Snap Decision: Leading Index Providers Nix Multi-Class Shares

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Changes Respond to Snap Controversy But Would Hit Many Other Public Companies

The Snap, Inc. IPO in March 2017 was the first in which only non-voting shares were offered to the public. In response, the Council of Institutional Investors and others lobbied the major index providers to bar non-voting shares from their indices, arguing that absent this change passive investors such as index funds would be forced to invest in non-voting shares that erode public company governance. In turn, global index providers S&P Dow Jones Indices, MSCI and FTSE Russell initiated market consultations to determine whether to revise their policies. S&P Dow Jones and FTSE Russell recently announced plans to revise their index eligibility rules. MSCI's consultation remains open until August 31, 2017.

S&P Dow Jones

On July 31, S&P Dow Jones **announced** that, effective immediately, companies with multiple share classes will no longer be eligible for inclusion in the indices comprising the S&P Composite 1500, including the S&P 500, S&P MidCap 400 and S&P SmallCap 600. The change will not affect existing S&P Composite 1500 index constituents, who will be grandfathered. S&P Dow Jones also stated that the S&P Global BMI Indices, S&P Total Market Index and other S&P and Dow Jones-branded indices will not be affected.

Importantly, a newly public company spun off from a current S&P Composite 1500 index constituent would not need to meet the criteria for new additions to the index, and so would effectively benefit from its parent's grandfathering. S&P Dow Jones believes this helps the index meet the objective of minimizing turnover.

FTSE Russell

On July 26, FTSE Russell announced a **proposal** to require more than 5% of a company's voting rights (aggregated across all equity securities, including shares that are not listed or traded) to be held by non-restricted (or "free float") shareholders, as defined by FTSE Russell, in order to be eligible for inclusion in FTSE Russell indices, including the broad-market Russell 3000 index and the small-cap Russell 2000 index. Subject to modification based on public reaction to the proposal, the policy would apply to new index constituents in FTSE Russell's upcoming September 2017 index review, but would not apply to current constituents until September 2022 – at which point grandfathering would end. FTSE Russell has indicated that it intends to review the voting rights threshold on an annual basis and that it may adjust requirements in the future.

According to FTSE Russell, its market consultation indicated broad support for the inclusion of a 5% voting-rights hurdle. Nonetheless, a significant minority of survey responders did not support voting-rights eligibility criteria, taking the position that an index provider should provide a comprehensive representation of the investable universe. FTSE Russell also noted concerns that a voting-rights hurdle would incentivize some companies in the tech sector to stay private and deprive investors of the opportunity to participate in that sector's growth. While FTSE Russell acknowledged these views, its prevailing concern appears to have been responding to Snap's corporate governance structure.

The policy would apply to all of a company's equity securities and would not be limited to non-voting securities. Accordingly, for a company with a relatively customary 10-to-1 high-vote stock where the free float is low-vote stock, there must be a free float equal to slightly more than 33% of all the shares before the 5% voting threshold will be satisfied. Given that newly public companies often float only 5-20% of their outstanding stock, many of these companies would be excluded from FTSE Russell indices.

An **indicative analysis** performed by FTSE Russell shows that 37 current index companies would not meet the 5% hurdle. Under FTSE Russell's grandfathering rule, these companies would have five years to increase the voting power of their free float or reduce the voting power of their high-vote stock to avoid index expulsion.

Implications

To meet FTSE Russell's eligibility criteria, newly public companies with dual-class stock would need either to reduce the voting power of high-vote stock (which could lead to fewer acquisitions with stock as consideration issued to target shareholders and fewer equity offerings as founders seek to retain control) or include a formulaic voting provision in their charters guaranteeing their low-vote stock will hold just above 5% of the vote.

The change to the S&P 1500 Composite – which applies to all "multiple share class structures" – is far more sweeping and at a minimum will exclude any company with differential common-share classes, without regard to the voting power held by the public. This change not only precludes index eligibility for many newly public companies that are controlled using a dual class structure, but also may impact newly public companies with "Up-C" structures, even when there is no differential voting, because public holders have a class of stock with economic and voting rights, while pre-IPO holders have a separate class of stock with just voting rights as they hold their economics in a separate subsidiary. At the moment it is not clear how S&P Dow Jones will interpret the phrase "multiple share class structures," perhaps creating uncertainty for companies with tracking or other preferred shares outstanding.

While the index providers are taking different approaches to address concerns over limited-vote public offerings, the impact in each case will likely deny index eligibility to fairly common high-vote/low vote structures that have met widespread market acceptance. With Congress and the SEC working hard to encourage companies to go public in the face of a long-term decline in IPOs, it is disappointing that these measures may discourage founders and other controlling shareholders from taking their companies public in a manner conducive to long-term management perspectives, which can give critical breathing room to companies otherwise facing the short-term demands of activists and analysts. These index provider moves also seem likely to reduce opportunities for retail investors to access mutual funds that reflect the broader U.S. market – in particular depriving them of investment exposure to some of the most innovative companies in the U.S. economy.

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