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Institutional Investors Oppose Stitch Fix Dual-Class Structure but Welcome Sunset Provision

More Dual-Class Companies Adopt Time-Based Sunsets

Washington, D.C., Nov. 16, 2017 —The Council of Institutional Investors (CII) says the clothing subscription company Stitch Fix's initial public offering (IPO), expected tomorrow, is problematic given its proposed dual-class share structure. CII is, however, encouraged by Stitch Fix's plans for a "sunset" provision that would terminate the dual-class structure in 10 years.

"A dual-class structure says to investors, 'We'll take your money, but we don't value your vote on how we use your capital to run the business.' That's not equitable treatment of investors, and it's certainly not effective corporate governance," said Ken Bertsch, CII's executive director.

At the vast majority of publicly traded U.S. companies, shareholders have voting power that is proportionate to their financial risk, in line with the longstanding corporate governance best-practice principle of "one share, one vote." But controlled or dual-class companies have a capital structure that gives founders and other insiders voting rights that outweigh their financial stake, typically 10 votes per share.

No founder is infallible. Independent boards accountable to owners should be empowered to actively oversee management and make course corrections when appropriate. Super-voting rights for insiders weaken board oversight and give investors little influence.

Nearly four out of every five 2017 IPOs of U.S.-based companies address these realities by using a "one share, one vote" structure. Yet CII and many institutional investors are alarmed by the proliferation of dual-class companies. CII reports that 24 of 108 companies that made IPOs on U.S. exchanges in 2017 (22%) have dual-class structures with differential voting rights (the total excludes foreign private issuers, "blank check" companies and master limited partnerships).

At IPO, these 24 companies accounted for 55% of the total market cap of the 108 companies. This high proportion is heavily skewed by the large size of two IPO companies that feature "non-voting" shares—Altice USA and Snap—although both Altice and Snap share prices have slumped since IPO while most of the companies have seen increased share values, reducing the Altice/Snap relative weight if current market cap is used. As of November 15, the 24 dual-class companies accounted for 49 percent of the 108 IPO companies' total market cap.

More dual-class companies opt for time-based sunsets. The silver lining in this trend is that a small but growing number of dual-class companies are adopting provisions that provide for automatic conversion to one share, one vote after a period of time. If Stitch Fix proceeds with its IPO this year, it will be the sixth dual-class company to IPO with a "clean" (non-contingent) time-based sunset provision this year (see table here), a record.

"We are encouraged that the Stitch Fix filing includes a sunset provision that offers a time-based path to avoid a permanent dual-class stock structure," Bertsch said. "Investors are better served with one share, one vote from the outset, but the Stitch Fix sunset provision limits potential for lack of accountability in the long term, which is particularly important." At 10 years, however, Stitch Fix's sunset is much longer than the three to five years that CII believes is reasonable.

In contrast, Bertsch noted, "the MongoDB and Switch IPOs last month both featured dual-class structures without meaningful sunset provisions. Even worse, Switch uses super-voting rights to vest control with its CEO and his descendants in perpetuity."

The most common terms for time-based sunset provisions are 10 years and seven years, though MuleSoft IPO'd with a five-year sunset earlier this year. Groupon did the same in 2011 and dissolved its dual-class structure in 2016. Time-based sunsets were rare prior to 2010, reports Stanford's Rock Center for Corporate Governance.

CII also is encouraged that since June, no U.S. companies have made IPOs with non-voting share classes. CII believes that a key reason are restrictions that index providers have since put on including dual-class companies, especially no-vote companies, in benchmark indexes. Shareholder litigation against non-voting stock also helped.

"Actions by index providers S&P Dow Jones, FTSE Russell and MSCI, as well as recent decisions by Facebook and IAC/Interactive to drop plans for non-voting share classes in the face of litigation, may be limiting the worst forms of dual class," Bertsch explained.