed that the hurdle should be set at 5%, while 55% thought that should be set at 25%.[134] FTSE Russell further limited the strength of its index exclusions by allowing those existing dual-class constituents that would otherwise be excluded to remain in the index for the next five years despite not meeting the eligibility criteria.[135]

3. MSCI

MSCI's reluctance was the starkest of the three index providers. MSCI published a consultation paper in January 2018 which took the position that "listed unequal voting shares should be eligible for inclusion in indexes because they meet the definition of equity."[136] In a June 2018 update following its first consultation paper, MSCI recognized that low-voting shares cause a dilemma for investors who choose to passively track an index, and indicated that MSCI intended to adjust the weights of these dual-class stocks in its indexes to reflect both the company's free float and level of voting power in the hands of outside shareholders.[137] However, in October 2018, MSCI rescinded its intention to reduce the weight of dual-class shares and announced instead that companies

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[133] *See, e.g.*, CamberView Partners, *S&P and FTSE Russell on Exclusion of Companies with Multi-Class Shares*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 5, 2017), https://corpgov.law.harvard.edu/2017/08/05/sp-and-ftse-russell-on-exclusion-of-companies-with-multi-class-shares [https://perma.cc/NXZ5-5WV4]. By way of comparison, constituents of FTSE U.K. Index Series are required to have a minimum free float of 25% for U.K. incorporated companies, or 50% for non-UK incorporated companies. *Id.*

[134] FTSE RUSSELL, FTSE RUSSELL VOTING RIGHTS CONSULTATION RESULTS 3 (July 2017), http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Results.pdf [https://perma.cc/4RHL-SK7A].

[135] FTSE RUSSELL, FAQ: MINIMUM VOTING RIGHTS HURDLE 4 (Nov. 2018), https://www.ftse.com/products/downloads/Minimum_Voting_Rights_Hurdle_FAQ.pdf [https://perma.cc/7XJH-N8ZY].

[136] MSCI, SHOULD EQUITY INDEXES INCLUDE STOCKS OF COMPANIES WITH SHARE CLASSES HAVING UNEQUAL VOTING RIGHTS? 3 (Jan. 2018), https://www.msci.com/documents/1296102/8328554/Discussion+Paper_Voting+rights.pdf/ [https://perma.cc/8RLY-25WU].

[137] MSCI, CONSULTATION ON THE TREATMENT OF UNEQUAL VOTING STRUCTURES IN THE MSCI EQUITY INDEXES 2 (June 2018), https://www.msci.com/documents/1296102/8328554/Consultation_Voting+Rights.pdf/ [https://perma.cc/ZYQ6-ERWE].

with dual-class structures would continue to be eligible for inclusion in MSCI indexes, without any weighting adjustment related to their voting structure.[138] MSCI explained that its previous proposed policy has proved to be a polarizing issue among international institutional investors.[139]

The largest MSCI indexes are worldwide indexes, in which U.S. companies have a proportionately smaller weight. That MSCI's index exclusions rules were expected to have less impact on U.S. dual-class companies may explain why there was less pressure on MSCI from U.S. companies to implement dual-class exclusion rules. Conversely, that MSCI's index exclusion rules would have greater influence on non-U.S. companies, which have greater prevalence of unequal voting right structures, may explain why there was greater opposition to MSCI's index exclusion rules from its clients that had proportionally greater investments outside the United States.

The relative weakness of the current formulation of the S&P and Russell dual-class exclusions and MSCI's unwillingness to implement a dual-class exclusion rule, demonstrate the reluctance of index providers to act as governance regulators. The weakness of these rules also has significant implications for the likely effects of the dual-class exclusions.

D. *The Likely Effects of Dual-Class Exclusions*

As discussed in Part II, the decision whether to use a disfavored governance arrangement like a dual-class structure that is the subject of an index exclusion rule will depend on the balance between the cost associated with the index exclusion and insiders' private benefits from that governance arrangement. Therefore, even if the dual-class exclusion imposes additional costs on IPO companies, those costs may be less than the significant countervailing benefits to insiders from using a dual-class structure. Even assuming that insiders fully internalize the costs of the dual-class exclusion at the IPO stage (a strong presumption by itself),[140] insiders who attribute significant value and private benefit to control of the company may be willing to bear the additional costs of the index exclusions. They may therefore go public with a dual-class structure, notwithstanding the index exclusions.

Our analysis suggests the costs to insiders of being excluded from the S&P indexes are expected to be moderate, at best, whereas the private benefits to insiders from maintaining a dual-class structure are likely to be substantial. First, as described in Section II.A, empirical evidence suggests the financial effects of the exclusion on the firm stock price is limited, and some have suggested that

[138] Press Release, MSCI, MSCI Will Retain the MSCI Global Investable Market Indexes Unchanged and Launch a New Index Series Reflecting the Preferences of Investors on Unequal Voting Structures 1 (Oct. 30, 2018), https://www.msci.com/documents/10199/238444/PR_Voting_Results.pdf/ [https://perma.cc/EK8Y-FB9H].

[139] *Id.*

[140] For a discussion of the problems associated with the IPO pricing mechanism, see *supra* note 39 and accompanying text.

there is *no* stock price effect from index exclusion. Second, due to the eligibility criteria of S&P, the impact of the index exclusion would be delayed to some uncertain future point when the company grows to the relevant market capitalization and profitability levels where it would otherwise be eligible for inclusion in the index. Most technology companies may not be eligible for inclusion in the S&P 500 or other S&P Composite Indexes for many years. This delay discounts the effect of the index exclusion: the larger the delay, the lower the costs for the insider. Third, because S&P index inclusion is discretionary, not all dual-class companies would be chosen for inclusion in the S&P even if they were eligible, further reducing the impact of the index exclusion. Finally, the delayed impact of the index exclusions extends insiders' "free option" to continue having a dual-class structure until the company would otherwise be eligible for index inclusion, when it could unify its share structure if it wished to be considered for index inclusion.

Unlike the limited costs of the S&P exclusion, which must be discounted by the time value of money and the uncertainty of index inclusion, the benefits from using a dual-class structure at the IPO stage are substantial, immediate, and certain. We therefore expect that insiders will have relatively weak incentives to relinquish dual-class structures at the IPO stage in order to comply with the S&P dual-class exclusion.

FTSE Russell's dual-class exclusion is likely to have an even weaker deterrent effect. FTSE Russell's exclusion rules can be circumvented relatively easily, by ensuring that public investors always hold slightly more than 5% of the company's voting rights. By maintaining just over 5% public voting rights, a dual-class company would increase their likelihood of being included in at least one important set of indexes: those provided by FTSE Russell. The impact of the Russell dual-class exclusion may also be limited because the financial benefit from inclusion in the FTSE Russell indexes may not be as great as that from inclusion in the S&P indexes. On the other hand, any impact of exclusion from FTSE Russell indexes will be felt much earlier than that related to S&P indexes, since the FTSE Russell index has no time-based eligibility threshold, lower minimum capitalization thresholds, and no discretionary factor limiting the probability of index inclusion. The discounts associated with delayed inclusion will therefore be lower, and there will be no reduction in impact from the uncertainty of index inclusion. The length of an IPO company's free option to have dual-class shares before FTSE Russell index eligibility will also be shorter.

Our analysis so far has focused on the decision whether to adopt a dual-class structure at the IPO stage. What about companies that have already gone public with a dual-class structure? If these companies are not already part of the S&P indexes, then they may face the impact of S&P index exclusion sooner than IPO companies. However, we predict that the potential impact of index exclusions is also likely to be limited. With the exception of the reduced time discount in the impact of the dual-class exclusion, the factors limiting the impact of index exclusions will also apply to midstream companies.

Finally, and most importantly, as Lucian Bebchuk and one of us have demonstrated, controllers have strong structural incentives not to dismantle the dual-class structure *midstream* even if such a structure could have an adverse effect on firm value (such as from dual-class exclusions).[141] Even assuming there is an adverse cost-of-capital effect on firm value from the dual-class structure, that effect will be shared by all investors. The controller's exposure to it will be limited to the proportion of cash-flow rights that the controller holds. This will often be very small, especially for small minority controllers. While the controller will bear only a small percentage of the cost of the dual-class exclusion, the controller will capture the full private benefit of control from the dual-class structure. Moreover, evidence shows that controllers' fractions of the equity capital of their companies tends to decrease over time.[142] When this occurs, insiders will bear an even smaller fraction of the cost of dual-class exclusion, while their incentives to use a dual-class structure to maintain control will increase.[143] This effect is demonstrated by recent empirical evidence showing the persistence of inefficient dual-class structures over time.[144]

E. *Some Preliminary Evidence on the Effects of the Dual-Class Exclusion*

While our analysis in Section III.D suggests that the dual-class exclusions are likely to have limited effects on insiders' incentives to go public with a dual-class structure, this does not mean that the dual-class exclusions are meaningless and should be eliminated, as some have argued. Our analysis in Part II suggests that the benefits of the dual-class exclusions may be non-zero. In this Section, we test these hypotheses by examining (1) the number of dual-class IPOs before and after the announcement of the S&P and Russell index exclusions in July 2017, and (2) the governance terms of these IPOs.

1. The Incidence of Dual-Class Structures in IPOs

We constructed a dataset of dual-class IPOs from three different sources: the Center for Research in Securities Prices database, the FactSet SharkRepellent.net database, and Professor Jay Ritter's list of dual-class IPOs.[145] Consistent with previous studies in the field, we excluded from our dataset financial companies, LLPs, REITs, foreign issuers, and acquisition

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[141] Bebchuk & Kastiel, *supra* note 51, at 613-17.

[142] *Id.* at 607-09.

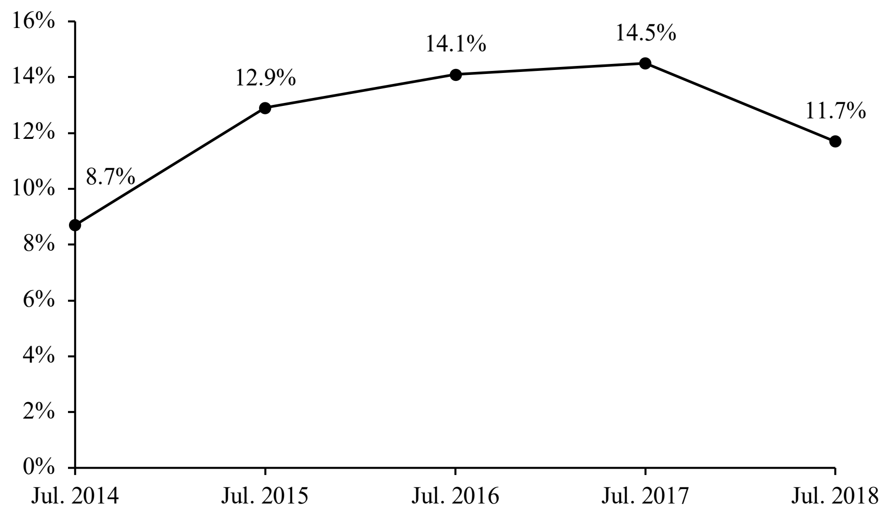
[143] Bebchuk & Kastiel, *supra* note 112 (manuscript at 8-10).

[144] Bebchuk & Kastiel, *supra* note 51, at 616-18; Martijn Cremers, Beni Lauterbach & Anete Pajuste, *The Life-Cycle of Dual Class Firm Evaluation* 32-35 (European Corp. Governance Inst., Finance Working Paper No. 550, 2018), https://ssrn.com/abstract=3062895 (commenting on empirical data which shows that many dual-class firms fail to self-correct).

[145] The data is available at Jay Ritter, *IPO Data*, WARRINGTON C. BUS., https://site.warrington.ufl.edu/ritter/ipo-data/ [https://perma.cc/ZH48-MHYW] (last visited Apr. 13, 2019).

companies. We hand-collected data on the proportion of IPO companies with dual-class provisions for the four-year period prior to the adoption of the index exclusion rules, and for the year following the adoption of the index exclusion rules. Figure 1 below shows the proportion of IPO firms in each of these years with dual-class structures. As Figure 1 shows, the proportion of IPO firms with dual-class structures was gradually increasing, from 8.4% in July 2014 to 14.5% in July 2017. In the year after July 2017, they fell to 11.7%.[146]

Figure 1. Percentage of Dual-Class IPOs.



Two observations can be drawn from the Figure 1. First, index exclusion rules were not effective enough to substantially eliminate the use of dual-class shares. A year after the adoption of the index exclusion rules almost 12% of IPO companies adopted a dual-class structure.[147] Insiders clearly continue to put in

[146] A recent study by CII provides additional support for our data. This study, which has similar parameters to our own, shows that the percentage of dual-class IPOs decreased from 19% in 2017 to 11% in 2018. *See* COUNCIL OF INSTITUTIONAL INV'RS, DUAL-CLASS IPO SNAPSHOT: 2017-2018 STATISTICS (Jan. 2, 2019), https://www.cii.org/files/2018Y%20 IPO%20Stats%20for%20Website.pdf [https://perma.cc/7UZ4-J86B].

[147] Another recent report, which does not use the same exclusions we use, found that dual-class IPOs as a percentage of total IPOs have actually been increasing year-over-year, from 17% in 2015, to 19% in 2016, 25% in 2017, and 27% in the first half of 2018. *See* Daniel Klausner, *Dual Class IPOs Are on the Rise: Tech Unicorns Jump on Board this New Trend*, PwC (July 18, 2018), http://usblogs.pwc.com/deals/dual-class-ipos-are-on-the-rise-tech-unicorns-jump-on-board-this-new-trend/ [https://perma.cc/3HCE-ZYHU]. According to this report, the first half of 2018 has already experienced more dual-class listings (in nominal

place dual-class structures in a substantial proportion of IPO companies, even after the adoption of the index exclusions. This desire for maintaining control through the use of dual-class structure is especially prevalent among unicorns, companies valued at $1 billion or higher.[148] Second, we do observe a 20% decrease in the proportion of dual-class IPOs following the adoption of the index exclusions. Although the relatively small proportion of dual-class firms each year makes it difficult to draw firm conclusions, it would appear that the index exclusions may have had *some* impact in deterring insiders from using dual-class shares at some IPO companies. While it may be too early to attribute significant weight to this finding of the non-zero effect of the index exclusions, if it is borne out over subsequent periods it would be consistent with the evidence that we discuss in Section III.D.2 regarding the detail of dual-class provisions in IPO companies.

2. Dual-Class Provisions of IPOs

A review of the provisions of the dual-class IPOs that have occurred since Snap's decision to go public with non-voting shares reveals two interesting trends.

Increase in time-based sunsets. First, there has been a limited, but increasing, number of multi-class companies that are choosing to go public with time-based sunset provisions in their charters. The triggering of such a sunset provision automatically eliminates the multi-class capital structure.[149] Groupon, Inc., for example, adopted a five-year sunset clause prior to its IPO in 2011, and, as a result, it converted to a single-class company in 2016.[150] Dual-class companies going public with such a provision would be eligible to enter the S&P Composite Indexes after the sunset expires, which may only be several years after their IPO.

CII has tracked 25 U.S. companies that went public with simple time-based sunsets since 2004, including 19 in 2013-2018. CII's data shows that the rate of adoption of sunset provisions in IPOs has increased. In 2017-2018 there were eleven such sunsets (representing 26% of the dual-class IPOs in 2017, and 33% in 2018), compared to only six sunsets in 2015-2016, and only two in 2013-2014. The period of such sunsets ranges from three years to twenty years. Most

numbers) than the entire year of 2016. *Id.*; *see also* Levine, *supra* note 97 (discussing impact of index exclusion rules on companies with non-voting stock).

148 *New Intelligize Report Finds Significant 2018 Increase in IPOs for Companies Valued at $1 Billion+*, IPO EDGE (Feb. 26, 2019), http://ipo-edge.com/2019/02/26/new-intelligize-report-finds-significant-2018-increase-in-ipos-for-companies-valued-at-1-billion/ (finding that "30 percent of unicorns went public [in 2018] with a multi-class stock structure").

149 For an economic analysis indicating that the benefits of multi-class structures can be expected to decline, and the costs to rise, over time, see Bebchuk & Kastiel, *supra* note 113, at 630.

150 Groupon, Inc., Amendment No. 7 to Registration Statement (Form S-1), at 6, 98 (Nov. 1, 2011). *See generally* Groupon, Inc., Current Report (Form 8-K) (Oct. 31, 2016).

sunsets are in the range of seven to ten years. The mean length of sunset periods so far in 2018 is 7 years, down from 9.5 years in 2017, and 10.3 years in 2016.[151]

No more non-voting shares issued in IPOs. The investors' response to the Snap IPO seems to have been successful in preventing other companies from following suit by issuing non-voting shares in their IPOs. In our dataset, we observed four multi-class companies that went public with an authorized class of non-voting shares following Snap's IPO: Altice USA, Angi Homeservices, Blue Apron, and Dropbox. None of these companies issued such non-voting shares at the IPO, but rather kept them "on the shelf" for future use. Thus, at least in theory, those companies would still be eligible for inclusion in the Russell 3000 indexes.[152] Of course, as Lucian Bebchuk and one of us have explained elsewhere, once a company goes public with an authorization for non-voting shares, its controller can use its majority voting power to unilaterally expand the number of authorized non-voting shares and issue them at a later stage as a dividend.[153]

Finally, we note that Lyft's recent high-profile decision to go public with a dual-class structure *does not* include non-voting shares.[154] Since Lyft's co-founders are expected to hold at the IPO stage slightly less than 50% of the voting rights, it would have been considerably more attractive for them to adopt a capital structure that includes non-voting shares.[155] The issuance of non-voting shares would have enabled Lyft co-founders to further unload their equity stake without diminishing their voting power, which is barely below 50%. Lyft's co-founders' decision not to issue non-voting shares would appear to be an illustration of the impact of investors' reactions to Snap, and of the adoption of index exclusions on founders' decision-making.[156]

3. The Dual-Class Exclusion as a Symbolic Victory

In the high-profile corporate governance controversy over non-voting shares and dual-class structures, the Snap IPO quickly became a test case regarding who would blink first between investors and IPO companies. The vocal opposition to the Snap IPO structure from institutional investors and asset managers sent a signal to potential IPO companies and their advisors, which led to the consideration and adoption of index exclusion rules by the index

[151] *See supra* notes 36 and 146.

[152] We also noticed that the number of authorized non-voting shares was somewhat limited compared to the total number of authorized shares: In Altice it is about 1% of the total authorized shares, in Blue Apron and Dropbox about 20% of the total authorized shares, and Angi Homeservices about 27%.

[153] Bebchuk & Kastiel, *supra* note 112 (manuscript at 31).

[154] Lyft, Inc., Registration Statement (Amendent No. 1 to Form S-1), at 13 (Mar. 1, 2019).

[155] *Id.* at 199-202.

[156] We note, however, that Lyft nonetheless exhibits extreme separation, providing its co-founders with 20 votes per share and compared to one vote per share for public investors. *Id.* at 13.

providers. This was an outcome with symbolic importance. This is reflected in the rhetoric of some leading figures in the debate. For example, Aeisha Mastagni, a portfolio manager with CalSTRS, the second-largest asset owner in the United States, stated that "[t]here is a line in the sand, and Snap crossed it. We don't want Snap to set a precedent."[157] Anne Sheehan, CalSTRS' director of corporate governance, stated that that "while CalSTRS and other large investors have been critical of dual-class shares elsewhere, the Snap IPO was the 'spark that raised the discussion to a new level. . . . [W]e are sending a message that this is not acceptable behavior.'"[158] Similarly, after the Snap IPO, CII Executive Director Ken Bertsch told the SEC Commission Investor Advisory Committee that, with Snap's listing, "perhaps the bottom has been reached" in a 30-year listing-standards race to the bottom.[159] These sentiments suggest to investors that their ability to push index providers to exclude dual-class companies sent a signal to the market that investors were not powerless, which could be considered a symbolic victory for those investors.

Of course, it is necessary to take into account the divergence among investors described in Section I.D. The index fund managers that have opposed the index exclusions may not regard the exclusions as a victory. Indeed, their opposition puts pressure on index providers and regulators to reverse the index exclusions, and therefore, to weaken even the symbolic victory.

IV. LESSONS AND WAYS FORWARD

The fundamental issue that underpins this Article—how investors can influence insiders' decisions regarding governance arrangements that the investors disfavor—is a collective action problem. If the vast majority of major outside investors shared the same views about these arrangements and could effectively act in a unitary fashion, they would not participate in the IPOs of dual-class firms, and IPO firms would be forced to go public with a single-class structure, or miss out on access to the public capital markets altogether. In the real world, however, achieving such a high level of agreement and coordination among a large number of investors is unrealistic. The reasonable solutions to the collective action problem involve legislation or regulation, either in state corporate law, federal securities laws or regulations, or at the exchange level.

However, the prospect of such regulation to further limit the freedom of insiders to adopt disfavored governance arrangements is unlikely. As we discussed in Part I, the competition for incorporations and listings usually leads state lawmakers and exchanges to follow the preferences of insiders rather than investors. SEC regulation could also limit exchanges from listing dual-class companies, which would have the advantage of overcoming the competition problem faced by U.S. exchanges. However, the SEC is likely to be reticent to

[157] Bradford, *supra* note 6.

[158] *Id.*

[159] *Id.*

implement such a rule. Part of this comes from the risk of the rule being vacated by the D.C. Circuit following *Business Roundtable*.[160] In addition, as discussed in Part I, the SEC has structural incentives to maintain the competitiveness of the United States as a prime location for listings compared to other jurisdictions, which further limit the willingness of the SEC to constrain dual-class structures.

Therefore, while we support investors' recent calls for the NYSE and Nasdaq to limit the use of dual-class shares without time limitation, we recognize the unlikelihood of U.S. exchanges constraining such disfavored arrangements at the behest of investors. Unless U.S. exchanges or the SEC change their policies, investors will have to evaluate other alternative channels of influence. To that end, Section IV.A lays out several important lessons regarding index exclusions, and Section IV.B considers alternative ways forward.

A. *Lessons from the Index Exclusion Experiment*

What should we make of the important corporate governance experiment, of having index providers act as "governance regulators"? The experiment has several lessons.

First, our analysis shows that index providers face a complex set of conflicted interests and incentives which make them reluctant regulators. Index providers' reluctance to regulate is clearly reflected in the dual-class exclusions that they have adopted, or rejected. Even where index providers have adopted dual-class exclusions, they have important loopholes and limitations. Investors should not expect index providers to be fearless protectors of investor interests. Instead, index providers are likely to come up with moderate rules that compromise between the different preferences of their clients and are less likely to trigger a regulatory reaction.

Second, in our view, the most significant constraint on index providers' action comes from the disagreement among investors regarding whether index exclusions should be used to achieve investors' common goals. Some investors advocate for this approach, others oppose it. This disagreement stems from the fact that all investors could benefit from limiting disfavored arrangements, but the potential costs from index exclusions are born by a subset of investors: those who blindly follow the index. If major outside investors—both indexed and actively managed—could reach common policy preferences regarding disfavored arrangements like dual-class structures, then index providers would implement such a policy without equivocation. We discuss this possibility in greater detail in Section IV.B.

Third, index exclusions have important natural limitations. By the very nature of their business, index providers aim to mimic the existing broad markets and are therefore limited in the extent to which they can exclude companies from their indexes. Given this natural limitation, we recognize that not every arrangement that investors disfavor can or should be an appropriate candidate

[160] *See supra* note 21 and accompanying text.

for an index exclusion. Index exclusions are a weapon of last resort; they should be exercised carefully, and only when investors have no real ability to influence insiders' decision through private ordering. In this light it is clear that dual-class structures are a good fit for index exclusions. Dual-class arrangements are categorically different from corporate governance in single-class companies. Where there is no dual-class arrangement, other corporate governance arrangements that are disfavored by a majority of the company's equity can be eliminated through the normal corporate election process. Because they are not susceptible to such private ordering, dual-class structures persist despite outside investor opposition.[161] Once companies adopt a dual-class structure at the IPO stage, outside investors have no power to eliminate them through the corporate election process. This is because insiders who retain control over the company's decision-making through the dual-class structure are the ones who determine the vote outcome, and can reject proposals to eliminate the dual-class structure or to replace directors even when they are supported by a majority of the company's equity.

Fourth, investors should also recognize that the structure of index inclusion rules limits the impact of index exclusions on IPO firms. Because such firms would only be eligible for inclusion at some future point in any case, the impact of index exclusions must be discounted for such delay. The delayed impact of the index exclusion rules also extends the free option that insiders have to use a disfavored arrangement while preserving the possibility of removing the arrangement when the company otherwise becomes eligible for index inclusion.

Fifth, despite the foregoing, we do not suggest that index exclusions are meaningless, as some scholars have recently argued.[162] In fact, our preliminary data shows that, at least at this stage, index exclusions appear to have had some limited impact on insiders' choice of IPO arrangements, or at least coincided with directional changes in those choices. The percentage of dual-class IPOs has decreased, there has been a limited but important increase in the use of time-based sunsets, and there have been no further IPOs where companies have issued non-voting shares. Investor opposition that triggered the index exclusions could also be considered a symbolic victory for investors.

Finally, we believe that the recent calls to eliminate index exclusions are premature. The limited evidence regarding the effects of the index exclusions makes it difficult to draw definitive conclusions regarding their effectiveness. We suggest that investors, index providers, and policy-makers would be better served by pausing to observe the impact of the index exclusions. In the meantime, outside investors should consider whether there are alternative viable and effective mechanisms to discourage insiders from adopting disfavored arrangements at the IPO stage. Of course, if investors conclude that there are no such viable alternatives, then index exclusions may be better than nothing. We turn to discuss the possibility of alternative mechanisms in Section IV.C.

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[161] *See supra* note 147.

[162] *See* Winden & Baker, *supra* note 76, at 49.

B. *Alternative Solutions*

In this Section we consider three alternative solutions to discourage insiders from adopting disfavored governance arrangements at the IPO stage: coordinated cooperative action of exchanges, providing index investors with a menu of investment index options with indexes that include and exclude the disfavored arrangement, and collective action by investors themselves.

1. The International Organization of Securities Commissions

In opposing MSCI's dual-class exclusion proposal, BlackRock argued that "a global body such as [the International Organization of Securities Commissions ("IOSCO")] is well positioned to establish global guidelines for listing standards that could then be translated into national regulation."[163] Constraining dual-class stock at the supranational level would also overcome the incentive problem of securities regulators in attempting to give their capital markets competitive advantages over other jurisdictions. However, the nature of IOSCO guidelines means that such a solution is unlikely to impose realistic constraints on disfavored governance arrangements like dual-class structures.

IOSCO operates by consensus of its members, the securities regulators of its 118 signatory countries, including the major international capital markets of Hong Kong, the United Kingdom, and the United States. Any attempt to constrain dual-class stock would require these markets to agree to constrain the disfavored arrangement. The SEC may be more willing to agree to constrain dual-class restrictions if other countries also agree to do so. However, the SEC might instead prefer to push the United States' competitive advantage over other jurisdictions that currently do not permit dual-class listings. Even if these other major jurisdictions were to agree to constrain dual-class arrangements, there are many other jurisdictions in the world that currently permit dual-class companies and therefore might object to such an agreement.

Even if IOSCO members decided to constrain dual-class structures, IOSCO operates by promulgating *non-binding* guidelines. It lacks effective enforcement mechanisms to ensure its members follow its guidelines. As a result, individual members would be free to disregard those guidelines. Competitive pressures for the listing of dual-class companies mean that there would be significant incentives to do so. As a result, IOSCO as it is currently structured cannot function as an effective mechanism for constraining dual-class structures.[164]

2. A Menu of Index Funds

An alternative approach to disfavored corporate governance arrangements would be to ensure that investors have a full menu of index options, some of

[163] Letter from Barbara Novick to Baer Pettit, *supra* note 23.

[164] That BlackRock suggested IOSCO as their preferred mechanism for addressing the problem suggests that they are not currently committed to a realistic constraint on dual-class stocks.

which exclude companies with the disfavored arrangement and some of which do not. Such an arrangement would allow investors to determine how to allocate their capital with respect to the corporate governance arrangement. Those who are interested in investing in companies with disfavored governance arrangements could follow the inclusive indexes. Those that oppose those arrangements could follow the indexes that exclude companies with those arrangements.

This approach would appear to satisfy index fund managers that wish to have access to indexes that contain the broadest possible set of companies. However, it misunderstands the goal of both diverging investor views regarding index exclusions. Those investors that favor index exclusions seek to discourage insiders from adopting disfavored governance arrangements such as dual-class structures. For index exclusions to influence the decisions of insiders, they must apply to the major indexes, especially the S&P 500, otherwise their effectiveness as a sanction is even further reduced. In order to ensure that insiders respect their preferences, outside investors need a coordination mechanism that reduces the amount of funds that automatically flow to companies with disfavored arrangements. To achieve that goal, a flat exclusion by all of the major indexes would be preferable to only some of the major indexes adopting such an arrangement, as the latter would still allow a significant amount of index investors' funds to flow to public companies with disfavored governance terms.

The index fund managers that oppose index fund exclusions are focused on the major indexes being as broad as possible. To those investors a new, broad index that has very few assets benchmarked to it would be a hollow solution if those companies are excluded from the major indexes that have the overwhelming majority of assets under management. This is because index funds wish to be able to compare their returns to other large index funds. If there is even a slight divergence in the benchmarks those funds follow (from differences in the inclusion or exclusion of those companies), then the ability to compare returns is reduced. The stickiness described in Section II.B.2 compounds this problem, making it more difficult for index funds to move to a new index. The majority of fund assets will therefore stay benchmarked to the existing major indexes. The decision is therefore a zero-sum game, focused on whether the major indexes include or exclude companies with the disfavored arrangement. It is salient that no such alternative indexes have arisen to mirror the S&P Composite indexes, but without the dual-class exclusions. It would not be expensive for S&P to create such indexes. That they have not done so suggests that it would not be an effective solution.

3. Collective Action by Investment Funds

As we discussed above, constraints on disfavored corporate governance arrangements are a collective action problem. The solution to collective action problems is collective action. In a sense, index exclusions are a mechanism to achieve high levels of coordination among all index fund investors. However, they may not be a sufficient sanction to discourage private companies from choosing disfavored arrangements, because they apply only to the pool of funds that are tied to indexes. As we have shown, that partial application creates divergence among investors, which decreases the likelihood that index exclusions will be used in the future.

Consider, however, a scenario in which a broad group of investors—including both index funds and actively managed funds—were to develop common strategies regarding the desirable constraints on dual-class shares. This would overcome the threat of those funds "defecting" from a common strategy in order to outperform the other funds (and thereby potentially attract assets away from those other funds). None of those investors would invest in companies that did not meet the constraint. Such a mechanism is considerably more likely to be a sufficient sanction to discourage insiders from taking their companies public with disfavored governance arrangements. If the company were to adopt a disfavored governance arrangement it would miss out on access to a much larger pool of investors' funds. Moreover, index providers would also have incentives to adjust their index exclusion rules accordingly.

One issue with such a solution is that collective action by any group is costly.[165] However, investors have already formed the Investors Stewardship Group ("ISG"), a group that includes index fund managers, active fund managers, and public pension funds. It is currently structured to recognize only existing consensus positions on corporate governance matters. But there is no reason why the ISG, or another group like it, could not become a forum for different investors to coordinate or act collectively on common positions on corporate governance arrangements, such as dual-class stock. Of course, this approach would mean that there would be limited sanctions for investors that failed to follow those principles in specific situations. Moreover, acting through an organization like the ISG would allow individual investors to reach their own decisions on *general principles*, rather than on firm-specific matters. This would obviate the need for investors to coordinate or act collectively with respect to particular companies. This has significant importance because acting collectively could cause the investors to be considered a "group" for the purposes of section 13(d) of the Securities Exchange Act, which would require those investors to file disclosure on Schedule 13D rather than Schedule 13G.[166]

The biggest problem with such collective decision-making would be that it might be successful. If so, it might demonstrate the power of investor decision-making, and could trigger a backlash by regulators of the kind discussed in Part I. However, the investor group could reduce this threat by picking its battles

[165] *See, e.g.*, Ann Lipton, *supra* note 58.

[166] *See* 15 U.S.C. § 78m(d) (2012) (reporting requirement for persons with more than five percent of any class of security); *id.* § 78m(g) (exceptions from those reporting requirements for certain investment companies); 17 C.F.R. § 240.13d-1(b) (2018) (clarifying obligations to file Schedule 13D or Schedule 13G). For a discussion of the effects of requiring large investment funds to file Schedule 13D disclosure, see Bebchuk & Hirst, *supra* note 112 (manuscript at 25-27).

judiciously. Adopting reasonable principles that do not threaten more than a limited set of public companies (such as companies with dual-class structures) would reduce the risk of a backlash. If investors following those general principles represented a substantial proportion of the stock of large public companies, it would also be more difficult for the managers of those companies to push back against those principles.

CONCLUSION

Certain governance arrangements, such as dual-class structures, have long been disfavored by a substantial majority of investors. However, public companies have continued to adopt those arrangements, because they have suited the insiders of those companies. For structural reasons, traditional sources of constraints on governance arrangements—state corporate law, listing exchanges, and federal securities regulation—have not been effective to constrain these disfavored arrangements. Index exclusions represent investors' response, pushing index providers to change their rules with the goal of limiting the disfavored arrangements. This Article has provided a comprehensive and structural analysis of index providers as governance regulators, including the complex motives of index providers that limit their effectiveness as regulators, and the impact of the exclusions on insiders' decision-making at the IPO stage. To date, the dual-class exclusion rules are the most important example of index exclusions in practice. The general structural analysis, and its application to the dual-class exclusions, allows us to draw a number of general lessons from the important corporate governance experiment that index exclusions represent. These lessons are all the more important, given the dominant role that index funds play in our capital markets, and consequently, the central place of index providers in corporate governance.