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Global Index Providers Announce Decision to Exclude Companies With Multi-Class Capital Structures or Limited Public Voting Rights

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In July 2017, global index providers S&P Dow Jones (S&P DJI) and FTSE Russell (FTSE) announced changes to their index eligibility rules, with S&P DJI excluding from certain of its indices companies with multi-class capital structures, effective immediately, and FTSE Russell releasing a proposal to exclude from certain of its indices companies with low, or no, voting rights, subject to final rulemaking. These announcements followed public consultation on the subject in response to growing concerns from shareholder groups and others over eroding corporate governance and shareholder accountability sparked, in part, by the March 2017 initial public offering of Snap Inc., which offered public investors only shares of nonvoting common stock as part of a three-class capital structure. A third index provider, MSCI, is also conducting a similar consultation on the issue of nonvoting shares, which is scheduled to conclude on August 31, 2017.

S&P Dow Jones

On July 31, 2017, S&P DJI announced that, effective immediately, companies with “multiple share class structures” will no longer be eligible for inclusion in the S&P Composite 1500 and its component indices, S&P 500, S&P MidCap 400 and S&P SmallCap 600. Existing S&P Composite 1500 index constituents will be grandfathered and are not affected by this change. In addition, in order to minimize turnover, S&P DJI clarified that companies that are spun off from current S&P Composite 1500 index constituents are not required to satisfy this new eligibility criteria but should have a total market capitalization representative of the index to which they are being added. The requirements for inclusion in the S&P Global BMI Indices, S&P Total Market Index and other S&P and Dow Jones branded indices are also not affected by this change.

S&P DJI’s announcement does not define “multiple share class structures.” Read broadly, S&P DJI’s change could arguably exclude any company with multiple classes of common stock, regardless of the total public voting power or other public shareholder protections, including sunset provisions in a company’s organizational documents providing that its multi-class structure converts into a “one share, one vote” structure after a set time interval or the occurrence of a specified event.

FTSE Russell

On July 26, 2017, FTSE announced a proposal requiring companies from developed markets (as classified by FTSE based on certain objective criteria in cooperation with the institutional investor community and domestic market authorities) to have greater than 5 percent of the company’s voting rights (aggregated across all of its equity

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securities, including shares that are not listed or trading) held by “unrestricted (free-float) shareholders” to be eligible for inclusion in any standard FTSE Russell indices, including the Russell 3000 index. The proposal remains subject to further feedback, and FTSE will issue a final rule on August 25, 2017.

FTSE generally defines “free float” under its index methodology documents as the percentage of a company’s shares that are considered to be freely available for public purchase. FTSE notes that the proposed 5 percent threshold is consistent with the current minimum free float for most FTSE Russell indices and that, while the change would also apply to constituents in the FTSE UK Index Series, the change is expected to have minimal effect because constituents in that index are required to maintain a higher free float threshold (25 percent for companies incorporated in the United Kingdom and 50 percent for companies incorporated outside the country).

As currently contemplated, the proposed change would apply to potential new constituents in FTSE’s upcoming September 2017 index review but would not apply to existing constituents for a five-year grandfathering period, ending September 2022. In addition, FTSE has indicated that it intends to review the voting rights threshold and definition annually and will adjust the requirements if appropriate.

Practical Implications

Companies considering going public in the United States should weigh the benefits of seeking inclusion on a global index against the limitations on the company’s capital structure. Aside from

the prestige of being included in a well-known index such as the S&P 500 or Russell 3000, companies that are included in such indices are able to reach many large institutional investors, such as public pension funds, that generally will not invest in companies that are not part of a major index, which has historically resulted in an increase to a company’s stock price.

Companies seeking to maintain a multi-class capital structure and still be eligible to be included on a FTSE index will need to reduce the relative voting power of its high-vote stock or adopt a voting provision that guarantees the stock held by public shareholders would be entitled to at least 5 percent of the company’s outstanding voting power. These changes could reduce the company’s willingness to issue equity consideration in acquisitions or the willingness of founders and sponsors to sell their equity holdings in order to retain control.

Companies seeking to be eligible to be included on an S&P index face even stricter requirements and would arguably be restricted from any multi-class structure. Founders seeking to retain control of their company may find going public less attractive. A company with a single voting class would also be less able to insulate itself against activist shareholders and hostile acquisitions that cause disruption in its long-term plans.

While the actual impact of these changes is yet to be seen, the announcements by S&P DJI and FTSE indicate the index providers’ growing willingness to play an active role in shaping corporate governance standards. Whether index providers will continue to advance their involvement in the corporate governance debate remains to be seen.

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