

**ICGN**

International Corporate Governance Network

## ICGN Viewpoint

### Differential share ownership structures: mitigating private benefits of control at the expense of minority shareholders

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The protection and enhancement of minority shareholder rights has been a long-standing focus of the ICGN. Our Global Governance Principles emphasise the importance of equal voting rights for all shareholders and call for disclosure and explanation of any divergences as well as commensurate extra protections for minority shareholders.

The ICGN position on differential ownership and control structures is clarified in our first Viewpoint statement on the subject issued in April 2015. The purpose of this updated statement is to present our latest thinking on this important topic. It also reflects the results of a recent ICGN Member survey which shows that a strong majority of our Members disapprove of differential ownership structures. This Viewpoint is intended to inform ICGN's engagement on this issue with policy makers, stock exchanges and other stakeholders. Importantly, it also aims to help guide ICGN Members when they engage with companies on the subject.

Differential ownership and control structures (e.g. non-voting shares, double-voting rights/loyalty shares, golden shares/priority shares) allow control over publicly listed companies which is disproportionate to the economic interests and cash flow rights of investors. Their availability and use vary depending on laws and regulations, listing rules, as well as corporate governance practice and attitudes of major providers of capital, such as institutional investors.

Since the financial crisis in 2008, there has been resurgence in the promotion and use of differential ownership and control structures in many markets (e.g. US, EU, China, Brazil). ICGN has contributed significantly to the public policy debate on this issue<sup>1</sup>. The rejection of differential ownership and control structures by the Hong Kong Securities and Futures Commission, the removal of respective proposals from the EU Shareholder Rights Directive and the Italian Growth Decree are among positive outcomes of these efforts.

#### ***Perspectives on the pros and cons***

The issue of short-termism in financial markets is often cited as the main reason for resurgence in differential ownership and control structures, particularly in developed

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<sup>1</sup> For examples of ICGN position statements on differential rights please see: <https://www.icgn.org/sites/default/files/Shareholder%20Rights%20Comment%20Letter.pdf>; [https://www.icgn.org/sites/default/files/Revision%20of%20the%20Shareholder%20Rights%20Directive\\_4.pdf](https://www.icgn.org/sites/default/files/Revision%20of%20the%20Shareholder%20Rights%20Directive_4.pdf); [https://www.icgn.org/sites/default/files/Italian%20Government%20-%2028.01.2015\\_1.pdf](https://www.icgn.org/sites/default/files/Italian%20Government%20-%2028.01.2015_1.pdf); <https://www.icgn.org/policy/viewpoints/differential-rights>;

markets. Proponents of differential rights regard these structures as a tool that allows management to take long-term decisions. Such structures are thought to shield companies from market forces and shareholder activism that can be too focused on short-term gains. Proponents also contend that these structures make it more compelling for entrepreneur-controlled firms to find their way to public capital markets. Particularly for smaller companies or companies in sectors with long-term planning horizons, differential ownership rights and/or dual class shares are seen by their proponents as a way to protect companies from influences that might undermine sustainable value creation.

Empirical evidence does suggest that controlling interests can lead to enhanced performance. However, this is much more likely to happen when majority control comes from a matching economic stake; in this way the economic interests of majority and minority shareholders are aligned and the investment risk is allocated proportionately.

At the same time, there is no strong evidence that differential voting rights provide companies with a better environment for long-term planning and execution. Indeed, the weight of evidence suggests otherwise. In a recent research literature review of this topic, academics David Larker and Brian Tayan conclude that “the evidence suggests that companies with dual-class structures tend to have lower governance quality”.<sup>2</sup>

For example, in an empirical study of dual class structures in the United States, the authors concluded “we find that firm value is positively associated with insiders’ cash-flow rights, negatively associated with insiders’ voting rights, and negatively associated with the wedge between the two.” The authors go on to say that “a majority owner of a private company can rationally choose to sacrifice some firm value in order to maintain private benefits of control.” That may be well and good for the controlling owner, but it also suggests that these private benefits come at a cost to minority investors.<sup>3</sup>

Differential ownership and control structures are increasingly seen in the high technology sector, where long-term thinking is needed to support innovation and invest in technologies, products and solutions that will drive growth in the long-term. However, over time, insulation from market forces can be a risk in itself as it can lead

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<sup>2</sup> David Larcker and Brian Tayan, “Corporate Governance Matters”, Second Edition, Pearson Education Inc., 2016.

<sup>3</sup> Paul A. Gompers, Joy Ishii and Andrew Metrick, “Extreme Governance: An Analysis of Dual Class Firms in the United States” *Review of Financial Studies* 23 (2010): 83-120.

to companies losing nimbleness and seeing their own business models being disrupted<sup>4</sup>.

The artificial enhancement of voting power and control does not guarantee positive outcomes for minority shareholders, but reduces their ability to address any misalignment of interests that may occur over time and denies investors the tools they can use to put things right if they go wrong. Where there is little incentive for a dialogue between companies and their shareholders, a quick exit from the stock (with the exception of index investors) will be seen as the only available option in the event of under-performance or any other concerns.

### ***ICGN Position on multiple voting rights and dual class shares***

ICGN advocates a “one share one” vote standard as the optimal long-term structure for both companies and investors, and would encourage all companies listed in public markets to adhere to this model or to add sunset provisions in cases of existing dual class arrangements. This includes cases of shares without voting rights.

ICGN supports a ‘one share one vote’ standard because it:

- Ensures equal treatment of all shareholders in the company by aligning control via voting rights with economic interest and, therefore, investment risk;
- Increases the board’s accountability to minority shareholders and prevents entrenchment of management, leading to improvements in governance and quality of board oversight;
- Alleviates conflicts of interests around major transactions and balances the interests of major and minority shareholders;
- Offers transparency of the share ownership structure and changes in voting rights;
- Prevents insulation of companies from market forces, and encourages adaptability/agility of business models;
- Supports liquidity, which in turn reduces investment risk and the cost of capital for the company.

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<sup>4</sup> At ICGN’s 2016 Academic Day in San Francisco, co-partnered with the Rock Center for Governance at Stanford University, the technology sector was a particular focus in the debate relating to differential ownership rights. Please see: <https://www.icgn.org/academic-days>

## ***Reducing investment risk in companies with differentiated ownership and control structures***

A growing number of investors explicitly integrate the assessment of corporate governance practices in listed companies and associated risks into their investment analysis. Any risks attached to differential ownership and control structures will be priced accordingly and will have greater impact on stock valuations and investment decisions. Therefore companies should be mindful of the impact such structures will have on their investor base and their share price performance.

Where companies have historically opted for differential ownership and control structures or are seeking high degree of protection from market forces after listing, ICGN recommends the following steps to reduce the risk for investors and make companies more attractive to public markets:

- Articulate the clear rationale for the need of differential ownership and control structures and identify specific circumstances under which these would be beneficial for the company and its shareholders.
- Assess whether alternative measures can be taken to address the issues without creating differential ownership and control structures.
- Introduce an annual review of differential ownership and control structures by the board.
- Introduce a sunset provision for any differential ownership and control structures (e.g. 5 years from the IPO date or departure of the management team at the IPO, whichever is shorter).
- Ensure minority shareholders have an equal say in decisions that can materially impact the investment case for the company (e.g. major M&A transactions, change of control, etc.).
- Ensure robust governance and control structures, including an independent board, separate Chairman/CEO roles, a conflicts committee, etc.

## ***Differential share-ownership structures vs tenured voting rights***

Tenured or time-based voting, i.e. additional voting rights acquired based on the length of shareholding, such as double voting rights in France, is regarded by some commentators as a compromise solution that encourages longer-term investment without perpetuating the dominance of a certain group of shareholders - as is the case with differential share ownership structures. While appealing in theory, and potentially a better solution than other differentiated structures, tenured voting rights present a very high risk for minority shareholders and institutional investors in particular.

Tenured voting rights carry all the risks associated with differential ownership and control mechanisms, including misalignment of economic interest and control and management entrenchment. In addition, this approach reduces transparency of ownership and control structures. For example, assessments of company-specific risks associated with multiple class share structures are often undertaken prior to investing. In the case of tenured voting rights, changes in ownership and control structures are much less predictable, which creates instability and increases investment risk. Tenured voting rights can also have an unintended consequence of encouraging undue shareholder activism by guaranteeing activist shareholders enhanced voting power and influence over a period of time.

Finally, there are operational and administrative burdens and costs that often prevent long-term institutional investors from benefiting from enhanced voting rights under tenured voting systems. For example, frequent changes in the voting rights register can create regulatory compliance issues for institutional investors (e.g. a fund manager may find itself in possession of a higher/lower stake in the company in relation to disclosable thresholds without undertaking any market transactions). This instability can make it harder for institutional investors to commit for longer-term, thus incentivising shorter-term investments.

### ***Alternative ways to help ensure long-termism by companies and investors***

It is essential that companies are able to plan and invest for the longer-term. It is also true that there is a large pool of long-term investors. Companies can attract and retain long-term investors through:

- Ensuring strong shareholder rights, particularly the equitable treatment of shareholders by virtue of appropriate voting rights aligned with their economic interests;
- Transparency and high quality reporting which puts historical performance into context while portraying the risks, opportunities and prospects for the future to enable purposeful dialogue with investors. This includes both robust financial reporting, as well as broader 'integrated reporting' that considers performance factors that are not reflected in formal financial statements and accounts;
- Robust governance structures and oversight by the board to ensure the high-quality execution of strategy by the management team to promote the long term success of the company and to create sustainable value.

As investor stewardship practices are developing in many markets and are being integrated into investment processes, companies should use the opportunities to work with their large institutional investors to protect and generate sustainable corporate value in the long term.

A practical way to embed longer-term thinking between asset owners and asset managers is to ensure that investment management agreements contain contractual terms that mandate responsible stewardship practices. Key areas of focus should include:

- Ensuring that the timescales over which investment risk and opportunity are considered match those of the client;
- Aligning asset owner and asset manager interests effectively through fees, pay structures and culture;
- Effectively integrating relevant environmental, social and governance factors into investment decision-making and ongoing management;
- Ensuring that portfolio turnover is appropriate to the mandate, in line with expectations and managed effectively.

### ***2016 ICGN membership survey feedback***

In summer 2016, ICGN invited Members to share their views on the perception of investment risk associated with differential ownership and control mechanisms, the impact of these mechanisms on their investment decisions, and the preferred policy options to guide ICGN's engagement work. The summary of responses below provides valuable insights to companies and markets considering differential ownership and control structures:

- 84% of respondents did not support differential voting rights and 22% would not invest in companies with differential voting and control structures. Most would consider investing on a case-by-case basis, depending on the level of investment risk associated with these mechanisms.
- 67% of respondents said differential voting and control structures would impact their stock valuation, including: (i) greater discount rate, lower valuation or higher returns requirement due to increased risk profile; (ii) lower conviction, resulting in underweight positions or shorter-term investment horizon; and (iii) tactical weighting decisions in passive funds.
- 82% of respondents perceive differential voting and control structures an investment risk. The level of risk depends on other protections available to minority shareholders, the ownership structure and the alignment of interests between the major/controlling shareholders and the minority shareholders, as well as the quality of board and management and actions/preferences of controlling shareholders.
- Importantly, the presence of a controlling interest is not necessarily seen as a governance/ investment risk, but depends on the identity of the controlling

shareholder, protections available to minorities, and alignment of economic interests between the controlling and minority shareholders. Differential ownership and control structures will be seen as higher risk where: a controlling stake is acquired (rather than enhanced) through differential voting rights, shareholders benefiting from increased voting power can block special resolutions, differential voting rights can influence the outcomes of M&A and other material transactions. A vast majority of respondents (82%) indicated that applying differential voting rights selectively to specified resolutions only (e.g. board elections) would not reduce perception of risk.

- The preferred structure for the vast majority of respondents (82%) would be “one share one vote”. For companies with differential ownership and control structures, investors would like to see strong mitigating measures (board independence, conflicts committee, exemptions from major transactions) and full plain disclosure of impacts on minority shareholder rights. Limiting companies with differential ownership and control mechanisms to special segments of a stock market is not favoured by investors with 57% citing it as the least preferred option.
- When asked specifically about double voting rights acquired with the length of holding, only 27% of respondents had applied for these despite eligibility, while 34% reported administrative barriers and operational issues.

In summary, ICGN believes that differential voting and control structures are not features of good corporate governance, and should generally be avoided. Companies should understand the downside of differential rights for their minority investors, particularly those with long-term investment perspectives. Investor engagement should challenge such structures when they are in place, and also should discourage new issues of shares with dual class or differential voting features.

## Annexes

### About ICGN

Established in 1995, the International Corporate Governance Network (ICGN) is an investor-led organisation of governance professionals with members including institutional investors based in 47 countries and collectively responsible for assets under management in excess of US\$26 trillion. ICGN's mission is to promote effective standards of corporate governance and investor stewardship to advance efficient markets and sustainable economies world-wide. ICGN is a global authority on high standards of corporate governance and investor stewardship. [www.icgn.org](http://www.icgn.org).

### About ICGN Viewpoints

ICGN Viewpoints provide opinion on emerging corporate governance issues and are intended to generate debate, whilst not defining a formal ICGN position on the subject. ICGN Viewpoints are produced by our member-led Policy Committees and we encourage dialogue by contacting Committee chairs directly or the ICGN Secretariat as follows:

- Eugenia Jackson, Co-Chairman ICGN Shareholder Rights Committee: [Eugenia.Jackson@AllianzGI.com](mailto:Eugenia.Jackson@AllianzGI.com)
- Bram Hendriks, Co-Chairman ICGN Shareholder Rights Committee: [BHendriks@ktmc.com](mailto:BHendriks@ktmc.com)
- George Dallas, ICGN Policy Director: [george.dallas@icgn.org](mailto:george.dallas@icgn.org)

### Global Network of Investor Associations Member positions

ICGN views on differential voting rights outlined above are broadly consistent with the policies, guidelines and opinion papers published by many shareholder associations worldwide, including members of the Global Network of Investor Associations (GNIA) convened by ICGN. We provide links below to the policy positions of GNIA members in key markets around the world on this issue:

- **Australia.** Australian Council of Superannuation Investors: ACSI Governance Guidelines (section D page 22): [https://www.acsi.org.au/images/stories/ACSIDocuments/ACSI\\_Governance\\_Guidelines.Oct15.pdf](https://www.acsi.org.au/images/stories/ACSIDocuments/ACSI_Governance_Guidelines.Oct15.pdf)
- **Brazil.** The Association of Capital Market Investors (AMEC): Letter to BM&F Bovespa on Super-Preferred Shares, November 2016: <http://www.amecbrasil.org.br/wp->



[content/uploads/2016/12/CARTAPRESI\\_14\\_2016\\_Vedacao\\_a\\_Superpreferencia\\_is\\_ingles.pdf](#)

- **Canada.** Canadian Coalition for Good Governance (CCGG): Dual Class Share Policy, September 2013:  
[http://www.ccg.ca/site/ccgg/assets/pdf/dual\\_class\\_share\\_policy.pdf](http://www.ccg.ca/site/ccgg/assets/pdf/dual_class_share_policy.pdf)
- **Netherlands.** Eumedion: Position Paper, 28 June 2016: Position of minority shareholders in companies with a controlling shareholder:  
<http://www.eumedion.nl/en/public/knowledgenetwork/position-papers/2016-06-position-paper-minority-shareholders-final-version.pdf>
- **United States.** Council for Institutional Investors (CII): Statement on Dual Class Stock: [http://www.cii.org/dualclass\\_stock](http://www.cii.org/dualclass_stock)