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MSCI Equity Index Committee
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Confidential

Re: Consultation on the treatment of unequal voting rights structures in the MSCI equity indexes

London 31st of May, 2018.

Dear Members of the MSCI Equity Index Committee,

We welcome the opportunity to provide our comments on this consultation.

Hermes EOS, is one of the world's leading engagement resources, advising on \$455 billion[1] on behalf of over 40[2] international institutional investors. Its purpose is to assist asset owners and asset managers to add long-term value to their investments and managing their risks, by engaging with companies and policy-makers on environmental, social, governance, strategic and financial issues. As part of our public policy work, we respond to consultations on behalf of clients, including Lothian Pension Fund, HESTA Super Fund, Mineworkers' Pension Scheme and British Coal Staff Superannuation Scheme. The views expressed in this communication do not necessarily represent the views of all clients.

Multiple class share structures

Hermes EOS strongly advocates the one-share, one-vote principle to ensure that all shareholders have the same voting and economic rights. Multiple class share structures often disenfranchise minority shareholders and run the risk to

[1] As of 31 December 2017
[2] As of 31 December 2017

leading to an entrenched management. As a result, they can limit the ability of institutional investors to deploy the full range of actions they may need to be effective stewards acting in their beneficiaries' best interests.

Stewardship

The theoretical and empirical rationale for stewardship codes and guidelines that have emerged around the world since the financial crisis of 2007/2008, suggests that appropriate shareholder rights and accountability mechanisms should be a key concern for regulators and governments.

The dilution of such rights and mechanisms through the proliferation of companies that have share classes with unequal voting rights (UVR) at a time when investors are encouraged to become more active owners around the globe amounts to a regulatory inconsistency.

While it may be impossible to make an empirical case for adherence to the one-share, one-vote principle across various life stages of companies and sectors, it is equally uncertain that UVR guarantee better long-term decision-making and outcomes. For example, experience indicates that at some point in the life of a company, a crisis or periods of sustained underperformance will occur. Similarly, family-controlled companies often face problems when passing on management from one generation to the next, as not many families consistently produce strong business leaders generation after generation.

In such cases, a UVR structure makes it difficult, if not impossible, for investors to intervene to ensure concerns are effectively addressed. An alignment between the economic interest of an investor and control rights through the one-share, one-vote principle thus seems the least imperfect share structure.

Innovative High Growth Companies and Sunset Provisions

Innovative high growth companies, when preparing to go public, often argue that their founders and cornerstone investors have a crucial role to play, especially in the companies' early life. UVR structures would allow controlling shareholders to focus on the long term, shielding them from undue pressure from financial investors on short term corporate issues.

Whilst we acknowledge, based on academic evidence discussed below, that founders and cornerstone investors may play a key role especially in a company's early life, the suggestion that pressure from the capital markets is something to be avoided using UVR structures is something institutional investors should take very seriously and seek to address.

Institutional investors could place themselves in a much stronger position in the discussion around differential voting rights if the industry would make more progress in addressing the issue of short-termism, for example, by lengthening typical performance measurement periods, focusing on absolute performance against agreed

objectives and systematically integrating longer-term factors within their decision-making processes and conversations with management.

This would mean focussing on a significant part of the underlying problem, rather than dealing with the symptoms through introducing ever more complicated share structures that disenfranchise investors and curb accountability. It would also mean acting in the interests of underlying beneficiaries.

It is important to note that at that an innovative high growth company's early life, much of the its valuation is vested with the founders and sometimes actively involved cornerstone investors. For the long-term sustainability of the company, this value should over time be institutionalised as firm value embedded in the products, processes, structure and culture of the company. Creating a superior voting right class only risks delaying the process of transferring value from individuals to the company.

Some recent academic studies looked into the value of UVR over the lifecycle of a company. Cremers, Lauterbach and Pajuste (2018)[3] showed that newly listed companies with UVR attract a valuation premium at the IPO, over a comparable company with a single class structure. However, they also found

[3] Cremers, Lauterbach and Pajuste (2018) The Life-Cycle of Dual Class Firms, European Corporate Governance
Institute (ECGI) Finance Working Paper No.550/2018.

that the premium dissipates over time and turns into discount six to nine years after the listing.

Bebchuk and Kastiel (2017)[4] examined the role of an expiration plan, or sunset provision, in mitigating agency problems and the discount at mature dual class firms. They also noted that UVR beneficiaries have perverse incentives to retain UVR structures even if they become inefficient over time.

We believe that, in order to realise the benefits of the founders' control in a company's early life, but also to mitigate the agency problems as the company matures, every UVR should have a built-in sunset provision at the time of listing, to be triggered after a fixed period of time (five to 10 years after the IPO, for example). After the deadline established in the sunset provision, the UVR structure would convert into a one-share, one vote structure.

At Zynga, a developer of internet games, we recently saw the founder convert some of its Class B and C shares, with super voting rights, into ordinary Class A shares, 7 years after its IPO. As a result, his voting power will be reduced from 70% to 10%.The rationale provided by Zynga's founder supports the findings of Bebchuk and Kastiel, in that he acknowledged that the company does not benefit from a UVR structure anymore and, as a result, he intended to reduce his level of involvement with the business.

<u>Mature Companies</u>

In certain markets such as Sweden, Denmark, Korea, South Africa, Russia, Brazil, Mexico and Colombia, UVR shares account for more than one third of the market capitalisation. Although the recent increase in listings with UVR have been driven by high growth companies, in those markets, the listed companies with UVR are mostly mature ones and their shareholding structures have been in place for decades. Holders of UVR shares are usually the founders' successors, being individuals, family trusts or charitable foundations. In some markets, like Sweden, large institutional investors hold UVR shares in

[4] Bebchuk and Kastiel (2017) The Untenable Case for Perpetual Dual-Class Stock, Virginia Law Review 103: 585-
631.

major companies as a long term strategic investment that allows them to sit on nomination committees.

MSCI's proposal will have an impact on many mature companies. However, collapsing a UVR into a one-share, one-vote structure brings challenges, such as loss of control. On the other hand, it also brings benefits, such as increased liquidity and reduction of a corporate governance discount applied by investors. The recent restructuring at Vale in Brazil is a good example of this. The group of investors that has controlled the company since its privatisation in 1997 decided to adopt a single share class structure in 2017, when the original shareholders' agreement that bound them expired. Shareholders in the controlling group, pension funds and other institutional investors, decided that liquidity was more important than control. The company is moving from a controlled ownership to a dispersed ownership model. The improvements in corporate governance have already started to show, such as the election of independent directors for the first time.

The implementation of MSCI's proposal may be an important encouragement for mature companies with UVR to reflect on their shareholding structure and the benefits of aligning voting and economic rights.

Commercial Imperatives of the Exchanges and the Role of Index Providers

It is our belief that the financial system and specifically the regulatory framework should operate in the interests of ultimate owners - the underlying savers. As fiduciaries of the ultimate owners, institutional investors should ask stock exchanges, regulators and governments around the world to focus on creating a framework that facilitates the long-term success of companies they invest in on behalf of the underlying beneficiaries, not the commercial success of a particular stock exchange or a market in which it is based. In our view this requires adequate shareholder rights, investor protection and management accountability through adherence to the principle of one-share, one-vote for listed companies, especially if there are forced buyers as a result of the issuance.

A more intensive global competition particularly between stock exchanges in the US and the Hong Kong stock exchange (HKXE) has manifested since the

IPO of Alibaba in 2014. As a result, several stock exchanges in Asia, most notably the HKXE but also the Singapore exchange, are softening their approaches with regard to listings of companies with differential voting rights. In the UK, the London Stock Exchange also vented the possibility of flexing its listing rules to attract the listing of Saudi Aramco.

The underlying saver, however, is interested in the sustainability of companies around the world and the long-term returns from investments in them which is facilitated by adequate shareholder rights, investor protection and management accountability. She or he is not normally interested in the commercial success of a particular stock exchange or the economic benefits for a market in which it operates.

Regulators, supervisory bodies of financial markets, and stock exchanges are the natural safeguards of listing requirements which in turn should reflect good corporate governance practice. However, we also realise that given the highly competitive environment amongst stock exchanges, it is rather unlikely that they will enforce more stringent listing requirements which take account of multiple-class share structures. In fact, the highly competitive nature of stock exchanges could in our view even lead to a 'race to the bottom' with more and more less stringently enforced listing requirements which do not feature governance qualities as a screening tool.

In the low likelihood of action by stock exchanges, index providers will have a role to play. Index weight adjustments based on financial factors, such as market capitalisation, and non-financial factors, such as carbon emissions, are not a new feature. These adjustments result in indexes that reflect the investable universe in a comprehensive, but not exhaustive way.

Given the growth of passive investing, index adjustments based on governance characteristics, such as unequal voting rights now proposed by MSCI, not just in its specialised ESG indexes, but also in its main indexes, will result in forced buyers and universal owners reducing their exposure to UVR shares.

However, this cannot be a panacea. At Hermes EOS we will continue to engage with stock exchanges and their regulators to make the case for the one-share, one-vote principle, and press for the introduction and enforcement of stricter listing requirements that take account of the multiple share-class issue.

For example, in response to the recent board consultation by the Hong Kong Stock Exchange on listing opportunities for companies with weighted voting rights structures, we strongly advised against the proposed non-standard governance structure in a one-track or dual-track listed regime.

In our feedback to a consultation by the Singapore Exchange (SGX), we again made it clear that we are not supportive of the introduction of a dual-class share framework in the city state. While we were disappointed with the outcome, we acknowledged the thorough consideration the SGX has given this matter and the steps it has suggested to address the risks of a dual class share structure, which, if implemented correctly, could be effective in mitigating much of the risk of abuse by owner managers of listed companies.

We also formally responded to the consultation by the UK's Financial Conduct Authority proposing a new premium listing category for sovereign-controlled companies, which would exempt them from some of the rules that provide their shareholders with additional protection. We contended that while the listing of sovereign-controlled companies in London under the new regime would be attractive from a short term commercial perspective, in particular for the stock exchange, investment bankers, lawyers and other advisers, it is questionable whether their listing is beneficial to the underlying beneficiaries, whose money will ultimately be invested in these companies in the long term.

<u>Our comments to MSCI's proposal</u>

1- We support MSCI's proposal to continue to include UVR shares in its equity indexes.
2- We believe the index weight adjustment proposed will act as a deterrent, discouraging companies that are planning to go public to adopt UVR structures. We agree with the methodology proposed, in which the security weight in the index is adjusted by the voting power free float. On an exceptional basis, MSCI could delay the index weight adjustment if the newly listed company has robust sunset provisions in place.

3- The implementation of MSCI's proposal for *mature companies* will have a significant impact on some markets like Brazil, Denmark and Mexico, which will have their weights reduced by more than 20%, according to

MSCI calculations. Once a UVR structure is in place, changing it to a one-share, one-vote structure is not an easy task. However, we believe the implementation of MSCI proposal will make affected companies reflect about their shareholding structure. Some of them may be incentivised to move to an on-share, one-vote structure, thus avoiding the index weight adjustment. Therefore, we also support the implementation of the proposal for existing listings.

4- If index weight adjustments are implemented, we agree with a 3 year grace period, but also recommend that the implementation after the grace period should not be done too quickly – a 2 year implementation period would help mitigate the impact on the markets the are expected to be more heavily affected.

Yours sincerely,

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