Securities Regulation Daily Wrap Up, CORPORATE GOVERNANCE—SEC's Jackson questions rationale for dual-class 'forever shares', (Feb. 16, 2018)

Securities Regulation Daily Wrap Up

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By Mark S. Nelson, J.D.

New SEC Commissioner Robert Jackson hit the ground running in his first substantive speech as a commissioner by taking on the topic of the proliferation of companies that have adopted dual-class share structures. Jackson's speech in San Francisco at a Silicon Valley event on M&A, antitrust, and governance issues comes at a time when initial public offerings (IPOs) have become scarcer and an abundance of private capital allows growing start-ups to remain private longer, thus giving the founders of some companies that do go public the leverage to demand share structures that may protect their jobs. For Jackson, though, the question is one of how long a company should retain a dual-class structure post-IPO rather than a debate about the merits and demerits of such structures. He said the outcome of the debate over dual-class structures may have long term implications for Main Street investors.

Control v.s. accountability. Jackson observed that dual-class structures can benefit newly public companies by giving their founders the freedom to shape a growing business without immediate external demands for outsized results. But he suggested that that the benefits of dual-class structures diminish over time and may conflict with American notions of fairness in both politics and business.

Jackson likened dual-class structures to the aristocratic traditions eschewed by America's founders. The perpetual or "forever" variant of the dual-class structure, he noted, could result in a company's founders' offspring controlling a company for generations regardless of their business acumen and without an effective mode to hold them accountable for company performance.

According to Jackson, the trend toward adoption of dual-class share structures has increased among public companies since 2005 (one percent) and 2015 (14 percent). Still, Jackson said the larger question is whether a public company with a dual-class structure should retain that structure forever. He noted that half of all public companies adopting dual-class structures during the last 15 years were on the forever track.

Jackson also said some stock indexes have already sought to limit the inclusion of companies with dual-class share structures. He urged exchanges to likewise mull proposals to deal with dual-class share structures. Jackson suggested the impact of dual-class structures on Main Street investors, absent some limits, could be significant over time because of the market share held by dual-class companies. In an appendix to his speech, Jackson cited data compiled by Capital IQ showing that, as of just over a week ago, there were 852 publicly-traded, U.S.-incorporated companies with dual-class structures representing $5.1 trillion in market capitalization (See appendix, n. 3; more on Jackson's appendix below).

A tale of two valuation trends. Unlike many SEC commissioners, who might cite outside studies or the work done by the SEC's Division of Economic and Risk Analysis, Jackson and his staff "ran the numbers" and obtained "preliminary" data on the impact of dual-class share structures on public company valuations over time. Jackson said the results suggested that while dual-class structures can help a newly public company, the benefits often decrease and the company's valuation begins to lag versus its peers without dual-class structures or that have given them up.

For his study, Jackson examined 157 IPOs during the last 15 years. Of these companies, 71 had sunset provisions that would eventually end their dual-class share structures. However, a majority of the companies (86) did not provide for the sunset of their dual-class structures. According to Jackson, both groups of companies had comparable, predicted valuations for up to two years post-IPO. But by year seven post-IPO, these companies' predicted valuations began to drift apart with companies that sunset their dual-class share structures outperforming companies that did not.

For those who wish to dig deeper into Jackson's data, he offers an appendix on the methodology he employed and a spreadsheet containing the data he analyzed. In the methodology appendix, one table stands out beyond the other charts showing a divergence in predicted valuations between companies with perpetual and non-perpetual dual-class structures. Table A.1 shows dual-class IPOs from 2001 to 2016 and indicates whether the dual-class structure was perpetual or subject to a sunset. In 12 of the 16 years depicted, 50 percent or more of dual-class IPOs were of the perpetual variety; overall, 55 percent of the 157 dual-class IPOs reviewed involved perpetual structures.

Two footnotes to Jackson's speech (Nos. 22 and 23) also suggest some caveats. For one, he appeared to counter the possible objection that he compared only variants of dual-class share structures (perpetual versus sunset) rather than comparing perpetual dual-class structures to single-class structures; Jackson explained that the latter comparison could overlook key, uncontrollable differences. Moreover, in the context of companies enjoying better valuations after they abandoned dual-class structures, Jackson cautioned that the results of his analysis did not necessarily mean that there is a causal relationship between lower valuations and dual-class share structures. Still, Jackson said his review of IPOs suggests an association between perpetual dual-class structures and lower valuations.

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