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December 8, 2021

Dual Class Stock: Background and Policy Debate

When investors acquire the common stock of publicly traded companies, that share ownership generally entitles a shareholder to two things: (1) a financial stake in the firm and (2) the right to vote at annual and special company meetings on such things as candidates for the board of directors, potential corporate acquisitions and mergers, management proposals, and non-binding shareholder proposals aimed at changing company policy. Overall, about three-quarters of publicly traded U.S. firms reportedly have shares with equal voting rights, popularly known as "one share, one vote." The remainder have common stock that have shares with differential voting rights called multi-class stocks and dual class stock (DCS) in cases where there are two classes. Multi-class stocks and DCSs have raised concerns for some over the implications of the power disparity between founder-managers with superior voting shares and the majority shareholders with inferior ones. The most common form of DCS involves one class of shares with 10 times the voting power of the other. Some firms, however, have issued shares with 20 times the voting power of the other.

Few firms have share classes wherein one class has voting rights and other shares are non-voting. One of the most controversial of this occurred in 2017 when an initial public offering (IPO) by Snap, the parent company of Snapchat, involved the issuance of three share classes, one with 10 votes per share, one with one vote per share, and one with no votes.

While controversial since the 1920s, DCS has witnessed renewed attention and seen revived controversy in the past couple of decades due to its heightened use by technology firms. Such firms have included Google (the DCS tech pioneer in 2004, now Alphabet), Facebook, Snap, Dropbox, Lyft, Groupon, Fitbit, Kayak, Blue Apron, Zoom Video, Roku, Chewy, and TripAdvisor. According to some reporting, in a given recent year, nearly half of tech IPOs have involved multi-class shares. Non-tech firms with DCS include Coca-Cola, the Ford Motor Company, Nike, Levi Strauss and Company, and the Hyatt Hotels. A host of media firms have also employed DCS and include the New York Times, News Corp., CBS, Comcast, and Liberty Mutual.

Proponents of DCS include NASDAQ, officials at various companies, and some academics. Key supportive arguments include (1) that it is a proper manifestation of *private ordering*, the idea that investors are free to invest in firms with various types of capital and governance structures and other attributes that meet their needs; and (2) that, particularly for tech firms, it allows entities who control a firm (such as its founders and funding venture capital firms) the latitude and time to pursue their often unique business visions unbothered by shorter-term pressures such as the vagaries of the stock market, unsolicited acquisition attempts, and the demands of activist shareholders.

Critics include the Securities and Exchange Commission (SEC) Investor Advisory Commission and Investor Advocate, the Investor Stewardship Group (a group of U.S. and global institutional investors and asset managers), and various academics. Principal criticisms are that (1) DCS subverts the widely embraced notion of shareholder equity, the idea that shareholders are entitled to equal voting power with respect to the individual shares that they own; and (2) it can cause the rights, needs, and prerogatives of majority shareholders to be subsumed by minority shareholders with superior voting shares, also known as the principal-agent problem. The latter may manifest itself through insulated and entrenched owner-managers more prone to engage in wasteful or inefficient self-interested behavior, including awarding excessive compensation, and pursuing vanity research and development projects; and imprudent corporate acquisitions.

History and Regulation

The first American publicly traded firm to issue multi-class shares was reportedly the International Silver Company in 1898. Use of differential voting shares, however, did not really take off until the early 1920s. By the middle part of that decade, public outcry over DCS ensued after a stock issuance by the Dodge Brothers, an auto maker. Traded on the New York Stock Exchange (NYSE), the firm's minority stakeholders' 1.7% of the issued common stock gave them complete voting control over the majority shareholders' non-voting shares. Widely seen as an unseemly disparity, it resulted in an uproar that prompted the exchange to issue a de facto ban on DCS in 1926. Later, in 1940, the exchange adopted a rule that, with few exceptions, barred listed firms from issuing non-voting stock and prohibited superior-voting stock from constituting more than 18.5% of all outstanding common shares. According to various sources, these effectively limited most multi-class NYSE listings.

In the early 1980s, the historically dominant NYSE faced growing competition from the American Stock Exchange (AMEX), which allowed DCS with some conditions, such as allowing classes of stocks with no more than a 10-to-1 voting ratio between them, and especially the NASDAQ, which had no DCS restrictions. Firms were also looking at DCS as a tool to help ward off unsolicited takeover attempts, which were on the increase. The NYSE had several firms that were threatening to delist from it if they could not recapitalize with DCS. Subsequently, in 1986, the exchange allowed recapitalization with multi-class stock.

In 1988, to level the multi-class share playing field among the exchanges, the SEC adopted Rule 19c-4 of the Securities Act of 1934. The reform prohibited a firm from being listed on a national exchange if it had taken actions that had the effect of "nullifying, restricting or disparately reducing the per share voting rights of existing" common stockholders. By various accounts, in doing so, the rule effectively banned most forms of DCS.

Soon afterwards, the Business Roundtable, a group of large public company corporate executives, challenged the SEC rulemaking, arguing that shareholder voting rights was a matter of state corporate law. Later, in Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990), in 1990, the Court of Appeals for the District of Columbia nullified the SEC reform, ruling that the agency had exceeded its authority under the Securities and Exchanges Act of 1934.

Subsequently, in 1994, the NYSE, NASDAQ, and the AMEX adopted similar policies that permitted their listed firms initially to issue multi-class shares but does not allow them to subsequently reduce the stock's voting rights during recapitalizations. That regulatory regime still stands.

In 2017, the aforementioned Snap IPO's unorthodox issuance of non-voting public stock was widely criticized. As part of the backlash from this, several entities, including the SEC's Investor Advisory Committee and the Council of Institutional Investors, petitioned owners of major stock indexes to exclude firms that issue DCS from the indexes. That same year, S&P Dow Jones announced that firms with new dual class share offerings would be excluded from its S&P Composite 1500 and its various indices, including the S&P 500. At the same time, FTSE Russell, a subsidiary of the London Stock Exchange, announced that firms with dual class stock would be excluded from its stock indexes, including the Russell 3000, if their majority-held shares had less than 5% of the voting power of their superior shares.

A Look at the Value of Multi-Class Shares

A fundamental question in the debate on multi-class structures is what their value is to their firms. This is the subject of considerable research. In 2021, Guerra-Martinez examined much of that work and observed that the preponderance of research indicates that the value of firms with multi-class shares diminishes over time. Saying that more research is needed, the study noted that some research has found that such firms can earn higher valuations at the IPO stage and have a beneficial effect on innovation and the promotion of local industry. It also found that since 2014, the percentage of newly public tech firms with DCS has been higher than non-tech DCS firms. It then questioned whether the historical research on multi-class stocks has fully reflected what some describe as "the higher idiosyncratic value [the value an entrepreneur places on her ability to execute a business idea] probably created by founders of tech firms."

Sunset Provisions

Various firms with multi-class shares have "sunset" measures in their charters that provide for triggers that result in all company common shares being converted into a single voting share class. The major kinds of triggers are:

- An event-based sunset in which the uniform stock conversion is precipitated by the occurrence of a designated event such as the founder's disability, death, or attainment of a retirement age. The underlying rationale is that firms benefit from the presence of healthy founders whose ability to lead is bolstered by their ownership of superior voting stock.
- A fixed-time-based sunset in which the conversion of multi-class stock to uniform voting shares occurs at a specified future date. An underlying premise (supported by some research) is that while initially beneficial for a firm after an IPO, over time dual class structures lose their value to the company. Time-based sunsets range from three to 20 years, with 10 and then seven years reportedly being the most common.

Sunset provisions appear to be growing in popularity. While they remain relatively limited—the Council of Institutional Investors (CII, a coalition of institutional investors) reported 41 by 2020—they have grown over time. For example, in 2018 then-SEC Commissioner Robert Jackson spoke about the absence of sunset provisions, observing that over the past 15 years, almost half of the companies whose IPOs involved DCSs awarded corporate insiders superior voting shares in perpetuity. CII, however, reports growing use of time-based sunsets. It found that while 26% of newly public dual class firms had such a provision in 2017, 51% adopted it in the first half of 2021.

The CII petitioned the NYSE and NASDAQ in 2018 to require newly listed dual class firms to adopt a time-based sunset provision. A critic of dual class firms, the CII argued that "evolving market practice and academic research suggest[s] that multi-class structures become problematic within five to nine years." (According to the CII, the mean time-based sunset in 2020 was 12 years.) It then said that a seven-year sunset was a good compromise vis-à-vis an outright ban.

Draft Sunset Legislation and Debate

There is currently draft legislation under committee consideration aimed at encouraging DCS to include sunset provisions. The draft bill would prohibit the listing of any security of an issuer with unequal voting classes of stock for more than seven years without shareholder approval.

Research on the effects of sunset provisions is mixed. In 2018, the staff of then-SEC Commissioner Jackson examined IPOs during the previous 15 years. They found that seven or more years away from an IPO, firms with perpetual DCS traded at significant discounts compared to those with sunset provisions. Related research (Bebchuk and Kastiel, 2017) found that controllers of firms with DCS have perverse incentives to retain them even after they result in inefficient firms. Alternatively, 2019 research by Fisch and Solomon observed that (1) academic research on the implications of time-based sunsets is insufficiently developed and (2) fixed-time sunsets are too arbitrary to reasonably accommodate the variability among dual class firms and their life cycles. Gurrea-Martínez (2021) has cautioned that a mandatory time-based sunset could dissuade some firms from going public. India is reportedly the only nation with a mandatory time-based DCS sunset.

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