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John Zecca
Senior Vice President
General Counsel North America and Chief Regulatory Officer
NASDAQ Stock Market
805 King Farm Boulevard
Rockville, MD 20850

RE: Time-Based Sunsets and the Problem of Early Unifications of Dual Class Share Structures

Submitted By: Bernard S. Sharfman*

Dear Mr. Zecca,

I am responding to the Council of Institutional Investors' ("CII") request[1] that the NASDAQ Stock Market ("NASDAQ") amend its listing standards to require companies seeking to go public with dual class shares (classes of common stock with unequal voting rights) to include in their certificates of incorporation a time-based sunset provision (a forced unification of shares into one share structure with equal voting rights after a certain period of time) that must go into

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[1] Letter from Ken Bertsch, Jeff Mahoney, and Ash Williams, Council of Institutional Investors to John Zecca, Senior Vice President, General Counsel North America and Chief Regulatory Officer, NASDAQ Stock Market (October 24, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NASDAQ%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf. The CII sent an identical letter to the NYSE. *See* Letter from Ken Bertsch, Jeff Mahoney, and Ash Williams, Council of Institutional Investors to Elizabeth King, Chief Regulatory Officer, Intercontinental Exchange Inc. (October 24, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NYSE%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf.

effect no more than seven years after the initial public offering (IPO) unless the minority shareholders vote to extend up to an additional seven years.[2]

This letter argues that such a mandatory provision would be extremely unwise and harmful to our most important public companies and their shareholders, current as well as future. As a creation of private ordering, the absence of time-based sunset provisions in dual class share structures serves a significant value enhancing purpose. It prevents the risk that a premature and therefore sub-optimal unification of shares may occur. This risk has so far been ignored by those advocating for the implementation of a mandatory time-based sunset provision.

I. In the Face of Private Ordering, Why the Controversy?

Market participants do not allow most companies to enter the public markets with dual class shares[3] and not every company with dual class shares are allowed to omit a time-based sunset provision.[4] This differentiation between IPOs is the result of private ordering. In the words of former SEC Commissioner Troy Paredes, private ordering is that wonderful freedom provided by corporate law that "allows the internal affairs of each corporation to be tailored to its own attributes and qualities, including its personnel, culture, maturity as a business, and governance practices."[5] As several scholars have noted, "observed governance choices are the result of value maximizing contracts between shareholders and management."[6]

Specific to dual class shares, Adena Friedman, President and CEO of Nasdaq, Inc. has said the following:

> One of America's greatest strengths is that we are a magnet for entrepreneurship and innovation. Central to cultivating this strength is establishing multiple paths entrepreneurs can take to public markets. Each publicly-traded company should have flexibility to determine a class structure that is most appropriate and beneficial for them, so long as this structure is transparent and disclosed up front so that investors have complete visibility into the company. Dual class structures allow investors to invest side-

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[2] It is important to differentiate between a time-based sunset provision and an event-based sunset provision. The latter is tied to a specific event such as the death or disability of the controller or the departure of the controller from the company.

[3] In 2017, a banner year for IPOs with dual class share structures, only 19% of total IPOs had such a structure. *See* Council of Institutional Investors, *Dual-Class IPO Snapshot: 2017–2018 Statistics* (1/2/19), https://www.cii.org/files/2018Y%20IPO%20Stats%20for%20Website.pdf. In 2018, only 11% had dual class shares. *Id.*

[4] CII reported that in 2018 five out of 15 IPOs with dual class share structures had time-based sunset provisions. *Id.*

[5] Troy A. Paredes, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations, U.S. SEC. & EXCH. COMMISSION, (May 20, 2009), available at http://www.sec.gov/news/speech/2009/spch052009tap.htm.

[6] David Larcker et al., *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431, 431 (2011).

by-side with innovators and high growth companies, enjoying the financial benefits of these companies' success.[7]

In sum, private ordering creates a strong presumption that the absence of time-based sunset provisions in many dual class share structures is value enhancing and should not be interfered with by regulatory authorities.

Unfortunately, this does not end the story. There are a number of institutional investors, such as investment advisers to mutual funds, corporate governance activists, and corporate governance commentators, who analyze the dual class share structure and all its possible provisions not through the lens of private ordering but through the lens of shareholder democracy or empowerment. When one does that one loses sight of what is really important, and that is making sure corporate governance arrangements are used to maximize the wealth of shareholders. It also leads to attacks on private ordering and calls for limitations on its use.

In the case of dual class shares, the attacks have been very strong and impactful. For example, two leading index providers, S&P Dow Jones Indices and FTSE Russell, have succumbed to the pressure and have taken steps to exclude dual class shares from their indices.[8] More recently, such as the CII proposal described above, the attacks on dual class shares have focused on the absence of time-based sunset provisions in IPOs and the call for their mandatory inclusion.

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[7] Adena Friedman, President and CEO, Nasdaq, Inc., *The Promise of Market Reform: Reigniting America's Economic Engine*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (May 18, 2017), https://corpgov.law.harvard.edu/2017/05/18/the-promise-of-market-reform-reigniting-americas-economic-engine/.

[8] *See* FTSE RUSSELL, FTSE RUSSELL VOTING RIGHTS CONSULTATION-NEXT STEPS 3 (July 2017) (The FTSE Russell bars companies from inclusion in its benchmark indexes unless more than 5% of the voting rights are in the hands of public shareholders, http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf. *See also*, FTSE RUSSELL, MINIMUM VOTING RIGHTS HURDLE, FAQ (November 2018), https://www.ftse.com/products/downloads/Minimum_Voting_Rights_Hurdle_FAQ.pdf; Press Release, S&P Dow Jones Indices, *S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rules* (July 31, 2017) (the S&P Dow Jones Indices has decided to exclude all new dual class share offerings, including Snap Inc.'s, from the S&P Composite 1500 and its components, the S&P 500, S&P MidCap 400, and S&P SmallCap 600), https://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjimulti-classsharesandvotingrulesannouncement7.31.17.pdf?force_download=true.

II. The Argument for Mandatory Time-Based Sunset Provisions

Talented insiders possess the "idiosyncratic vision"[9] that allows their companies to earn excess returns. Idiosyncratic vision is a term coined by Zohar Goshen and Assaf Hamdani and has two parts:

> First, it reflects the parts of the entrepreneur's business idea that outsiders may be unable to observe or verify. This could be because the entrepreneur cannot persuade investors that she is the best person to continue running the firm or that her business plan will produce superior returns. Second, it reflects the above-market pecuniary return expected by the entrepreneur, which, if the business succeeds, will be shared on a pro rata basis between the entrepreneur and investors. Importantly, idiosyncratic vision need not concern an innovation or new invention: as long as the entrepreneur has a plan that she subjectively believes will result in above-market returns, she has idiosyncratic vision.[10]

Therefore, it is not unreasonable to argue that dual class share structures add value by protecting talented insiders from the interference and distraction caused by restive and uninformed shareholders.[11] For example, back in 2012, Mark Zuckerberg of Facebook faced a lot of heat for his decision to have the company purchase Instagram for an expected closing price of $1 billion.[12] This acquisition occurred just one month before the company issued its dual class shares to the public.[13] To add fuel to the fire, Zuckerberg enter into the agreement without informing his board of directors.[14] To make matters worse, the price of Facebook stock fell like a rock shortly after its IPO, down 54% after four months of public trading.[15] As late as July 2015, analysts were still wondering if the acquisition would earn money for Facebook.[16]

Without a dual class share structure to protect him, the 27 year old Zuckerberg may have felt quarterly pressure to prove that he had made the right decision.[17] Moreover, the board may eventually have had second thoughts about allowing the very young Zuckerberg to retain

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[9] Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L. J. 560 (2016).

[10] *Id.* at 567.

[11] *Id.* at 590 (Uncontestable and indefinite control provides the entrepreneur with maximum ability to realize her idiosyncratic vision,….).

[12] Facebook, Inc., Form 10-Q, for the quarterly period ended September 30, 2012, submitted to the SEC (September 30, 2012), https://www.sec.gov/Archives/edgar/data/1326801/000132680112000006/fb-9302012x10q.htm.

[13] Bernard S. Sharfman, *A Private Ordering Defense of a Company's Right to use Dual Class Share Structures in IPOs*, 63 VILLANOVA L. REV. 1, 14-15 (2018).

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.*

operational control of the company.[18] Instagram is now estimated to have a market value of over $100 billion.[19]

Nevertheless, it is reasonable to argue that the value of a leader's idiosyncratic vision erodes over time.[20] Even if it doesn't erode over a leader's lifetime, the leader's mortality will surely put an end to her competitive advantage. The point being that once this value approaches zero, the value of the dual class structure will also approach zero. Moreover, if the governance arrangement is simply used to allow the controller to act opportunistically, then the shares would trade at a discount to their unification price.

It is also reasonable to argue that a company leader, who has decided to sell most of her shares over time and retain only a minority of the company's shares outstanding, may avoid the unification of shares even though the value of the dual class share structure has passed and unification would yield a premium on her share sales. The purpose of such a strategy would be to retain voting control of the company. To retain control, the controller would sell her shares with low voting power but retain shares with high voting power. This gap between share ownership and voting power is commonly referred to as the "wedge."[21]

As Bebchuk and Kastiel explain, the reason for the controller's resistance to unification, even though the benefits of a dual class structure has passed, is "that the controller would capture only a fraction of the efficiency gains [of unification], which would be shared by all shareholders, but would fully bear the cost of forgoing the private benefits of control associated with the dual-class structure."[22] And indeed, empirical evidence appears to bear this out,[23] even though Fisch and Solomon have taken issue with the methodologies that are used in these studies.[24] Nevertheless, it would appear that the problem of controllers wanting to delay unification, even though

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[18] *Id.*

[19] Emily McCormick, *Instagram Is Estimated to Be Worth More than $100 Billion*, Bloomberg (June 25, 2018), https://www.bloomberg.com/news/articles/2018-06-25/value-of-facebook-s-instagram-estimated-to-top-100-billion.

[20] Lucian A. Bebchuk and Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585 (2017).

[21] *Id.*

[22] *Id.* The private benefits of control may include the hiring of family members instead of more qualified outsiders, self-dealing, or usurping a corporate opportunity. *Id.* at 603.

[23] Martijn Cremers, Benie Lauterbach, and Anete Pajuste, *The Life-Cycle of Dual Class Firm Valuation* (December 19, 2018), https://ssrn.com/abstract=3062895. *See also*, Hyunseob Kim & Roni Michaely, *Sticking Around Too Long? Dynamics of the Benefits of Dual Class Structures* 1, 26 (2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3145209.

[24] *See* Jill E. Fisch and Steven Davidoff Solomon, *The Problem of Sunsets*, forthcoming, BOSTON U. L. REV. 1, 9-12, https://ssrn.com/abstract=3305319. According to Fisch and Solomon, "The primary issue with finance studies of dual class stock is selection effects, namely that the companies that select into dual class structures differ, in important ways, from companies that adopt single class structures." *Id.* at 12.

unification would provide a boost to the share price, is a valid concern for those investing in dual class shares without time-based sunset provisions.

In sum, based on the analysis found in this Part, the inclusion of a time-based sunset provision makes some sense. However, to come to the conclusion that they must be mandatory in every single dual class share structure one must go farther and rebut the strong presumption that private ordering is value enhancing for shareholders. To rebut this presumption, strong evidence of some sort of irrationality or market failure must be found when market participants refuse to include time-based sunset provisions in IPOs. As discussed in Part III, such evidence does not exist.

III. An Explanation for the Persistent Absence of Time-Based Sunset Provisions

It can be assumed that the downside of dual class shares without time-based sunset provisions as discussed in Part II is now common knowledge to market participants. Evidence for this is the recently reported increase in the use of time-based sunset provisions.[25] Yet, dual class share structures without such provisions remain in the majority.[26] For example, while the upcoming Lyft IPO is expected to include a provision requiring unification upon the death or total disability of the last of the co-founders (event-based sunset provision), it is not expected to include a time-based sunset provision.[27] Therefore, there must be something missing in the prior analysis that makes the absence of time-based sunset provisions appealing to market participants. That missing element can be found in the path breaking work of Henrick Bessembinder.[28]

Bessembinder observed that there is a significant amount of positive skewness in the returns of individual public companies that have made up the stock market from July 1926 to December 2016.[29] He found that "in terms of lifetime dollar wealth creation" ("accumulated December 2016 value in *excess of* the outcome that would have been obtained if the invested capital had earned one-month Treasury bill returns") [30] "the best-performing 4% of listed companies explain the net gain for the entire US stock market since 1926, as other stocks collectively matched Treasury bills."[31] His results also showed that the sum of the individual contributions to lifetime dollar wealth creation provided by the top 50 companies represented almost 40% of total lifetime

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[25] CII reported that in 2018 five out of 15 IPOs with dual class share structures had time-based sunset provisions. *See* Council of Institutional Investors, *Dual-Class IPO Snapshot: 2017–2018 Statistics* (updated 1/2/19).

[26] *Id.*

[27] Lyft, Inc., S-1 Registration Statement (March 1, 2019), https://www.sec.gov/Archives/edgar/data/1759509/000119312519059849/d633517ds1.htm.

[28] Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?* 129 J. OF FIN. ECON. 440 (Issue 3, 2018).

[29] *Id.* at 440.

[30] *Id.* at 454, Table 5.

[31] *Id.*

dollar wealth creation.[32] Thus, the returns earned by a relatively small number of best-performing companies were critical to the stock market earning returns above short-term Treasuries.

The understanding that positive skewness exists in stock market returns means that investors are best served if those select few firms who are *expected* to be the best performers in terms of returns are provided governance arrangements that give them the best shot of reaching their optimum. Governance arrangements can support this objective by making sure that the leadership skills that exist in a company at the time of its IPO are given the maximum opportunity to be utilized. I believe this is why a few select firms are provided dual class share structures without time-based sunset provisions.

While not every company that has a dual class structure without a time-based sunset provision will hit the highest of heights, the results appear to bear out that this private ordering strategy has been highly successful. Included in Bessembinder's top 50 list of wealth creators are four companies with dual class share structures without time-based sunset provisions; Alphabet, Facebook, Berkshire Hathaway, and Comcast. If Bessembinder were to rerun the numbers through 2018, it appears that another such company, Nike, would also be in the top 50 or very close to it. It is also interesting to note that these highly successful companies vary significantly in terms of the number of years from the date when they first went public with dual class shares and that in most cases the number of years out are significantly greater than seven: Alphabet (15 years), Facebook (seven years), Berkshire Hathaway (23 years), Comcast (41 years), and Nike (38 years).

As of March 19, 2019, the current market values of these five best-performers are quite mind-boggling: Alphabet ($835 billion), Facebook ($461 billion), Berkshire Hathaway ($505 billion), Comcast ($180 billion), and Nike ($110 billion). Together, these five companies have a market value of over $2 trillion. No wonder market participants and investors are willing to provide a small select number of firms with dual class shares that omit time-based sunset provisions. The absence of these provisions are a small price to pay, the lost returns resulting from delayed unification, for helping to make sure that those companies who are expected to be the stock market's best performers are allowed to reach their full wealth creating potential.

Yes, on average dual class shares may persist too long without time-based sunset provisions, creating a situation where eventually a very small number of dual class shares companies, that have not failed, been acquired, or have not gone through a process of voluntary unification, may have common stock that trades below their unification price. It is interesting to note that these companies are so few in number that supporters of mandatory time-based sunset provisions can only point to one that is of any significance, Sumner Redstone's control of CBS and Viacom

[32] *Id.* at 454, Table 5.

through National Amusements Inc.[33] However, this is not what market participants are interested in when negotiating such a governance arrangement in an IPO with dual class shares. They are willing to take the risk of delayed unification if it provides the maximum opportunity for a leader's idiosyncratic vision to result in that company generating large asymmetric returns.

Finally, the idea of having a mandatory shareholder vote to determine if a dual class share structure should continue for up to another seven years creates new governance problems and does not solve the problem of premature unification. First, such a requirement puts pressure on a company's leadership to make the objective of its decision making the maintenance of its voting control, not the leveraging of the leader's idiosyncratic vision for the economic benefit of its shareholders. This cannot be beneficial for shareholders or the company.

Second, according to Fisch and Solomon, "Any expectation that a vote of existing minority shareholders will function efficiently to identify situations in which there is value to retaining a dual class structure is highly problematic."[34] Shareholders suffer from the problem of asymmetric information and the simple inability of most shareholders to make the proper evaluation of a leader's idiosyncratic vision.[35] This leaves shareholders in the position of having the knowledge that ending the dual class share structure will expose the shares to the market for corporate control and hedge fund activism, an expected positive for the company's share price, without being able to evaluate the cost. Since the greater risk to shareholders is voting to cut off the dual class share structure too soon, assuming it is a company that is still implementing the leader's idiosyncratic vision which will lead to above market returns, this makes a shareholder vote on extending a dual class share structure an extremely high risk proposition for both the company's shareholders and its leadership.

Conclusion

How the governance arrangements of IPOs are determined is best handled by market participates through the process of private ordering. If the market is concerned about dual class share structures creating family dynasties, then it will include an event-based sunset provision such as unification upon the death or disability of the controller. Consistent with that approach, the proposal presented by the CII to the NASDAQ will disrupt private ordering and lead to harmful results for dual class share companies and their investors. As explained by Fisch and Solomon,

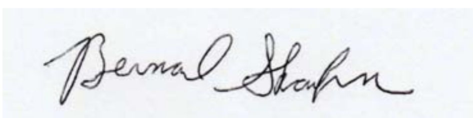
> a one-size fits all approach to sunsets – like that proposed by the CII … does not make sense. The time frame necessary for realization of company's goals is likely to vary depending on the company based on factors like the company's maturity at the IPO stage,

[33] Bebchuk and Kastiel, supra note 20, at 587-88.
[34] Fisch and Solomon, *supra* note 24, at 19.
[35] *Id.* at 20.

the duration of its business model, and the time required to develop its products or services and bring them to market.[36]

As provided by private ordering, the omission of a time-based sunset provision in dual class share structures has a defined and obvious benefit, protecting the idiosyncratic vision possessed by those companies who have been identified as possibly turning into one of the stock market's best performers. These are the companies who allow the stock market to generate overall returns that are greater than short-term Treasury rates. The cost of delayed unification for a handful of companies may be significant on an individual basis but in terms of the stock market as a whole, the effect appears de minimus. In sum, even if the implementation of a mandatory one-size-fits-all sunset provision only results in inhibiting one company from becoming the next Alphabet or Facebook, then that is one company too many.

Very truly yours,



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[36] *Id.* at 17.