Securities Regulation Daily Wrap Up, INITIAL PUBLIC OFFERINGS—CII urges IPO companies to reconsider dual-class structure, (Apr. 19, 2018)

Securities Regulation Daily Wrap Up

Click to open document in a browser

By John Filar Atwood

The Council of Institutional Investors (CII) has written to the boards of Pivotal Software and Vrio, both of which are preparing their IPOs, urging them to reconsider using a dual-class structure as a public company, or alternatively to incorporate sunset provisions that revert to one share, one vote within seven years. CII believes that the dual-class structure severely limits a company's accountability to public shareholders over the long-term.

CII noted that without the dual-class structure, Dell already owns in excess of 70 percent of Pivotal's outstanding shares, and AT&T owns in excess of 83 percent of Vrio, which is enough to exercise control in the near-term. Due to the dual-class structure, Pivotal public shareholders will control just four percent of the voting power despite owning 30 percent the company. CII noted in the Vrio letter that its public shareholders will control less than two percent of the voting power despite owning 17 percent of the company. In CII's view, this misalignment of ownership and controlling interests undermines the fairness of the capital markets.

CII believes public companies should provide all shareholders with voting rights proportional to their holdings. According to CII, both Dell and AT&T have recognized and upheld the principle of one share, one vote in their years as public companies.

Exclusion from indices. CII stated that the importance of the one share-one vote approach has been underscored repeatedly by market participants, including the recent decision by index providers to discourage multi-class arrangements. As currently structured, Pivotal will not be included in the S&P 1500 Composite or its component indices, including the S&P 500. In addition, the Russell 3000 and other FTSE Russell indices also exclude new listings like Pivotal that leave less than 5% of voting power in the hands of "unrestricted" investors, CII pointed out.

In its letter to Pivotal, CII noted that Dell receives ten votes per share as sole owner of Pivotal's Class B shares, and elects nine of the 11 directors. CII said that Class A shareholders, voting together with Dell on a one share-one vote basis, should have the right to elect the remaining two directors. However, given Dell's total equity holding, Dell will control the vote to elect all of Pivotal's directors. In CII's opinion, Pivotal's director elections are structured to erode a defining feature of the corporation—the separation between the company's management and its owners.

CII believes that independent boards accountable to owners should be empowered to actively oversee management and make course corrections when appropriate. Disenfranchised public shareholders have no ability to influence management or the board when the company encounters performance challenges, as most companies do at some point, CII continued. For these reasons, CII is concerned about the process of electing directors, the unequal voting structure, and the lack of a reasonable time-based sunset provision for Pivotal and Vrio.

CII acknowledged that some technology companies have attracted capital on public markets despite having multi-class structures. However, CII pointed out that the performance record of multi-class companies is decidedly mixed, with some studies finding a substantially lower total shareholder return compared to their single-class counterparts after ten years. CII cited a second study which found that where multi-class structures provide a value premium at the time of the IPO, that premium dissipates within six to nine years before turning negative.

Jackson's remarks. CII's argument was echoed by SEC Commissioner Robert Jackson in a February speech in which he argued in favor of putting a limit on the duration of a dual class structure. He noted that early in a company's life, giving control to the firm's founders makes sense, but at some point that structure is no longer beneficial. As a result, some observers believe that dual-class firms should include some limit on the amount of time before shareholders can weigh in on whether dual-class still makes sense for the company, he noted.

Jackson and his staff examined 157 dual-class IPOs that have occurred over the past 15 years, and found significant differences between the 71 dual-class companies with sunset provisions and the 86 who gave insiders control forever. According to their research, seven or more years out from their IPOs, firms with perpetual dual-class shares trade at a significant discount to those with sunset provisions. Jackson and his staff also found that, among the small subset of firms that decided to drop their dual-class structures later in their life cycles, those decisions were associated with a significant increase in valuations.

Ultimately, Jackson called for securities exchanges to consider proposed listing standards addressing the use of perpetual dual-class shares. The standards would allow retail investors to share in companies' growth—but avoid asking them to trust corporate management forever. Companies would still be able to IPO with dual-class voting arrangements, but only if management is willing to someday give shareholders their say, he concluded.

Sunset provisions. In its letters, CII also argued in favor of sunset provisions for the dual-class structures of Pivotal and Vrio. CII noted that recognizable companies like Yelp, Fitbit and Kayak went public with time-based sunsets. Public shareholders at those companies know that they will have a say in company matters equal to their ownership interests within reasonable periods of time, CII said. Similarly, Groupon collapsed its dual-class structure in 2016 and adopted one share-one vote after a five-year sunset expired. CII noted that more companies went public with time-based sunsets in 2017 than in any other year.

CII urged Pivotal and Vrio to reconsider their dual-class structures before going public. In CII's opinion, investors have demonstrated repeatedly that they will support innovation and investment for the long-term, as has been the case at companies such as Amazon. Establishing accountability to new owners does not always maximize comfort and compensation for management, but accountability is important for longer-term performance, CII concluded.

Companies: Pivotal Software, Inc.; Vrio Corp.; AT&T Inc.; Dell Inc.; Yelp Inc.; Fitbit Inc.; Kayak Software Corp.

IndustryNews: IPOs SecuritiesOfferings CorporateGovernance CorpGovNews GCNNews