INDEX-MAKER ACTIVISM AND PRIVATE RULEMAKERS

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I. INTRODUCTION

In 2017, three major index-makers took swift action to impose rules excluding companies with dual class share structures from some of their largest indices, including the S&P 500.[1] The decisions came following the Snap, Inc. initial public offering, which provided no voting rights to common stockholders.[2] In general, norms of "one share, one vote" have eroded as companies increasingly go public with dual class structures.[3] After months of consultation, the index-makers imposed a private rule that the Securities and Exchange Commission ("SEC") had tried and failed

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[1] *See Snap Decision: Leading Index Providers Nix Multi-Class Shares*, DAVIS POLK & WARDWELL LLP (Aug. 1, 2017), https://www.davispolk.com/publications/snap-decision-leading-index-providers-nix-multi-class-shares.

[2] Maureen Farrell, *In Snap IPO, New Investors To Get Zero Votes, While Founders Keep Control*, WALL ST. J. (Jan. 16, 2017), http://www.wsj.com/articles/in-snap-ipo-new-investors-to-get-zero-votes-while-founders-keep-control-1484568034.

[3] *See Discussion Draft: Dual Class and Other Entrenching Governance Structures in Public Companies*, SECURITIES & EXCHANGE COMMISSION, INVESTOR ADVISORY COMMITTEE (Dec. 17, 2017), http://www.sec.gov/spotlight/investor-advisory-committee-2012/discussion-draft-dual-class-recommendation-iac-120717.pdf (finding a 44% increase in dual class companies from 2005 to 2015).

to implement as a public rule.[4] In this paper, we will question whether index-makers are a desirable source of corporate governance regulation.

In Robert Jackson's first speech as a newly minted Commissioner of the SEC, he lamented the rise of dual class companies, asking whether it was wise to "place eternal trust in corporate insiders" and "grant corporate executives control of our public companies literally *forever*."[5] Rather than turning to the index-makers, however, Commissioner Jackson expressed "hope that our national securities exchanges will soon consider proposed listing standards addressing the use of perpetual dual-class stock."[6] Similarly, both BlackRock and T. Rowe Price endorsed a recent petition by the Council of Institutional Investors ("CII") asking the exchanges, not index-makers, to require sunset provisions for listed firms.[7] Vanguard questioned "whether index construction is the right place to the solve the problem" of dual class shares.[8] In calling upon the quasi-public national securities exchanges and challenging regulation by index-makers, Commissioner Jackson and large institutional investors are expressing a preference for a particular private rulemaker to take action.

This paper will utilize the dual-class share exclusions to illuminate the tensions between private and public rulemaking in corporate law. Government can opt for various levels of involvement when responding to policy challenges. This "broad spectrum" of public rulemaking ranges from deferring entirely to private parties, to establishing agencies which create and enforce extensive mandatory laws.[9] This spectrum has various distinctive nodes, each with numerous benefits and drawbacks. The government may, for example, explicitly delegate rulemaking authority to private actors. Some states do this by automatically adopting the professional responsibility rules of the American Bar Association. Alternatively, the government may choose to adopt wholesale the published recommendations of a "private legislature" like the American Law Institute.[10]

Private rulemakers, like the index-makers who imposed the dual class restrictions, complicate this traditional narrative. By private rulemakers, I refer to rulemaking entities whose rules and decisions impact corporations despite the absence of any contractual relationship. Private rulemakers supplement Frank Easterbrook and Daniel Fischel's description of the corporation as a "complex set of explicit and implicit contracts."[11] Private rulemakers, like government, set rules

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[4] Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (striking down Rule 19c-4 as exceeding the SEC's authority under the Securities Exchange Act).

[5] Robert J. Jackson Jr., *Perpetual Dual-Class Stock: The Case Against Corporate Royalty*, U.S. SECURITIES AND EXCHANGE COMMISSION (Feb. 15, 2018), http://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty.

[6] *Id.*

[7] Benjamin Bain, *BlackRock Backs Limits on Listings with Separate Share Classes*, BLOOMBERG (Oct. 24, 2018), http://www.bloomberg.com/news/articles/2018-10-24/blackrock-backs-limits-on-listings-with-separate-share-classes.

[8] Chris Dieterich et al., *Stock Indexes Push Back Against Dual-Class Listings*, WALL ST. J. (Aug. 2, 2017), http://www.wsj.com/articles/stock-indexes-push-back-against-dual-class-listings-1501612170.

[9] *See* Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319, 324 (2002) ("Private ordering can be viewed as part of a broad spectrum within which rulemaking is classified by the amount of governmental participation involved.").

[10] For further detail on the rulemaking processes of the American Law Institute, *see* Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595 (1995).

[11] Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989); *see also* Frank H. Easterbrook & Daniel R. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 12 (1991).

that affect corporations without their consent. The powers and functions of private rulemakers have critical implications for the appropriate level of government intervention.

Private rulemakers have become prevalent in financial markets. Proxy advisory firms such as Institutional Shareholder Services ("ISS") and Glass Lewis wield tremendous power over corporate governance decisions.[12] ISS publishes Proxy Voting Guidelines which effectively serve as rules for its voting recommendations.[13] These recommendations have tremendous implications for shareholder votes across public companies.[14] Large pension funds, including the California Public Employees' Retirement System ("CalPERS"), have established rules regarding socially responsible investing which affect the flow of billions of dollars in investment.[15] Stock exchanges, functioning as quasi-private rulemakers, impose rules through extensive listing standards, as discussed further *infra* Section V.B.

This paper will utilize the index-makers' dual-class share exclusions in order to illuminate the tensions between private and public rulemaking in corporate law. Clearly, there are innumerable policy differences and dimensions when comparing private and public rulemaking. This paper will focus on a select few elements of particular importance in the context of the dual class restrictions. Overall, we will find that private rulemakers, specifically index-makers, are subject to similar forms of disfunction and bias that plague public rulemakers. Moreover, private rulemakers create additional challenges due to the uncertain effects of their decisions and lack of formal, reviewable decision-making processes. When selecting a point along the spectrum of government intervention, policy-makers should recognize these underappreciated dimensions rather than embrace the myth of idyllic private ordering.

In Part II, we will discuss the market function of index-makers and the ongoing debate over dual class share structures. Then, we will gain further detail on the restrictions on dual class structures imposed by the three largest index-makers. Part III will reveal the conflicting demands imposed on index-makers by their primary customers, institutional investors. The fundamental flexibility of index creation allows index-makers to respond to these customer demands through their index construction methodologies. Part IV begins to assess the effects of such index-maker activism, as exemplified by the dual class share restriction. The dual class restrictions create tremendous market uncertainty while making indices less representative of their underlying benchmark. Moreover, such activism decreases the incentives of states to invest in their corporate law infrastructure. In Part V we will consider regulatory responses to index-maker activism, including the exchanges as an alternate source of dual class share restrictions. Finally, in Part VI we will conclude and address the future of index-maker activism.

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[12] *See, e.g.*, David F. Larcker et al., *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J.L. & ECON. 173 (2015). There has been a strong push to regulate these firms, and the House of Representatives recently approved legislation that would require SEC registration of proxy advisory firms. Andrew Ramonas, *Proxy Advisory Firm Registration Bill Passes House*, BLOOMBERG LAW: SECURITIES & CAPITAL MARKETS (Dec. 20, 2017), https://news.bloomberglaw.com/securities-law/proxy-advisory-firm-registration-bill-passes-house?context=search&index=0.

[13] *United States Proxy Voting Guidelines: Benchmark Policy Recommendations, Effective for Meetings on or after February 1, 2018*, INSTITUTIONAL SHAREHOLDER SERVICES (Jan. 4, 2018), http://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf.

[14] *See* James Cotter et al., *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 VILL. L. REV. 1, 2 (2010) (finding that mutual funds "tend to vote in line with ISS recommendations across the board").

[15] *See, e.g.*, *Sustainable Investments Program*, CALPERS, http://www.calpers.ca.gov/page/investments/governance/sustainable-investments-program (last visited Apr. 13, 2019).

II. INDEX-MAKERS AND DUAL CLASS SHARES

A. The Role of Index-Makers

Index funds have transformed modern investing. Nobel Prize-winning economist Paul Samuelson compared the invention of the index fund to that of "the wheel, wine and cheese, the alphabet and Gutenberg printing."[16] Index funds, as explained by Gabriel Rauterberg and Andrew Verstein, sit "[a]t the intersection of" the Efficient Markets Hypothesis and Modern Portfolio Theory by providing a mechanism to execute an "investment strategy based on investing in a diversified portfolio of passively managed assets."[17] Colloquially referred to as passive investing, the strategy of owning a broad swath of securities stands at odds with traditional notions of retail investors purchasing shares in individual companies. Various scholars have identified the concerning effects of decreased competition[18] and less management accountability.[19] To some, passive investing is "worse than Marxism."[20]

Index-maker power has expanded due to the rise of passive investing.[21] Index-makers perform the critical function of developing the innumerable indices that match desired passive investing strategies. MSCI Inc. ("MSCI") alone calculates more than 200,000 end-of-day indices and over 11,000 real-time indices.[22] In other words, index-makers enable effective passive investment. As Alex Matturri, chief executive of S&P Dow Jones Indices ("S&PDJI"), put it: "Why do we calculate a million indices every night? Because there's a demand for that."[23]

Like their institutional investor counterparts, the index-makers are heavily consolidated: S&PDJI, FTSE Russell ("FTSE"), and MSCI provide the benchmarks for 73% of mutual fund

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[16] Jason Zweig & Sarah Krouse, *John C. Bogle, Founder of Vanguard Group, Dies at 89*, WALL ST. J. (Jan. 17, 2019), http://www.wsj.com/articles/john-c-bogle-founder-of-vanguard-group-dies-11547677745.

[17] Gabriel Rauterberg & Andrew Verstein, *Index Theory: The Law, Promise and Failure of Financial Indices*, 30 YALE J. ON REG. 1, 8 (2013).

[18] *See* José Azar et al., *Anti-Competitive Effects of Common Ownership*, 73 J. FINANCE 1513 (2018); *see also* Einrer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016).

[19] Vladyslav Sushko & Grant Turner, *The Implications of Passive Investing for Securities Markets*, BANK INT'L SETTLEMENTS QUARTERLY REV. (2018), http://www.bis.org/publ/qtrpdf/r_qt1803j.pdf ("A higher share of passive investors could therefore weaken market discipline and alter the incentives of corporate and sovereign issuers to act in the interest of investors.").

[20] Luke Kawa, *Bernstein: Passive Investing Is Worse for Society Than Marxism*, BLOOMBERG (Aug. 23, 2016), http://www.bloomberg.com/news/articles/2016-08-23/bernstein-passive-investing-is-worse-for-society-than-marxism.

[21] An analysis based on Morningstar data found that "passive market share of US equities has increased from just 12% in 1998 to 46% at the end of 2016." Mary Fjelstad, *Friend or Foe? The Remarkable Growth of Passive Investing*, SEEKING ALPHA (Oct. 17, 2017), http://seekingalpha.com/article/4113914-friend-foe-remarkable-growth-passive-investing. BlackRock estimates that 18% of the global stock market is held in index funds. Trevor Hunnicutt, *Less than 18 Percent of Global Stocks Owned by Index Investors: BlackRock*, REUTERS (Oct. 3, 2017), http://www.reuters.com/article/us-funds-blackrock-passive/less-than-18-percent-of-global-stocks-owned-by-index-investors-blackrock-idUSKCN1C82TE. However, due to "closet indexing," this number could be significantly higher in reality. *See* Martijn Cremers et al., *Indexing and Active Fund Management: International Evidence*, 120 J. FIN. ECON. 539 (2016) (estimating that 20% of active funds are "closet indexing").

[22] MSCI Inc., Annual Report (Form 10-K) (Feb. 22, 2018).

[23] John Authers, *Investing: The Index Factor*, FIN. TIMES (Aug. 16, 2015), http://www.ft.com/content/40bb7c10-419f-11e5-9abe-5b335da3a90e.

assets in the United States.[24] The S&P 500 alone has $8.7 trillion dollars benchmarked or indexed to it,[25] and State Street Global Advisors' SPDR S&P 500 ETF is the "single most heavily traded listed security on the planet."[26] As *The Economist* has acknowledged, these three index-makers "dominate equity index-making."[27] In 2016, these big three index-makers earned close to $2 billion collectively thanks in part to the increased demand for passive investment, with each firm experiencing significant growth during the year.[28] The general business model, with some variation, is to charge a small licensing fee to companies that wish to utilize a particular basket of securities.[29] Index-makers are a necessary ingredient to the passive investing revolution.

B. The Dual Class Share Controversy

Investors in public companies typically obtain voting power in proportion to their financial equity in the company. Dual class companies like Facebook and Snap reject this historically fundamental pillar of corporate governance, awarding substantially disparate voting power to each class of shares. Mark Zuckerberg, despite holding a clear minority of equity in Facebook, controls all major decisions through Class B shares holding 10 votes per share.[30] Snap simply declined to provide its Class A shareholders with any voting rights, a first for an initial public offering on a U.S. stock exchange.[31] From 2005 to 2015, the number of companies employing multi-class structures increased by 44%,[32] and in 2015, 14% of companies that listed on U.S. exchanges had dual-class voting (compared with 1% in 2005).[33]

There is extensive debate, which we need not fully rehash, over the effects of dual class shares. Opponents contend that dual class shares decrease corporate accountability and cement founder control in perpetuity. Proponents counter that investors can easily price any perceived dangers of dual class shares into the cost of the stock.[34] Dorothy Shapiro Lund suggests that dual class shares in fact decrease the cost of equity capital by retaining influence in the most informed

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[24] *Id.* Note that these are the largest providers in the equity arena; Barclays has meaningful market share in bond indices. This paper focuses exclusively on equity indices, though much of the analysis would apply to bond indices as well.

[25] Nicole Bullock, *Investors Hail S&P 500 Move Over Multiple Class Shares*, FIN. TIMES (Aug. 1, 2017), http://www.ft.com/content/0a441900-76ca-11e7-a3e8-60495fe6ca71.

[26] Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 298 (2017).

[27] *Financial-Market Index-Makers Are Growing in Power*, THE ECONOMIST (Aug. 24, 2017), http://www.economist.com/news/finance-and-economics/21727090-their-role-facing-greater-scrutiny-result-financial-market-index-makers-are.

[28] Robin Wigglesworth & Stephen Foley, *ETF Providers Float Idea of Setting Up Their Own Market Indices,* FIN. TIMES (May 24, 2017), http://www.ft.com/content/e20327d8-3b05-11e7-821a-6027b8a20f23.

[29] *See, e.g.*, S&P charges an iShares fund owned by BlackRock a license fee of .0308% of fund value. Rauterberg & Verstein, *supra* note 17, at 127.

[30] Facebook, Inc., Annual Report (Form 10-K) (Feb. 1, 2018); *see also* Farhad Manjoo, *How Mark Zuckerberg Became Too Big To Fail*, N.Y. TIMES (Nov. 1, 2018), http://www.nytimes.com/2018/11/01/technology/mark-zuckerberg-facebook.html. For further detail regarding the agency costs of controlling minority shareholders, see Lucian A. Bebchuk & Kobi Kastiel, *The Perils of Small-Minority Controllers*, GEO. L.J. (forthcoming), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=3128375.

[31] Snap Inc., Annual Report (Form 10-K) (Feb. 22, 2018); Snap Inc., Registration Statement (Form S-1) (Feb. 22, 2017).

[32] SEC INVESTOR ADVISORY SUBCOMMITTEE, *supra* note 13.

[33] Jackson, *supra* note 5.

[34] For an example of a dual class share pricing study, see Brian F. Smith & Ben Amoako-Adu, *Relative Prices of Dual Class Shares*, 30 J. FIN. & QUANT. ANALYSIS 223 (1995).

and personally invested shareholders.[35] Indeed, dual class shares appear to mitigate the separation of ownership and control, first identified by Berle and Means.[36] The recent dramatic increase in dual class companies provides ample opportunity for further empirical research on this difficult question.

C. Index-Makers Enter the Dual Class Fray

Index-makers have served an essential yet understated role in securities markets, at least until 2017. In just a few months, each of the three major index-makers took action to exclude companies with dual class share structures from certain key indices. Though index-makers frequently adjust their methodology, these changes were distinctive because they reflected disapproval of a particular corporate governance structure.[37] More importantly, the restrictions bear no apparent relation to the underlying purposes of the indices.

Shortly after Snap completed its March 2017 initial public offering, in which common stockholders received no voting power, each of the three major-index makers initiated consultation processes.[38] The CII, a large coalition of primarily pension and retirement funds with roughly $25 trillion in assets, aggressively lobbied the index-makers to begin these deliberations.[39] S&PDJI acted quickly, announcing on July 31, 2017 that companies with multi-class share structures would be excluded from the S&P 500 (and certain other indices) immediately.[40]

The S&PDJI restrictions, while seemingly broad, carried two substantial carveouts. For one, the policy would grandfather in existing index constituents with dual class structures, such as Facebook and Berkshire Hathaway. Second, the S&P Global BMI Indices and S&P Total Market Index would not adopt this rule because they are “broad market indices intended to represent the investment universe.”[41] Despite these limitations, the investment community unquestionably took notice.[42]

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[35] Dorothy Shapiro Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. 687 (2019); *see also* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 565 (2016) (“[C]ontrol allows entrepreneurs to pursue business strategies that they believe will produce above-market returns by securing the ability to implement their vision . . . in the manner they see fit.”).

[36] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[37] Adriana Robertson notes that the S&P 500 methodology was adjusted at least eight times from January 1, 2015 to April 30, 2018. Adriana Robertson, *Passive in Name Only: Delegated Management and “Index” Investing*, YALE J. ON REG. (2019)

[38] DAVIS POLK & WARDWELL, *supra* note 1.

[39] Vijay Govindarajan et al., *Should Dual-Class Shares Be Banned?*, HARV. BUS. REV. (Dec. 3, 2018), http://hbr.org/2018/12/should-dual-class-shares-be-banned; Letter from Kenneth A. Bertsch, Exec. Dir., The Council of Institutional Investors, to Members of the MSCI Equity Index Committee (Mar. 29, 2017), http://www.cii.org/files/issues_and_advocacy/correspondence/2017/03_29_17_MSCI_letter_request_for_consultation.pdf; Letter from Kenneth A. Bertsch, Exec. Dir., The Council of Institutional Investors, to Members of the FTSE Russell Governance Board (Mar. 24, 2017), http://www.cii.org/files/issues_and_advocacy/correspondence/2017/03_24_17_letter_ftse.pdf.

[40] Press Release, S&P Down Jones Indices, S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rules (July 31, 2017), http://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjimulti-classsharesandvotingrulesannouncement7.31.17.pdf?force_download=true.

[41] *Id; See* Matt Levine, *Index Rules and Analyst Fatigue*, BLOOMBERG (Aug. 1, 2017), http://www.bloomberg.com/view/articles/2017-08-01/index-rules-and-analyst-fatigue. Levine accurately comments that “[i]n casual usage, the S&P 500 is ‘the market,’ and it is easy to confuse it with ‘the investment universe’.”

[42] *See* Dieterich et al., *supra* note 8.

FTSE utilized a slightly different mechanism to limit the inclusion of dual class companies.[43] Rather than exclude all such companies, FTSE will require that 5% of a company's voting rights be held by unrestricted shareholders (*i.e.*, the free-float). The rule is significantly less aggressive than S&PDJI's, since companies with meaningful voting power disparities can meet the 5% threshold. Like S&PDJI, existing companies are grandfathered in, but with a five-year deadline to alter their stock structures. Despite these restrictions, CII quickly applauded FTSE for their decision.[44] FTSE fully acknowledged that it was attempting to appease both sides of a contentious debate, describing the ultimate decision as a "pragmatic compromise" between whose who were concerned about the Snap IPO and others who worried about losing access to the investable universe of securities.[45] As evidence of their precarious position, FTSE has already committed to reconsidering its dual-class share policy.[46]

MSCI has changed course multiple times in its treatment of dual class shares. In November 2017, MSCI announced an immediate ban of dual class companies on two of its major indices.[47] In January 2018, however, MSCI released a Discussion Paper touting an alternative and noticeably less forceful recommendation: decreased weight in indices for companies with dual class shares, where "only the portion of total share capital that offers voting rights is deemed to be eligible for inclusion."[48] In October 2018, MSCI scrapped the policy altogether, concluding that they "do not believe that preferences and constraints on voting rights . . . should impact the definition of the investable universe underpinning these benchmarks."[49]

There is considerable debate over whether these restrictions will meaningfully impact corporate governance decisions. To some, the index-makers' actions have killed the trend of dual-class stock: "Why would you do an IPO if you can never make it into the index?"[50] Others, however, are far less concerned: "The reported demise of dual-class stock appears to be, to paraphrase Mark Twain, 'greatly exaggerated.'"[51] Since the restrictions were announced, multiple companies have gone public or announced intention to do so with multi-class structures, including

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[43] *See* FTSE RUSSELL, FTSE RUSSELL VOTING RIGHTS CONSULTATION – NEXT STEPS (July 26, 2017), http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf (includes complete detail on FTSE Russell decision).

[44] *Id.*; Press Release, Council of Institutional Investors, CII Applauds FTSE Russell Decision To Set Voting Rights Minimum for Inclusion on Indexes (July 26, 2017), http://www.cii.org/ftserussellsnap.

[45] FTSE RUSSELL, FTSE RUSSELL VOTING RIGHTS CONSULTATION – NEXT STEPS (July 26, 2017), http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf. Indeed, 68% of respondents in FTSE's customer survey desired a minimum hurdle of public equity voting rights, and 55% of those thought it should be 25% (compared to only 23% who thought it should be 5%).

[46] Andrea Vittorio, *FTSE Russell to Revisit Voting Power One Year After Snap IPO*, BLOOMBERG LAW (Mar. 14, 2018 https://biglawbusiness.com/ftse-russell-to-revisit-voting-power-one-year-after-snap-ipo.

[47] Trevor Hunnicutt, *MSCI Blocks New Stocks Lacking Voting Rights From Some Indexes*, REUTERS (Nov. 3, 2017), http://www.reuters.com/article/us-msci-governance/msci-blocks-new-stocks-lacking-voting-rights-from-some-indexes-idUSKBN1D32CM.

[48] MSCI, SHOULD EQUITY INDEXES INCLUDE STOCKS OF COMPANIES WITH SHARE CLASSES HAVING UNEQUAL VOTING RIGHTS 12 (Jan. 2018), http://www.msci.com/documents/1296102/8328554/Discussion+Paper_Voting+rights.pdf/d3ba68f1-856a-4e76-85b6-af580c5420d7.

[49] Press Release, MSCI, MSCI Will Retain the MSCI Global Investable Market Indexes Unchanged and Launch a New Index Series Reflecting the Preferences of Investors on Unequal Voting Structures (Oct. 30, 2018), http://www.msci.com/documents/10199/0b548379-fbe7-71c7-b392-7140b2215cc9.

[50] Levine, *supra* note 41.

[51] David J. Berger et al., *The Continuing Support for Dual-Class Stock by Companies and Investors*, HARV. L. SCH. FORUM CORP. GOVERNANCE & FIN. REG. (Nov. 2, 2017), http://corpgov.law.harvard.edu/2017/11/02/the-continuing-support-for-dual-class-stock-by-companies-and-investors/.

Dropbox.[52] An event study of the index-makers' dual class announcement has apparently found that there was no significant effect on included or excluded firms and that the exclusion "will not affect corporate governance choices."[53]

Whatever the ultimate effects, three major index-makers have opened the door for activism by index methodology. In Scott Hirst and Kobi Kastiel's recent analysis of the dual class restrictions, they described index exclusions as "a new and important tool in the corporate governance landscape."[54] Below, we consider the process for implementing such extraordinary restrictions through index creation.

III. PROCESS: INCENTIVES AND METHODOLOGY

A. Index-Makers and Institutional Investors

Like any business, index-makers are guided by the demands of their customers. As Rauterberg and Verstein identify, "Many of the best-known indices, such as . . . the S&P 500, are created primarily as products for sale."[55] Index-maker customers are predominantly large institutional investors who are able to exercise control over a fundamentally malleable decision-making process. According to MSCI's 2018 Annual Report, BlackRock alone accounted for 11.5% of total revenue, and only 10 customers made up nearly 28% of total revenue.[56] MSCI specifically identified the risk that a "limited number of clients account for a material portion of [its] revenue.[57] Across index-makers, a relatively small group of companies has considerable financial influence.

The index-makers clearly account for the views of these customers, especially when making controversial decisions. Mark Makepeace, Chief Executive Officer of FTSE, stated that "if we do a rule change, we have to consult with the institutions. The power is with them. We only make changes with their support."[58] The various consultations on the dual class restriction demonstrate the influence of institutional investors. Each of the three major index-makers conducted extensive stakeholder surveys and developed their proposals in light of the consultation results.[59] MSCI acknowledges that in addition to soliciting general feedback, it will "actively

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[52] Dropbox's Class A shares, which are mainly owned by the co-founders, will retain ten votes per share, while Class B shares have only one vote per share. Hannah Kuchler & Tom Braithwaite, *Dropbox Plans for IPO Raise Ire Over Share Structure*, FIN. TIMES (Feb. 23, 2018), http://www.ft.com/content/a8dafc0a-18dc-11e8-9376-4a6390addb44. Dropbox maintained this structure despite vocal opposition from CII. Letter from Kenneth A. Bertsch, Exec. Dir., Council of Institutional Investors, to Margaret C. Whitman, Chair of Dropbox's Nominating and Corporate Governance Committee, Dropbox's Multi-Class Structure (Feb. 27, 2018), http://www.cii.org/files/issues_and_advocacy/Feb%2026%20Letter%20to%20Dropbox%20on%20Multi%20Class.pdf.

[53] Andrew Winden & Andrew C. Baker, *Dual-Class Index Exclusion,* SSRN (June 23, 2018), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=3201578.

[54] Scott Hirst & Kobi Kastiel, *Corporate Governance by Index Exclusion*, 99 B.U.L. REV. 1229, 1233 (2019).

[55] Rauterberg & Verstein, *supra* note 17, at 27.

[56] MSCI Annual Report, *supra* note 22, at 58.

[57] *Id.*

[58] Authers, *supra* note 23.

[59] *FTSE Russell Voting Rights Consultation*, *supra* note 43; MSCI, *Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes* (Jan. 2018, updated June 2018), http://www.msci.com/documents/1296102/8328554/Consultation_Voting+Rights.pdf/15d99336-9346-4e42-9cd3-a4a03ecff339; FTSE RUSSELL, *FTSE Russell Voting Rights Consultation Results* (July 2017), http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Results.pdf; S&P DOW

source views from its clients" and "may weigh the feedback of some market participants, e.g., Asset Owners, Asset Managers (passive or active), Broker/Dealers, etc., more heavily."[60]

For the most part, the interests of these institutional investors vis-à-vis index-makers are aligned: everyone wants low fees. For passive investing to grow, fees must remain extremely low.[61] As the "ferocious price war" between institutional investors continues, "index licensing costs eat up more of their profit margin."[62] In 2012, Vanguard transitioned much of its business from MSCI to FTSE and others in order to lower its licensing costs.[63]

Parsing the wishes of institutional investors as a category, however, is more difficult. Indeed, the term institutional investor may itself paint too broad a brush. The CII, which strongly supports the index-makers' dual class restrictions, is primarily comprised of pension funds. These funds, like CalPERS, have virtually complete discretion to choose among index-makers when making investment decisions.

Alternatively, institutional investors like BlackRock and Vanguard are often locked into ownership via their clients' choice of index fund, making them more susceptible to any change that may harm returns. As Larry Fink, CEO of BlackRock, stated in his 2018 Annual Letter to CEOs: "In managing our index funds . . . BlackRock cannot express its disapproval by selling the company's securities as long as that company remains in the relevant index."[64] Cyrus Taraporevala, Chief Executive Officer of State Street, has described index funds as "permanent capital."[65]

The dual class share controversy brings this distinction between types of institutional investors squarely into focus. Companies like Snap drastically limit the political power of institutional investors since common shares possess no voting rights. Intuitively, institutional investors like BlackRock and Vanguard should recoil at the prospect of being unwilling owners of companies over which they have no control. Larry Fink's 2018 Letter to CEOs described BlackRock's "responsibility to engage and vote" as "more important than ever" given the rise of index investors.[66] Vanguard specifically identifies the importance of companies "empower[ing] shareholders and ensur[ing] accountability of the board and management" as one of its four pillars of investment stewardship.[67] State Street's CEO, Cyrus Taraporevala, recently penned an op-ed entitled *Index funds must be activists to serve investors*.[68] BlackRock, Vanguard, and State Street are all members of the Investor Stewardship Group, whose principles include the adoption of a

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JONES INDICES, *S&P Dow Jones Indices Announces a Consultation on the Eligibility of Non-Voting Share Classes* (Apr. 3, 2017), http://us.spindices.com/documents/index-news-and-announcements/20170403-spdji-eligibility-non-voting-share-classes-consultation.pdf.

[60] MSCI, *MSCI Index Policies* 8 (Feb. 2018), http://www.msci.com/eqb/methodology/meth_docs/MSCI_Index_Policies_Feb_2018.pdf.

[61] Fidelity now offers certain index funds for zero fee. Justin Baer, *Fidelity Eliminates Fees on Two New Index Funds*, WALL ST. J. (Aug. 1, 2018), http://www.wsj.com/articles/fidelity-index-fund-fees-tumble-to-zero-1533141096.

[62] Wigglesworth & Foley, *supra* note 28.

[63] Mia Lamar, *Vanguard Drops MSCI Benchmarks for 22 Index Funds*, WALL ST. J. (Oct. 2, 2012), http://www.wsj.com/articles/SB10000872396390444004704578032710785348152.

[64] Larry Fink, *Larry Fink's 2018 Letter to CEOs: A Sense of Purpose*, BLACKROCK (Jan. 16, 2018), http://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter.

[65] Cyrus Taraporevala, *Index Funds Must be Activists To Serve Investors*, FIN. TIMES (July 24, 2018), http://www.ssga.com/investment-topics/environmental-social-governance/2018/07/FINAL%20-%20FT%20Reprint%20of%20Cyrus%20OpEd.pdf.

[66] Fink, *supra* note 63.

[67] *Principles and Policies*, VANGUARD, http://about.vanguard.com/investment-stewardship/principles-policies (last visited Apr. 13, 2019).

[68] Taraporevala, *supra* note 65.

"one-share, one-vote standard."[69] Dual class shares effectively strip these very institutional investors of their voice.

Despite this lip service, would index funds in fact prefer not to vote? Lucian Bebchuk and others note that institutional investors "bear the cost of stewardship activities, but capture only a small fraction of the benefits they create."[70] In practice, moreover, institutional investors like BlackRock devote minimal resources to policing corporate governance in the companies they hold.[71] Dorothy Shapiro Lund has argued that lawmakers should simply deny institutional investors the right to vote, since they already "leave company performance to the invisible hand of the marketplace."[72]

BlackRock, Vanguard, and State Street all publicly opposed the index-makers' dual class restrictions, in apparent contradiction to their avowed 'one-share, one-vote' principles. As Glenn Booraem, Principal & Investment Stewardship Officer at Vanguard, explained: "As a fundamental governance matter, one-share, one-vote remains a really important tenet of our principles. The question is whether index construction is the right place to solve the problem."[73] BlackRock similarly announced its belief that "[p]olicymakers, not index providers, should set equity investing and corporate governance standards."[74] In comparably cautious language, State Street described the index-makers' exclusion as "tempting" but expressed concern that it "alters the basic construction methodology of the market-cap weighted indices."[75]

It is not our goal here to divine the precise incentives of institutional investors regarding dual class shares. Rather, the discussion above demonstrates the challenges faced by index-makers when attempting to appease their most significant customers. At a CII conference in March 2018, MSCI CEO Henry Fernandez stated explicitly that MSCI is "not looking to play this role" on dual class shares, despite their decision to play the role.[76] Following BlackRock and others coming out against the dual class restriction, MSCI scrapped the plan altogether, announcing that it will instead "launch a new index series that will reflect the desire of many investors to account for unequal voting structures in the indexes they use."[77] MSCI acknowledged in its announcement that the dual class issue "has proven to be a polarizing question among international institutional investors."[78] The institutional investors, meanwhile, have turned to the exchanges.[79]

The various consultations, decisions, and reversals by index-makers on the dual class share question indicate the inherently political and customer-oriented nature of index-making. As the

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[69] Dieterich et al., *supra* note 8.
[70] Lucian Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPECTIVES 89, 96 (2017).
[71] M. Todd Henderson & Dorothy S. Lund, *Index Funds Are Great for Investors, Risky for Corporate Governance,* WALL ST. J. (June 22, 2017), http://www.wsj.com/articles/index-funds-are-great-for-investors-risky-for-corporate-governance-1498170623 ("As of October 2016, Vanguard's governance team employed 15 people to cover some 13,000 companies; BlackRock employed about 20 for its 14,000 companies; and State Street employed fewer than 10 for about 9,000 companies."). In Larry Fink's 2018 Letter to CEOs, BlackRock committed to doubling the size of its investment stewardship team over the following three years. Fink, *supra* note 63.
[72] Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 37 J. CORP. L. 493 (2018).
[73] Dieterich et al., *supra* note 8.
[74] BlackRock, *A Potential Solution for Voting Rights and Index Inclusion Issues* (Oct. 2017), http://www.blackrock.com/corporate/en-br/literature/publication/blk-a-potential-solution-for-voting-rights-and-index-inclusion-issues-october2017.pdf.
[75] State Street Global Advisors, *Shareholder Rights in the Age of Snap* (Apr. 2017).
[76] Vittorio, *supra* note 46.
[77] MSCI Press Release, *supra* note 49.
[78] *Id.*
[79] See *infra* Part V.B.

SEC debates the merits of dual class shares, whether Facebook will remain on the S&P 500 is discussed over a series of surveys, conferences, and private conversations between index-makers and institutional investors. Hirst and Kastiel accurately describe index-makers as "reluctant regulators," who "are motivated by a complex set of conflicted interests and incentives and are subject to several significant constraints."[80] Despite the public consultations, moreover, the ultimate decisions lay with an unaccountable closed-door committee.[81] Naturally, institutional investors continue to separately lobby the SEC, but this is by no means their only avenue for change.[82]

B. The Flexibility of Index Creation

If index-maker activism were limited to the dual class share restriction, there may not be substantial cause for concern. As head of the S&PDJI Index Committee David Blitzer acknowledges, however, "there are no rigid or absolute rules for the S&P 500; the Index Committee has some discretion in selecting stocks or responding to market events."[83] Adriana Robertson found that the S&P 500 methodology was altered at least eight times in a three year period, and index methodologies often "explicitly grant the index creator some amount of discretion."[84] Due to the fundamentally malleable and active nature of index construction, the dual class restriction is simply one of many opportunities for index-makers to exert pressure on constituent companies.

The commercial reality of index-making starkly contradicts the "myth of objectivity," under which the public "characterizes indices as near-Platonic mathematical constructs that exist largely outside of human intervention and creativity."[85] While many perceive indices as formulaic attempts to achieve an "accurate" price for the underlying benchmark, actual index construction is a far more complex and flexible endeavor. Adriana Robertson contends that index funds are passive in name only, since the indices "represent the deliberate decisions made by their managers."[86] After reviewing a large dataset of index methodologies, Robertson found that "[e]ven the most mechanical indices . . . allow for some discretion on the part of the index committee."[87]

There are countless mechanisms for index-maker activism through index construction. First, index-makers can overtly impose corporate governance requirements on constituents, similar to the dual class restriction. For example, the S&P 500 could announce a board diversity requirement. The Russell 2000 could exclude companies with poison pills. S&PDJI could use its existing methodology, which requires U.S. companies to have "a corporate structure consistent

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[80] Hirst & Kastiel, *supra* note 54, at 1243.

[81] Akane Otani, *David M. Blitzer: Stock Picker Behind the S&P 500*, WALL ST. J. (May 19, 2017) http://www.wsj.com/articles/david-m-blitzer-stock-picker-behind-the-s-p-500-1495186202 ("The committee, which includes nine other S&P Dow Jones Indices employees whose identities are kept anonymous, meets monthly to discuss potential changes.").

[82] *See, e.g,*, Madison Marriage, *State Street Asks SEC To Block Non-Voting Shares*, FIN. TIMES (June 18, 2017), http://www.ft.com/content/9595e5c4-51db-11e7-bfb8-997009366969.

[83] David Blitzer, *Inside the S&P 500: An Active Committee*, S&P DOW JONES INDICES: INDEXOLOGY (Aug. 7, 2014), http://www.indexologyblog.com/2014/08/07/inside-the-sp-500-an-active-committee/. During the financial crisis, for example, the Index Committee explicitly disregarded its own rules by keeping AIG in the S&P 500 despite its free float falling below the minimum requirement. The committee "set the 50% float rule aside" because "[i]n those scary moments, dropping AIG would have sent the markets tumbling yet again." *Id.*

[84] Robertson, *supra* note 37, at 13.

[85] Rauterberg & Verstein, *supra* note 17, at 114.

[86] Robertson, *supra* note 37, at 3.

[87] *Id.* at 50.

with U.S. practice," to implement such changes.[88] We will assess whether such proposals would actually cause changes in corporate governance in Section IV.A, *infra*. The possibility of index-maker activism, however, looms over ongoing debates in these controversial areas.

Second, index-makers can utilize their discretionary powers to obscure activist policies. Consider indices which cover broad classifications like "emerging markets" or "technology." In 2010, MSCI's reclassification of Israel from emerging to developed market "result[ed] in about $2 billion of net equity outflows from Israel during the month in which the change came into effect."[89] It is plausible that sufficient evidence of Israel's economic development convinced an objective group of committee members to change Israel's classification. Alternatively, in the case of China's recent inclusion in MSCI's Emerging Market Index, the decision "came after [MSCI] came under heavy pressure from the Chinese government, which tried to curtail the company's business in the country."[90] Investors expect tens of billions of dollars to flow to Chinese companies as a result of the decision.[91]

By analogy, S&PDJI could potentially increase Snap's cost of equity capital by classifying the company as a "Communication Services" company rather than an "Information Technology" company. If less passive capital reaches "Communication Services," S&PDJI may use this discretionary decision to exert pressure on Snap's corporate governance practices. Presumably, there is a limit to the index-makers' discretion based on the market tolerance for divergence from the underlying concept; Snap could not be classified as "Industrials" or else investors seeking exposure to industrial companies would find another index. Similarly, if the S&P 500 no longer truly represented the large-cap U.S. equity market, investors may find an alternative.

These competitive effects, however, are quite limited by the nature of index funds. Per the Investment Company Act, changes in fundamental policy (which would include changing indices) require a shareholder vote.[92] Rather than actually vote, fund investors would simply redeem their shares if they are no longer satisfied. As a result, as John Morley and Quinn Curtis have found, "The investor base of a mutual fund at any given moment will . . . consist mostly of investors who are either content with the status quo or simply apathetic. Getting these investors to approve significant changes is extremely difficult."[93] Existing funds cannot realistically switch indices because it will be extremely difficult to garner sufficient shareholder support for a fundamental change.

Beyond this statutory limitation, some existing indices enjoy such considerable influence due to their sheer size, history, and name recognition that competition is minimal. As Rauterberg

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[88] S&P DOW JONES INDICES, *S&P U.S. Indices Methodology,* 39 (Jan. 2019), http://us.spindices.com/documents/methodologies/methodology-sp-us-indices.pdf.

[89] Sushko & Turner, *supra* note 19. In 2018, Twitter stock jumped 6% upon inclusion in the S&P 500. Barry Ritholtz, Chief Investment Officer at Ritholtz Wealth Management, described Twitter's inclusion as "a bit of a head-scratcher" and wondered whether S&PDJI was simply responding to President Trump's considerable use of Twitter. Akane Otani, *Betting on New S&P 500 Stocks Like Twitter? It's a Risky Game*, WALL ST. J. (June 11, 2018), http://www.wsj.com/articles/betting-on-new-s-p-500-stocks-like-twitter-its-a-risky-game-1528709401.

[90] Mike Bird, *How China Pressured MSCI To Add its Market to Major Benchmark*, WALL ST. J. (Feb. 3, 2019), http://www.wsj.com/articles/how-china-pressured-msci-to-add-its-market-to-major-benchmark-11549195201?mod=itp_wsj&ru=yahoo

[91] Shen Hong & Michael Wursthorn, *Chinese Shares Gain Global Sway Thanks to Index Firm's Move*, WALL ST. J. (Mar. 1, 2019), http://www.wsj.com/articles/chinese-shares-gain-global-sway-thanks-to-index-firms-move-11551392626.

[92] 15 U.S.C. § 80a-13 (2018).

[93] John D. Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 107 (2010).

and Verstein identify, "Indices enjoy substantial network effects, and so, just as with trading venues, we should expect the dominance of one index in a given niche . . . . Some users may prefer a malproduced or manipulated index to one that is less liquid or well-known."[94] Adriana Robertson found that 41% of assets under management in U.S. equity index funds are benchmarked to the S&P 500.[95] Indeed, it is difficult to imagine the type of index-maker activism that would result in substantial outflows from the S&P 500.

Index-makers fundamentally reject the charge that inappropriate considerations affect their index selection processes. The S&P 500 selection committee, for example, keeps the identities of its members anonymous (though they are all S&PDJI employees).[96] In response to allegations of improper influence, MSCI defended itself by noting that "its index-inclusion process is handled by its editorial division, which is separate from its commercial operations."[97] These formal boundaries, however, hardly establish actual independence of index-makers. Through this Part, we have seen how both the incentives and processes of index creation lend themselves to index-maker activism. Next, we will use the dual class restriction to demonstrate the effects.

IV. EFFECTS: UNCERTAINTY, SPILLOVER, AND THE MARKET FOR CORPORATE LAW

A. The Uncertain Impact of the Dual Class Restriction

Mandatory federal rules are comply-or-else propositions for public companies. If Congress were to prohibit dual class share structures, virtually all companies would comply, or else risk severe penalties. Naturally, such a rule would impose the standard uniformity costs associated with mandatory rules. After the passing of the Sarbanes-Oxley Act of 2002, Chancellor Chandler Chief Justice Strine expressed concern that the act's "prescriptions impinge on the managerial freedom permitted to directors by state corporation law."[98] Similarly, a federal law prohibiting dual class shares would increase the cost of capital for those companies who may benefit from dual class share structures.[99]

Alternatively, the index-makers' dual class share restrictions illustrate the uncertainty created by private rulemaking. After the index-makers announced the results of their consultations, predictions regarding the future of dual class share structures ran the full range of possibilities. Matt Levine questioned why any company would go public if it could not enter the major indices.[100] Others described the "reported demise of dual-class stock" as "greatly exaggerated."[101] Actual responses by companies were equally divided. MuleSoft announced a plan to convert to one-share, one-vote by 2022.[102] Yet multiple companies, including Dropbox, have gone public or

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[94] Rauterberg & Verstein, *supra* note 17, at 143.
[95] Robertson, *supra* note 37, at 803.
[96] Otani, *supra* note 79.
[97] Bird, *supra* note 88.
[98] William B. Chandler & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 958 (2003).
[99] For an argument that such companies exist, *see* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560 (2016).
[100] Levine, *supra* note 41 ("Why would you do an IPO if you can never make it into the index?").
[101] Berger et al., *supra* note 51.
[102] Rob Cox, *Sun Will Be Setting on Silicon Valley Imperialism* (Dec. 21, 2017),https://www.breakingviews.com/considered-view/sun-will-be-setting-on-silicon-valley-imperialism/. Since the announcement, MuleSoft has been acquired by Salesforce. Press Release, Salesforce Investor Relations, Salesforce

announced intention to do so with multi-class share structures.[103] Promising technology companies like Lyft, Slack and Pinterest are expected to IPO in 2019 or have already done so with dual class share structures.[104] One recent event study found no meaningful effect on the stock of companies that may be affected by the dual class exclusions.[105]

The dual class restrictions demand a complex calculation by newly public companies. First, the restrictions create uncertainty because companies must assess the fluctuating value of index inclusion. Generally, companies perceive index inclusion as valuable because it creates passive demand for the stock, thereby increasing share price and decreasing cost of capital. In 2017, roughly 17% of Facebook's market capitalization lay in passive funds tracking the S&P 500 alone.[106] Multiple studies have estimated the "S&P 500 index addition effect" as providing a 5-7% increase in stock price in the month following announcement, with much of that growth being permanent.[107] These inclusion premiums will necessarily rise (or fall) with the growth (or decline) of passive investing generally. Issuers will have to make effectively permanent decisions regarding share structure on the basis of the highly variable benefit of index inclusion.

Second, the restrictions create additional uncertainty because they lack permanence. MSCI fully reversed course in just over a year, announcing in October 2018 that it would create new indices rather than impose restrictions on existing indices.[108] FTSE is already revisiting its decision.[109] A company that went public in the midst of MSCI's decision-making process could not have accurately priced the cost of index exclusion given the reversal. Due to differential treatment by index-makers, moreover, companies must assess the competitive positioning of the respective indices: what is the cost of being excluded from the S&P 500 as compared with the Russell 2000?

Signs Definitive Agreement To Acquire MuleSoft (Mar. 20, 2018), https://www.salesforce.com/company/news-press/press-releases/2018/03/180320/.

[103] Dropbox's Class A shares, which are mainly owned by the co-founders, will retain ten votes per share, while Class B shares have only one vote per share. Hannah Kuchler & Tom Braithwaite, *Dropbox Plans for IPO Raise Ire Over Share Structure*, FIN. TIMES (Feb. 23, 2018), http://www.ft.com/content/a8dafc0a-18dc-11e8-9376-4a6390addb44. The CII was quick to criticize Dropbox and note their likely exclusion from major indices. Kenneth A. Bertsch, Executive Director, Council of Institutional Investors, *Dropbox's Multi-Class Structure* (e-mail to Margaret C. Whitman, Chair of Dropbox's Nominating and Corporate Governance Committee) (Feb. 27, 2018), http://www.cii.org/files/issues_and_advocacy/Feb%2026%20Letter%20to%20Dropbox%20on%20Multi%20Class.pdf.

[104] Maureen Farrell & Cara Lombardo, *Lyft Founders To Tighten Grip with Supervoting Shares in IPO*, WALL ST. J. (Feb. 12, 2019), http://www.wsj.com/articles/lyft-founders-to-tighten-grip-with-supervoting-shares-in-ipo-11549978201. Lyft holds only one class of shares as a private company, but upon going public intends for the founders to retain a majority of voting power despite holding less than 10% of the financial equity.

[105] Winden & Baker, *supra* note 53.

[106] Tom Braithwaite, *Snap Over-Reach Creates Problems for Airbnb and Pinterest IPOs*, FIN. TIMES (Dec. 4, 2017), http://www.ft.com/content/c34de89c-d6f9-11e7-a303-9060cb1e5f44.

[107] Yen-cheng Chang et al., *Regression Discontinuity and the Price Effects of Stock Market Indexing* (Nat'l Bureau of Econ. Research, Working Paper No. 19290) (Aug. 2013), http://www.nber.org/papers/w19290.pdf. For just one recent example of such an effect, note that Norwegian Cruise Line experienced an immediate jump of nearly 4% upon news of its inclusion in the S&P 500. Crystal Kim, *Norwegian Cruise Line Rallies on S&P 500 Inclusion,* BARRONS (Oct. 5, 2017), http://www.barrons.com/articles/norwegian-cruise-line-rallies-on-s-p-500-inclusion-1507215351. *But see* Jay Fitzgerald, *Stock Price Reactions to Index Inclusion*, NAT'L BUREAU OF ECON. RESEARCH, http://www.nber.org/digest/nov13/w19290.html (challenging the index addition effect and finding there is no apparent decrease upon index removal).

[108] MSCI, *supra* note 49.

[109] FTSE, *supra* note 43.

Lyft, the successful ridesharing service which went public in 2019, described precisely these uncertainties in its recent Form S-1 Registration Statement:

> These policies are still fairly new and it is as of yet unclear what effect, if any, they will have on the valuations of publicly traded companies excluded from the indices, but it is possible that they may depress these valuations compared to those of other similar companies that are included. Because of our dual class structure, we will likely be excluded from certain of these indexes and we cannot assure you that other stock indexes will not take similar actions. Given the sustained flow of investment funds into passive strategies that seek to track certain indexes, exclusion from stock indexes would likely preclude investment by many of these funds and could make our Class A common stock less attractive to other investors. As a result, the market price of our Class A common stock could be adversely affected.[110]

Lyft recognizes the two key uncertainties we have identified: first, we do not know whether these policies will remain in place or more may come into effect; and second, we do not know how much passive investment will continue to flow into these funds. While Lyft ultimately decided to keep its dual class structure, their own disclosures demonstrate the challenge faced by companies going public in 2019 and beyond.

Whether companies will change their share structure in order to access the indices remains to be seen. The strengths (or weaknesses) of index-maker activism closely resemble those of socially responsible investment initiatives. The key question is whether access to indices, or funds with environmental, socially responsible and governance ("ESG") criteria, is sufficiently valuable to alter corporate governance decisions. One recent report found asset managers consider ESG factors across $11.6 trillion in assets in the United States alone, and this capital should encourage firms to adopt ESG-friendly policies.[111] BlackRock CEO Larry Fink, in his 2018 letter to CEOs, noted that BlackRock will be "increasingly integrating [ESG matters] into [their] investment process."[112] NASDAQ, meanwhile, advises listed companies that "[s]trong ESG programs can increase stock liquidity."[113] Like the dual class restrictions, it is difficult for companies to isolate and assess the risk of losing access to ESG capital.[114]

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[110] Press Release, Lyft, Inc., Registration Statement (Form S-1), (Mar. 1, 2019), https://investor.lyft.com/static-files/8b1170f8-3f41-4a78-916f-fc376e513519.

[111] US SIF: THE FORUM FOR SUSTAINABLE AND RESPONSIBLE INVESTMENT, *US SIF Foundation Releases 2018 Biennial Report On US Sustainable, Responsible and Impact Investing Trends* (Oct. 31, 2018), http://www.ussif.org/blog_home.asp?display=118.; *see also* Sara Bernow et al., *From 'Why' to Why Not': Sustainable Investing as the New Normal*, MCKINSEY & COMPANY (Oct. 2017), http://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/from-why-to-why-not-sustainable-investing-as-the-new-normal (identifying $22.89 trillion in professionally managed ESG assets globally).

[112] Fink, *supra* note 64.

[113] *Strong ESG Practices Can Benefit Companies and Investors: Here's How*, NASDAQ: LISTING CENTER (June 5, 2018), http://listingcenter.nasdaq.com/ClearinghouseArticle/Strong-ESG-Practices-Can-Benefit-Companies-and-Investors-Heres-How-1542.

[114] Indeed, it remains unclear if self-avowed ESG funds actually vote in line with their avowed priorities. *See* Asjylyn Loder, *Funds Don't Always Vote for Policies They Publicly Back*, WALL ST. J. (Apr. 2, 2019), http://www.wsj.com/articles/funds-dont-always-vote-for-policies-they-publicly-back-11554206401.

Regardless of the source, private rulemaking by index-makers creates greater uncertainty for investors and issuers than public, or governmental, rulemaking. While public rulemaking is by no means permanent, existing structures prevent sharp reversals and increase predictability. In the agency rulemaking context, scholars frequently criticize these limitations as "ossification."[115] These very obstacles, however, "erect a barrier against an agency carrying out such a fait accompli by forcing the agency to move slowly and publicly, giving politicians . . . time to act before the status quo is changed."[116] The index-makers employ procedures such as notice and comment which superficially resemble administrative rulemaking, but there are minimal formal requirements. Perhaps most obviously, moreover, there is no judicial branch available to strike down index-maker rulemaking gone awry.

On the issue of dual class share restrictions, the index-makers carried out extensive consultation processes. However, as discussed *supra* Part III.B, index-makers have immense discretion and critical decisions frequently do not involve such quasi-administrative procedures. Adriana Roberton's recent analysis fully demonstrates the discretion allotted to index-makers by the very terms of the indices.[117] Index-makers are not, as David Blitzer of S&PDJI notes, "a bunch of people sitting in a room throwing darts at a wall."[118] But they are also not public agencies subject to the scrutiny and disclosure requirements of the SEC. This positioning allows for unpredictable, impermanent index-maker activism and creates uncertainty for companies and investors.

Arguably, the lack of formal processes is precisely what makes index-makers effective; unlike the government, they are nimble and able to innovate without bureaucracy. While this is almost certainly a feature in some respects, it creates uncertainty costs when it comes to corporate governance regulation. As discussed further in Part V, *infra*, attempts to restrict index-maker activism by regulation risk increasing the cost of passive investing by imposing additional hurdles for index-makers.

B. Spillover Effects of Index-Maker Activism

Index-makers' role, described most simply, is to build and license a basket of securities that provides a desirable form of investment. For example, S&PDJI creates and licenses the S&P 500 to allow investment in the large-cap U.S. equity market. Other indices allow investment in a particular industry (*e.g.*, technology) or type of economy (*e.g.*, emerging markets). Index-maker activism, as evidenced by the dual class share restrictions, fundamentally jeopardizes this function. Any time index-makers attempt to utilize their power to influence corporate governance, there are spillover effects jeopardizing the index-makers' market purpose. Index-maker activism creates a rift between the index's methodology and investor preferences.

The criticisms levied against the dual class restriction consistently reflect this concern. Commissioner Robert Jackson described the dual class restriction as a "blunt tool" and worried that "Main Street investors may lose out on the chance to be a part of the growth of our most innovative companies."[119] BlackRock, while suggesting that "policy-makers, not index providers" should set dual class restrictions, defended the seemingly incontrovertible principle that "index

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[115] Rule *See, e.g.*, Thomas O. McGarity, *Some Thoughts on "Deossifying" the Rulemaking Process*, 41 DUKE L.J. 1385 (1992).

[116] Matthew D. McCubbins et al., *Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies*, 75 VA. L. REV. 431, 442 (1989).

[117] Robertson, *supra* note 37.

[118] Otani, *supra* note 79.

[119] Jackson, *supra* note 13.

providers should make every effort to reflect the investable marketplace in the broad benchmark indices they produce."[120] According to this argument, if certain investors specifically wish to avoid dual class companies, they should do so through separate indices devoted to that objective. In its reversal on the dual class share restrictions, MSCI committed to creating "a new index series that will reflect the desire of many investors to account for unequal voting structures in the indexes they use."[121]

Spillover effects are not limited to index-makers; rather, any private rulemaker risks spillover when imposing rules that fall outside the scope of their natural function. As discussed in Section V.B, *infra*, both the SEC and institutional investors have turned to the exchanges to regulate dual class shares. Yet scholars have frequently criticized the exchanges for encroaching on corporate governance.[122] Roberta Karmel has noted that exchanges are treated as Self-Regulatory Organizations ("SRO") precisely due to the "conflicts between an exchange's regulatory functions and its members, market operations, listed issuers, and shareholders."[123] Given international competition for listing among exchanges, stringent listing standards can be a competitive disadvantage. Private rulemakers, whether index-makers, exchanges, or otherwise, jeopardize their function when employing their market power as leverage for changes in corporate governance.

C. Effects on the Market for Corporate Law

Delaware's dominance of the market for corporate law has generated considerable debate.[124] Despite any disagreement among legal scholars, all recognize that Delaware has invested considerably, and successfully, in order to obtain corporate charters.[125] Professor Roberta Romano describes much of this investment as "legal capital," or the "store of legal precedents forming a comprehensive body of case law, judicial expertise in corporate law, and administrative expertise in the rapid processing of corporate filings."[126] This infrastructure at least partially explains why other states cannot attract corporations by simply copying the Delaware General Corporation Law verbatim.

As this investment in legal capital suggests, corporations must feel confident that their state of incorporation will thoughtfully respond to their developing needs. Professor Romano explains that "a state with a favorable corporation code must guarantee its code's continued responsiveness to be successful in the corporate charter market."[127] A state simply cannot guarantee continued responsiveness, however, when index-makers may at any time remove an issue from their control.

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[120] BlackRock, *supra* note 73.

[121] MSCI, *supra* note 49.

[122] *See, e.g.*, Robert B. Thompson, *Delaware, The Feds, and The Stock Exchange: Challenges to the First State as First in Corporate Law*, 29 DEL. J. CORP. L. 779 (2004). For an assessment of the exchanges' attempt to restrict dual class shares particularly, see Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119 (1987).

[123] Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J. L. BUS. & FIN. 151, 169 (2008).

[124] *See, e.g.*, Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775 (2002); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); Ralph K. Winter Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEG. STUDIES 251 (1977); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974).

[125] More than 60% of Fortune 500 companies are incorporated in Delaware. Delaware.gov, *Why Businesses Choose Delaware*, http://corplaw.delaware.gov/why-businesses-choose-delaware/ (last visited Mar. 4, 2019).

[126] Romano, *supra* note 125, at 722.

[127] *Id.* at 721.

Delaware courts can spend years developing a coherent case law for a particular issue, only for index-makers to make it irrelevant through a short consultation and press release. For now, Delaware clearly has sufficient incentive to continue investing in its corporate law infrastructure. However, there is a tipping point where states will question the value of continued investment.

The growth of passive investing has made index-makers one of the most powerful private regulators of corporate law. As fully private rulemakers, index-makers are not restricted by the general acknowledgment that states "prescribe [corporations'] powers, and . . . define the rights that are acquired by purchasing their shares."[128] Index-makers now wield this authority as well. Index-maker activism, as seen by the dual class share restrictions, has three pernicious effects. First, it instills uncertainty in companies and investors, who must now assess the value of index inclusion and the durability of the restrictions. Second, index-maker activism harms passive investing generally by index methodology to achieve corporate governance objectives. Third, index-maker activism negatively impacts the market for corporate law by decreasing incentives for states to invest in a responsive corporate law infrastructure.

V. ALTERNATIVES TO INDEX-MAKER ACTIVISM

A. Time to Regulate the Index-Makers?

This paper contends that index-maker activism is a serious concern. The natural question, then, is whether Congress or the SEC should step in to regulate the index-makers. Thus far, there has been no discussion of any such regulation. If anything, the SEC has exacerbated the impact of the dual class share restrictions by recommending that companies disclose the risk of index exclusion.[129] The SEC's Investor Advisory Subcommittee has recommended that the Division of Corporate Finance "continue to scrutinize disclosure documents filed by companies with [dual class and other entrenching governance structures.]"[130] In particular, the subcommittee identified "the risks of being excluded from major indices" as insufficiently acknowledged in disclosure documents.[131] More recent IPOs of companies with dual class stock have commonly included language indicating this risk. Switch, Inc. made just such a disclosure in its Registration Statement:

> We cannot assure you that other stock indices will not take a similar approach to S&P Dow Jones or FTSE Russell in the future. Exclusion from indices could make our Class A common stock less attractive to investors and, as a result, the market price of our Class A common stock could be adversely affected.[132]

Even Spotify, which does not have a dual class share structure, nevertheless indicated that its power to issue beneficiary certificates could result in exclusion depending upon future action by the index-makers.[133]

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[128] CTS Corp. v. Dynamics Corp., 481 U.S. 69, 91 (1987).
[129] One can question the actual effect of this disclosure: sophisticated investors and analysts setting the market price would certainly know about the risk of index exclusion, regardless of its mention in a company's registration statement. Nevertheless, to the extent that we consider disclosure important and the SEC's primary mechanism for action, such disclosures are certainly relevant here.
[130] SEC INVESTOR ADVISORY SUBCOMMITTEE, *supra* note 3.
[131] *Id.*
[132] Switch, Inc., Registration Statement (Form S-1 (Sept. 8, 2017).
[133] SPOTIFY TECHNOLOGY, S.A., RULE 424(B)(4) PROSPECTUS 53 (2018).

Any regulation of index-makers, whether direct or indirect, would involve significant tradeoffs for passive investing. In an analysis of the effects of direct and indirect regulation on the hedge fund industry, Hossein Nabilous & Alessio M. Paces define the concept well: "Direct or entity regulation involves regulatory measures focusing immediately on the regulation of the target industry. In contrast, indirect regulation utilizes an intermediary to transmit the imperatives or commands to the primarily intended regulated entity or activity that is ultimately the target."[134] The recently enacted European Union Regulation 2016/2011 (hereinafter the "EU Regulation"), enacted in response to the LIBOR manipulation scandal, provides a clear example of direct regulation of index-makers.[135]

The EU Benchmark Regulation has four major components: governance and conflict of interest requirements, including oversight, control, and accountability (Title II, Chapter 1, Articles 4-8; Chapter II, Article 16); input data and methodology requirements (Title II, Chapter 2, Articles 11-13); transparency requirements (Title IV); and administration and registration requirements (Title VI). Similar to the U.S. securities laws, the EU Regulation requires registration of indices, meaningful disclosure of their input data and methodology, and minimization of underlying conflicts of interest.

Such targeted regulation of index-makers, however, has two critical drawbacks. First, it would be difficult to effectively target problematic index-maker activism. Congress could bluntly prohibit the use of corporate governance criteria in indices. But this clearly goes too far – some investors specifically seek to invest in companies with particular corporate governance practices. Though not precisely on point, BlackRock's Global X S&P 500 Catholic Values ETF offers a version of the S&P 500 but only with companies "whose business practices adhere to the Socially Responsible Investment Guidelines as outlined by the United States Conference of Catholic Bishops."[136] Similar investors may seek an index including only companies whose bylaws ensure a commitment towards environmentally responsible business practices.

Rather than employing a broad prohibition, the EU Regulation requires that a financial benchmark

> (a) is robust and reliable; (b) has clear rules identifying how and when discretion may be exercised in the determination of that benchmark; (c) is rigorous, continuous and capable of validation including, where appropriate, back-testing against available transaction data; (d) is resilient and ensures that the benchmark can be calculated in the widest set of possible circumstances, without compromising its integrity; (e) is traceable and verifiable.[137]

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[134] Hossein Nabilou & Alessio M. Pacces, *The Hedge Fund Regulation Dilemma Direct vs. Indirect Regulation*, 6 WM. & MARY BUS. L REV. 183, 190 (2015). For further discussion of direct and indirect regulation, and a source that Nabilous & Paces extensively rely upon in their definitions, see PHOEBUS ATHANASSIOU, HEDGE FUND REGULATION IN THE EUROPEAN UNION: CURRENT TRENDS AND FUTURE PROSPECTS (2009).

[135] 2016 O.J. (L. 171). *See also* Clifford Chance, *The New EU Benchmarks Regulation: What You Need To Know* (Sept. 2016), http://www.cliffordchance.com/briefings/2016/09/the_new_eu_benchmarksregulationwhatyounee.html ("The new Regulation is a key part of the EU's response to the LIBOR scandal and the allegations of manipulation of foreign exchange and commodity benchmarks.").

[136] GLOBAL X FUNDS S&P 500 CATHOLIC VALUES ETF, http://www.globalxfunds.com/funds/cath/ (last visited Dec. 12, 2019).

[137] EU Regulation, *supra* note 135, ch. 2, art. 12.

The dual class restrictions would undoubtedly meet these requirements. The index-makers would also meet the requirements imposed by the Regulation that any material change to an index effectively go through a notice and comment period, a process each of the index-makers followed in their pronouncement on dual class shares.[138] Evidently, disclosure and transparency alone are not sufficient to prevent index-maker activism.

Direct regulation of index-makers, moreover, would carry the very pathologies of mandatory rules created by index-maker activism. Rather than permitting competition among index-makers to encourage investor-friendly rules, such regulation would create another avenue for institutional investors to lobby for favorable treatment.

Given these challenges, indirect regulation seems like a more promising alternative. Indirect regulation typically utilizes "economic instruments with the aim of harnessing market power" and targets an intermediary actor rather than the primary target of the regulation.[139] Indirect regulation of index-makers may take the form of limiting the market power of institutional investors or allowing index funds to change indices without investor approval. There are two critical drawbacks, however, to indirect regulation.

First, it is difficult to pull the appropriate levers and actually create incentives for the desired behavior by the index-makers. For example, one avenue of indirect regulation would be through targeting institutional investors, who seem like a natural surrogate regulator for index-makers. Calls for hindering the power of the Big Three have already been made quite forcefully. Eric Posner, Fiona Scott Morton, and Glen Weyl called them the "great, but mostly unknown, antitrust story of our time," claiming that "[c]ontrol of the economy has not been this concentrated since the Gilded Age."[140] Much of the recent criticism of institutional investors' power stems from research identifying the harms of common ownership across competitors. Most notably, a group of authors have suggested through multiple studies that institutional investors' common ownership decreases competition and therefore increases ticket prices in the airline industry.[141]

Yet less concentrated power among institutional investor does not ensure index-makers will exit the corporate governance arena. Perhaps any one firm will be less able to exert pressure, but the firms could easily exert collective pressure on index-makers (*e.g.*, the CII). Moreover, regulation of institutional investors would not limit the influence of pension funds like CalPERS, which have been the strongest proponents of index-maker activism.[142]

Second, it is difficult to isolate the effects of indirect regulation, especially in an industry as interwoven as financial markets. Indirect regulation of index-makers carries immense regulatory spillover. As discussed above, debates over the influence of institutional investors are hotly contested. Regulating BlackRock in order to change the behavior of S&PDJI will have various collateral consequences. In short, it would be exceedingly difficult to craft an indirect regulation

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[138] *Id.* ch. 2, art. 13(2).

[139] Nabilou & Pacces, *supra* note 134 at 190-191. Recent attempts to increase the supply of electric cars serve as a prime example of indirect regulation. Rather than simply provide tax incentives to original equipment manufacturers, the United States gave tax breaks to individuals who bought electric cars. 26 U.S.C. § 30D.

[140] Eric Posner, Fiona Scott Morton & Glen Wyl, *A Monopoly Donald Trump Can Pop*, N.Y. TIMES (Dec. 7, 2016), http://www.nytimes.com/2016/12/07/opinion/a-monopoly-donald-trump-can-pop.html?ref=opinion; *see also* Eric Posner, Fiona Scott Morton & Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669 (2017).

[141] Azar et al., *supra* note 18. *But see* Daniel P. O'Brien & Keith Waehrer, *The Competitive Effects of Common Ownership: We Know Less Than We Think*, 81 ANTITRUST L.J. 729 (2017). For a more tempered view of this threat, *see, e.g.,* Edward B. Rock & Daniel L. Rubinfeld, *Antitrust for Institutional Investors*, 82 ANTITRUST L.J. 221 (2018).

[142] *See supra* § III.A.

that both meaningfully alters index-maker behavior and primarily cabins its effects to the index-makers. This is the primary cost of employing surrogate regulators.

Mutual funds may be a more promising surrogate regulator for index-makers. As discussed *supra* Section II.A, mutual fund investors lack the incentive to engage in mutual fund governance or decision-making regarding investment policy.[143] Currently, mutual fund investors can pressure the index-makers to reverse their decisions on dual class shares. As Professors Morley and Curtis demonstrate, however, mutual fund investors will simply redeem if they are dissatisfied with performance. Put another way, "the directors of a fund do not have the same freedom [as directors of an ordinary business corporation] to change the operational aspects of the fund."[144] Therefore, one method of indirect regulation of index-makers would be to allow mutual funds, or investment companies broadly, to alter their underlying indices without obtaining approval of a majority of shareholders.

There would clearly be regulatory spillover from any such change. 15 U.S.C. § 80a-13(a)(3) currently states that an investment company may not "deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement."[145] The statute recognizes the precarious position of investment company investors, especially a concern in index funds with millions of unsophisticated investors, and protects them accordingly through binding disclosure and requirements of a shareholder vote for fundamental changes. Additionally, index funds could still voluntarily bind themselves through their disclosures in order to assure customers that they will not deviate from the applicable index.

Similar challenges apply to any regulation of private rulemakers, as evidenced by efforts to regulate proxy advisory services. The SEC recently held a roundtable on the proxy process, with considerable attention devoted to proxy advisory firms.[146] On November 13, 2018, six U.S. Senators introduced the Corporate Governance Fairness Act seeking to regulate proxy advisory services.[147] The bill attempts to directly regulate proxy advisors as investment advisers under the Investment Advisers Act of 1940. Such a change would require registration and various disclosures by proxy firms like ISS and Glass Lewis, increasing the cost of advisory services. Advisory services, however, increase shareholder engagement, a "hallmark of our capital markets."[148]

There are challenges to both direct and indirect regulation of index-makers. Perhaps indices could be regulated as SROs, and the SEC would hold veto power over any major rule changes. We have not exhaustively reviewed all potential regulatory responses to index-maker activism, but we have illuminated the inevitable challenges to any such regulation. Ultimately, it will be difficult to prevent undesirable index-maker activities (*e.g.*, interfering with corporate governance) while fostering innovation in index creation and passive investing broadly.

B. Exchanges and Dual Class Shares

Various individuals and entities have pointed to the exchanges as an optimal source for regulation of dual class shares. As discussed *supra* Part I, Commissioner Robert Jackson wants the

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[143] Morley & Curtis, *supra* note 93.
[144] Nathan D. Lobell, *The Mutual Fund: A Structural Analysis*, 47 VA. L. REV. 181, 192 (1961).
[145] 15 U.S.C. § 80a-13(a)(3) (2018).
[146] SEC. AND EXCH. COMM'N, ROUNDTABLE ON THE PROXY PROCESS (2018).
[147] Corporate Governance Fairness Act, S. 3614, 115th Cong. (2018).
[148] Jay Clayton, Chairman, Sec. and Exch. Comm'n, Statement Announcing SEC Staff Roundtable on the Proxy Process (July 30, 2018).

exchanges to address dual class shares through listing standards.[149] A large group of investors including BlackRock, T. Rowe Price, and CalPERS, all speaking through CII, have requested that the exchanges minimally require sunset provisions by companies with dual class stock arrangements.[150] The exchanges would levy such restrictions by setting listing standards that prohibit dual class shares.

The SEC, for its part, has already attempted to use the exchanges as a mechanism to regulate dual-class shares.[151] In 1984, General Motors ("GM") announced plans to issue a second class of stock that would have restricted voting rights.[152] The New York Stock Exchange ("NYSE") had listing standards prohibiting dual class shares but did not plan to enforce them against GM and ultimately announced a moratorium on compliance with the rule.[153] As Marcel Kahan explains, "In the 1980s, dual class recapitalizations became a popular takeover defense, and the NYSE feared that it would lose listings to the AMEX or NASDAQ. It thus proposed to relax its one-share-one-vote rule."[154]

In 1988, in response to this controversy, the SEC passed Rule 19c-4. According to the rule, exchanges shall not permit the listing of any equity security if the issuer takes action "with the effect of nullifying, restricting or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock."[155] The D.C. Circuit quickly struck down the rule, however, holding that it exceeded the SEC's authority under the Securities Exchange Act.[156] Critically, the court in *Business Roundtable* expressed concern that "[i]f the Commission's one share/one vote rule is to survive, then, some kind of firebreak is needed to separate it from corporate governance as a whole."[157] Given the SEC's lack of statutory authorization, the exchanges would need to take it upon themselves to limit dual class shares, an unlikely proposition.

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[149] Jackson, *supra* note 5.

[150] Letter from Ash Williams, Chair of the Council of Institutional Investors, et al. to Elizabeth King, Chief Regulatory Officer of Intercontinental Exch., Inc. (Oct. 24, 2018), http://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NYSE%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf. CII specifically requested that a company's certificate of incorporation require conversion to a one-share, one-vote structure within seven years of the IPO.

[151] It is critical to recognize that the exchanges, unlike the index-makers, are quasi-public regulators. They are regulated as Self-Regulatory Organizations under § 3(a)(26) of the Securities Exchange Act. Through the Securities Exchange Act Amendments of 1975, the SEC gained the ability to initiate SRO rule-making and must approve all rules, with some limited exceptions. 15 U.S.C. § 78s(b) (2018). The SEC may also by rule "abrogate, add to, and delete from . . .the rules of a self-regulatory organization . . . as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization . . . or otherwise in furtherance of the purposes of this chapter." 15 U.S.C. § 78s(c) (2018). Given these extensive powers, at least one scholar has considered whether SROs are federal agencies. Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J. L. BUS. & FIN. 151 (2008). Perhaps most obviously, unlike the index-makers, the exchanges are also not fully private regulators since they have an explicit contract with the companies they regulate.

[152] Voting Rights Listing Standards; Disenfranchisement, Release No. 24623 (June 22, 1987).

[153] *Id.* (to be codified at 17 C.F.R. pt. 240). According to the SEC, NYSE had 55 listed companies with disparate voting rights or charter provisions permitting issuances of shares with disparate voting rights. *Id.* The NYSE provision against dual-class stock had a long history and was first implemented in 1926. Robert B. Thompson, *supra* note 122, at 794.

[154] Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation*, 83 VA. L. REV. 1509, 1515 n.30 (1997). *See also* Hans Christiansen & Alissa Kolertsova, *The Role of Stock Exchanges in Corporate Governance*, FIN. MARKET TRENDS 14 (OECD 2009/1), http://www.oecd.org/finance/financial-markets/43169104.pdf (noting that NASDAQ "gained competitive ground over NYSE" in the 1980s by permitting dual class stock listings).

[155] 17 C.F.R. § 240-19c.4(a) (1990).

[156] Business Roundtable v. SEC, 905 F.2d 406, 416 (D.C. Cir. 1990).

[157] *Id.* at 413.

The exchanges are not a plausible solution to the dual class dilemma. First, exchanges have recently been moving towards greater acceptance of dual class shares in order to attract large technology companies, similar to the 1980s trend. In 2014, Hong Kong Exchanges and Clearing ("HKEx") suffered a major blow when Alibaba chose to list on the NYSE at least partly due to HKEx's restrictions on dual class shares.[158] After a public consultation process, HKEx reversed course in 2018, acknowledging that the Alibaba decision had forced them to "reckon with the issue."[159] NASDAQ president Nelson Griggs has endorsed the "flexibility of share structure" since he hopes investors can access high-growth listings.[160] The exchanges are unlikely to impose restrictions on dual class shares and risk alienating promising companies like Lyft, Slack and others.

Similar to the index-makers, moreover, there is good reason to question the exchanges' motivations imposing any strict corporate governance regulations. Despite Fleckner's claim that the primary incentive is to list quality companies, the true incentive is to list as many large companies as possible. Stock exchanges' primary sources of revenue are transaction, data, and listing fees, all of which increase when exchanges list large companies with high trading volumes.[161] Intercontinental Exchange, Inc., owner of NYSE, made $440 million from listing fees alone in 2018.[162] A recent description of the "frenetic fight for IPO listings" in the *Wall Street Journal* is indicative of these distorted incentives, noting lavish benefits being offered to companies in exchange for listings.[163]

Second, any restrictions on dual class shares would suffer from the same challenges as index-maker activism with regard to the market for corporate law. Paul Mahoney, while defending the exchanges as regulators, contends that "[f]or most of their history [the] exchanges have been the primary regulators of securities markets."[164] Mahoney continues to argue that "[e]xchanges have strong incentives to provide rules of market structure that investors want and to compel adherence by their members to contractual and fiduciary obligations."[165] Andreas Fleckner similarly identifies exchanges' incentive to not only ensure the quality of trading but also "the quality of the traded products: the companies."[166] Competition among the exchanges should

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[158] Neil Gough, *After Loss of Alibaba I.P.O., Hong Kong Weighs Changes to Its Listing Rules*, N.Y. TIMES: DEALBOOK (Aug. 29, 2014), http://dealbook.nytimes.com/2014/08/29/hong-kong-begins-thinking-aloud-about-issue-that-lost-it-alibabas-i-p-o/.

[159] Benjamin Robertson, *Hong Kong Adds Dual-Class Shares, Paving Way for Tech Titans*, BLOOMBERG (Apr. 24, 2018), http://www.bloomberg.com/news/articles/2018-04-24/hong-kong-approves-dual-class-shares-paving-way-for-tech-titans; Emma Dunkley, *HKEX Admits Alibaba Forced it to Rethink Dual-Class Shares*, FIN. TIMES (Jan. 16, 2018), http://www.ft.com/content/6f0e9914-fa96-11e7-a492-2c9be7f3120a. Since the reversal, Jack Ma has indicated that Alibaba will now "seriously consider" listing on HKEx. Brenda Goh & Jennifer Hughes, *Alibaba Will "Seriously Consider" Hong Kong Listing, Says Founder Ma*, REUTERS (Jan. 8, 2018), http://www.reuters.com/article/us-alibaba-hongkong-listing/alibaba-will-seriously-consider-hong-kong-listing-says-founder-ma-idUSKBN1EY062.

[160] Chris Hughes, *The Problem with Dominant Mark Zuckerberg Types*, BLOOMBERG: BUS. (Dec. 10, 2018), http://www.bloomberg.com/opinion/articles/2018-12-10/the-problem-with-dominant-mark-zuckerberg-types.

[161] For Intercontinental Exchange, Inc., which owns NYSE, the "Trading and Clearing" business segment accounted for 49% of total revenue in 2018 while "Data and Listing" accounted for the other 51%. Intercontinental Exchange, Inc., Annual Report (Form-10K) 5, 7 (Feb. 27, 2019).

[162] Corrie Driebusch, *Gold Badges and Boozy Breakfasts: Inside the Frenetic Fight for IPO Listings*, WALL ST. J. (Apr. 5, 2019), http://www.wsj.com/articles/gold-badges-boozy-breakfasts-denim-suits-nyse-and-nasdaqs-frenetic-fight-for-ipos-11554479531.

[163] *Id.*

[164] Paul Mahoney, *The Exchange as Regulators*, 83 VA. L. REV. 1453, 1457 (1997).

[165] *Id.* at 1500.

[166] Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 FORDHAM L. REV. 2541, 2548 (2006).

therefore encourage optimal corporate governance practices since investors will seek out those companies.

Yet such regulation unquestionably incurs on state control of corporate law, as discussed in relation to index-maker activism *supra* Section IV.C. Various scholars made this precise criticism when the Sarbanes-Oxley Act of 2002 utilized exchange listing standards to impose numerous corporate governance requirements. Chancellor Chandler and Chief Justice Strine questioned the "marked increase in federal government and Exchange regulation of the corporate boardroom" brought on by Sarbanes-Oxley.[167] Stephen Bainbridge has made this criticism more explicitly, identifying that corporate governance listing standards "effectively preempt state corporate law by creating a uniform quasi-federal law of public corporations."[168] Exchanges, therefore, are both an unlikely and seemingly undesirable regulator of dual class shares.

VI. CONCLUSION: THE FUTURE OF INDEX-MAKER ACTIVISM

Corporate governance requirements are an effective and virtually costless mechanism for index-makers to satisfy their largest customers. The flexible nature of index creation grants considerable discretion to index-makers, creating an avenue for future governance-related restrictions. In practice, whether index-makers will move forward with the dual class restrictions, let alone engage in further corporate governance activism, remains uncertain. A few companies have already benefitted from MSCI's sharp reversal on the dual class issue.[169] High-profile companies continue to go public with multiple share classes, suggesting they are not sufficiently concerned about the restrictions to make such a significant change to share structure.

The dual class restrictions do, however, establish a precedent for private rulemaking via index creation. The index-makers unquestionably used their market power and function to influence a controversial corporate governance issue. The S&P 500 attempts to represent the large-cap U.S. equity market; barring dual class companies does not serve this purpose in any meaningful sense. The potential for subsequent index-makers activism warrants a deeper understanding of the relationship between index-makers and institutional investors, their primary customers. Index-maker activism will only become more effective and problematic if passive investing becomes increasingly popular.

There are various potential sources of private corporate law beyond the index-makers. As discussed in Part I, *supra*, rules imposed by proxy advisory services like ISS can change the outcome of corporate elections. Stock exchanges are quasi-governmental bodies which already regulate corporate governance through extensive listing standards. Environmental activists are pressuring university endowments to self-impose rules requiring divestment from fossil fuel

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[167] Chandler & Strine, *supra* note 98. S*ee also* Thompson, *supra* note 122, at 792 ("The new listing standards proposed by the New York Stock Exchange and NASDAQ in 2002 and approved by the SEC in November 2003 are a more direct intrusion into Delaware's governance space.").

[168] Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards* 26 (UCLA Sch. of L., Research Paper No. 02-15). S*ee also* Thompson, *supra* note 122, at 780 ("The stock exchanges have encroached further on Delaware's space through the expansion of their listing standards that relate to internal corporate governance.").

[169] Jeanny Yu & Benjamin Robertson, *Xiaomi, Meituan Among Dual-Class Stocks to Join MSCI Indexes*, BLOOMBERG (Feb. 11, 2019), http://www.bloomberg.com/news/articles/2019-02-12/xiaomi-meituan-among-9-dual-class-stocks-to-join-msci-indexes.

intensive companies.[170] The CII, representing managers of roughly $25 trillion in assets, frequently takes positions on controversial corporate governance issues.

In Section V.A *supra*, we recognized that it is difficult to regulate index-makers without incidentally restricting desirable behavior. This concern often applies to regulation of private rule makers, as evidenced by attempts to rein in the power of proxy advisory firms. At a minimum, however, government must weigh potential action by private rule makers when assessing the value of deferential corporate law. Arguments for enabling corporate law frequently account for corporations' incentives to voluntarily adopt best corporate governance practices. The "bonding hypothesis" relies entirely on such private incentives.[171] As Anita Indira Anand has suggested, "One way to maintain a high level of investor protection without creating excessive costs to issuers is to take advantage of firms' incentives to voluntarily adopt recommended corporate governance practices."[172]

The index-makers' dual class restrictions apparently fit Anand's conception. The SEC disfavors dual class structures, and the index-maker restrictions impose costs on dual class companies without the SEC having to impose a mandatory rule. Such costs may change the voluntary behavior of corporations. As we have seen, however, these private incentives for voluntary behavior hardly exist in a vacuum.

After considerable lobbying by some of their largest customers, index-makers utilized their critical and highly discretionary market function to punish companies with dual class share structures. The restriction has no justifiable relation to the underlying objectives of index creation (*i.e.*, creating a benchmark representing a broad swath of securities). In the process, the index-makers have fomented uncertainty in the capital markets while discouraging states from investing in their corporate law infrastructures. The SEC has already lamented the index-makers' newfound role in corporate governance. Going forward, when the government selects a point along the broad spectrum of public rulemaking, it will necessarily do so in the shadow of potential index-maker activism. Mandatory corporate law becomes more attractive when index-maker activism looms in the background.

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[170] *See, e.g.*, Geraldine Fabrikant, *Yale Advances in Shaping Portfolio to Address Climate Change*, N.Y. TIMES (Apr. 13, 2016), http://www.nytimes.com/2016/04/13/business/energy-environment/yale-advances-in-shaping-portfolio-to-address-climate-change.html.

[171] *See, e.g.*, John C. Coffee Jr., *Racing Towards the Top: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1782 (2002).

[172] Anita Indira Anand, *An Analysis of Enabling vs. Mandatory Corporate Governance Structures Post-Sarbanes-Oxley*, 31 DEL. J. CORP. L. 229, 234-35 (2006).