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The Hague, 23 May 2018

Ref: B18.17

Subject: Eumedion's response to 'Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes'

Dear Members of the MSCI Equity Index Committee,

Eumedion appreciates the opportunity to respond to your second consultation on the treatment of unequal voting structures in the MSCI Equity indexes. Eumedion represents the interests of 65 institutional investors, all of whom are committed to a long-term investment horizon. Together our participants invest over € 4 trillion of capital in equity and corporate debt instruments. Eumedion aims to promote good corporate governance and sustainability in the companies our participants invest in. We regard index services as a key part of the global financial infrastructure, as most asset owners and managers use indexes to define and manage the risks of their portfolios. Institutional investors, predominantly in their role as minority shareholders, may even be the key stakeholders of MSCI. This is in contrast with strategic investors who would be less typical users of MSCI's index services for managing the risks in their portfolios.

MSCI's revised proposals clearly acknowledge the principle that shareholders' power should be proportionate to their economic interest (the so-called 'proportionality principle'). The proposals contain a profound incentive for companies to reduce any deviations from the proportionality principle: the less a company deviates, the higher its index weight.

## The need for index providers to act

Eumedion concurs with MSCI, and the other two major index providers, that index providers need to take into account breaches of the proportionality principle in the weighting of company shares in the leading indexes. Eumedion is of the opinion that the right to vote at the AGM in itself is as fundamental to the share-ownership of listed companies, as is the right to receive dividends paid. The voting power of a shareholder should in principle be proportionate to his economic interest. If minority shareholders' voting rights are limited in any way, this will immediately resonate negatively in their ability to exercise their stewardship role as responsible and engaged long-term shareholders. The use of disproportional voting share classes will increase the risk of malpractices and scandals.<sup>1</sup> It can even affect the trust of the general public in investing in shares, thereby affecting the access to capital for other companies as well. Given that equity indexes form the starting point of portfolio construction of most minority shareholders, it is justified that index providers by default adjust the index weight to reflect any deficiencies in the voting structure of a company.

Ideally, unequal voting rights would never have been allowed by either stock exchanges or by law. However, an increasing number of exchanges have strong commercial incentives and tend to compete for new listings. The more degrees of freedom a stock exchange can offer on governance, the more attractive it tends to become for companies seeking to IPO. MSCI's discussion paper highlights how many stock exchanges already allow unequal voting rights. Their number is even increasing: the Hong Kong and Singapore stock exchanges recently changed their stance towards allowing dual class shares due to competitive pressures from the New York Stock Exchange for Chinese IPOs<sup>2</sup>. It highlights the current forces that influence the listing requirements of exchanges. Therefore, it seems not realistic to assume that predominantly all exchanges will introduce a ban on unequal voting rights for new IPOs anytime soon.

With an increasing number of exchanges opposing a ban on unequal voting structures together with the vested interests of any existing company that may have unequal voting structures, it will take both significant time and courageous governments to disallow such shareholder structures by law. Governments tend to believe that legal restrictions on deviations from the one share, one vote principle will impair the country's business climate, but seem to forget that an attractive investment climate for institutional investors is an integral part of the competitive position of a country. However, there is an undeniable trend towards a flexibilisation of company law in countries, i.e. allow companies to better protect themselves against unsolicited public bids and undesired shareholder activism.<sup>3</sup> Index providers are therefore the last 'authority' institutional investors can rely on in setting basic market standards that help protect the proportionality principle.

Therefore, Eumedion applauds MSCI for acknowledging there is a need to act firmly on adjusting index weights for unequal voting rights.

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<sup>1</sup> IRRRC Institute, *Controlled Companies in the Standard & Poor's 1500: A Follow-Up Report of Performance & Risk*, March 2016.

<sup>2</sup> <https://www.economist.com/news/finance-and-economics/21737530-trend-threat-time-honoured-idea-one-share-one-vote-hong-kong>

<sup>3</sup> E.g. the so-called 2014 Florange Act in France, the 2014 'Growth Decree' in Italy and the plans of the Dutch Government to introduce a so-called standstill period of up to 250 days that a listed company can invoke when faced with activist shareholders proposing fundamental changes to the company's strategy.

### **Specific adjustments necessary for Dutch listed entities**

Although we generally support the revised proposals, we have two concerns regarding the treatment of specifically Dutch companies.

First, the Dutch corporate governance code stipulates that the voting rights attached to financing preference shares should be based on the fair value of the capital contribution (best practice provision 4.3.4 of the Dutch Corporate Governance code). At this moment there are two Dutch companies that deviate from this best practice provision, and therefore from the proportionality principle: Unilever and DSM. MSCI has recognised the Unilever case and intends to decrease the weight of Unilever shares in the indexes. However, Unilever is currently in the process of cancelling the financing preference shares, with the positive consequence that this company will not be affected by the final MSCI proposals. DSM is not recognised by MSCI yet, because the nominal value of the DSM preference shares is similar to the nominal value of the ordinary shares (€ 1.50). However, this does not take into account the fact that the preference shares are not listed. It is also important to keep in mind that the preference shares were created in 1996 through a conversion of ordinary shares held by the Dutch State to enable the latter to dispose of a last part of its participation in the company without disturbing the market. Although the preference shares were issued at a discount of 54% in comparison with the market price of ordinary shares, the voting rights attached to the preference shares were not adjusted. As a consequence, the voting rights were at the time of issuance not aligned with the fair value of the capital contribution. This distortion in voting rights was not removed after the introduction of the Dutch Corporate Governance Code in 2003 that asked Dutch listed companies to adjust the voting rights of the preference shares by aligning them to their economic interest. Other Dutch listed companies, such as Royal Ahold Delhaize, Randstad and Heijmans, did take action to align the voting rights of the preference shares with their economic interest. Therefore, we encourage MSCI to take this unequal voting structure into account in drafting the final proposals.

Second, many Dutch companies have an independent anti-takeover foundation to thwart off a hostile bid or undesired shareholder activism. In such events, the foundation can exercise its call-option to take anti-takeover preference shares up to 100% of the issued capital. The foundation will only have to pay up 25% of the nominal value of the anti-takeover preference shares. As a result, the foundation will become majority shareholder in a very cheap way. As of that moment in time, an unequal voting structure is created. It is not clear to us how MSCI will deal with such a situation. As explained in our answer to question 10 of your consultation document, we suggest providing exemptive relief to all companies that have such an anti-takeover foundation, under the condition that such companies choose to adopt the specific provision in their governing documents that the unequal voting structure will be dissolved as soon as the hostile situation is over, in principle within six months.

Please find below our response to the specific questions in the consultation.

If you would like to discuss our views in further detail, please do not hesitate to contact us. Our contact person is Martijn Bos (martijn.bos@eumedion.nl, +31 70 2040 304).

Yours sincerely,

Rients Abma

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Eumedion

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**Answers to the questions in the consultation document**

*Treatment of unequal voting structures*

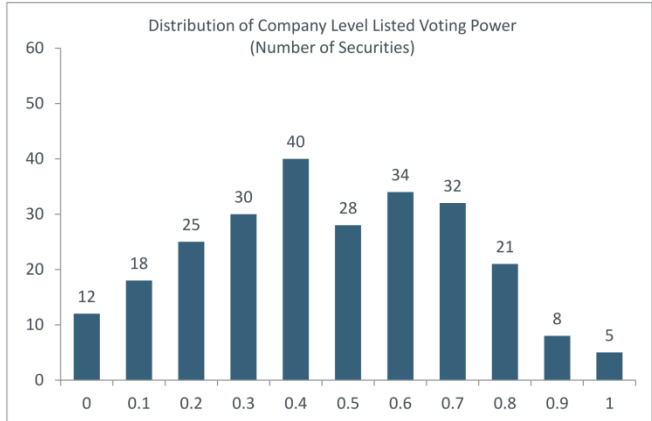
- 1) Do you agree that unequal voting shares should remain eligible for index inclusion?
- 2) Do you agree that the index weight of securities with unequal voting structures should be linked to voting power?

Eumedion response:

We agree with the proposed approach where the weight of stocks in the indexes is adjusted to reflect both free float and the voting power of the listed shares of a company. We strongly support the principle that shareholders' power should be proportionate to their economic interest (the so-called 'proportionality principle'), as explained in the introduction of this letter. A proportionate adjustment in the index weight based on voting power is justified as the negative impact on the company's governance structure of a deviation increases with the magnitude of such deviation.

Deviations from the proportionality principle vary considerably, as evidenced by exhibit 11 of MSCI's discussion paper:

Distribution of Voting Power of Unequal Voting Rights Stocks, Indicative Data as of Sept.1, 2017



The alternative of a 'bright line'- approach where only companies that meet a certain threshold would be fully excluded from the index fails to recognise the still harmful impact of deviating structures below the threshold. A bright line may even be wrongly interpreted as a signal that any deviating structures up to the threshold would not constitute an infringement of minority shareholder rights. Besides, any chosen threshold would be arbitrary as it would lack a conceptual basis.

Neither would a bright line approach provide a proper incentive to improve voting rights for all companies: only those companies that consider crossing the threshold benefit from increased index weight. The proportional approach that MSCI proposes provides an important incentive for each company to improve on any existing deviation as each improvement would raise the index weight of the company.

*3) Is it appropriate to delete securities with zero company voting power from the MSCI Equity Indexes? An alternative could be to maintain such securities in the indexes at very reduced weights (e.g., using 10% of the securities' free float)*

Eumedion response:

Yes, it is appropriate to remove from the index those companies that did not list a single share class with voting power. Allocating zero voting power to listed shares is a choice of the Board together with the shareholders that have voting power. As explained before, we consider voting power to be a fundamental right of shareholders. Investors that use MSCI as an index provider should not need to explain why they deviate from your indexes if they do not invest in companies that deprive them of their say on any matter that is up for vote at the AGM. This is not necessarily a static situation, as such company can also propose to revise its deviating voting structure.

We are not in favour of maintaining such company at a heavily reduced index weight of for example 10%; the identified shortcomings of introducing a bright line in our answer to question 1 and 2 apply here as well.

*Voting power adjustment*

*4) Is the application of a voting power adjustment an appropriate way to reflect misalignment between voting power and economic interest?*

Eumedion response:

Yes. We refer to the introduction of this letter and to our answer to question 1 and 2.

*5) Is the method for calculating the adjustment adequate?*

Eumedion response:

Yes, we consider the proposed method that makes a single adjustment to all the securities of a single company ('company level method') to be adequate. We see one alternative method: a method that adjusts index weights at the individual securities level ('securities level method'), as initially proposed by Eumedion in our response to MSCI's initial consultation in August 2017<sup>4</sup>.

The outcome of the securities level method is that shares with no voting rights will have zero weight, which from a minority shareholder perspective is an intuitive outcome. The proposed company level outcome will result in a less intuitive outcome where non-voting shares will be included if there also are shares listed with voting rights. Even though that we consider all departures from the proportionality principle as undesirable we find the proposed company level method as adequate because the proposed company level method also has two significant advantages over the security level method. Firstly, due to the very large amounts that are invested according to MSCI's indexes, the price difference between securities with voting rights (included in index) and without voting rights (excluded from index) from the same company could become rather unpredictable and possibly so

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<sup>4</sup> <http://bit.ly/2wq4VzZ>.

large that they become economically not justifiable. Price differences between share classes may be especially prominent in the transition phase. The proposed company level method better serves an orderly functioning market. Secondly, the proposed company level method differentiates between unequal voting rights that benefit strategic shareholders (this would lower the index weight) and those that benefit non-strategic shareholders (this would not affect index weight). Voting rights that benefit strategic shareholders and founders indeed pose more risks from a governance perspective. Some voting structures allow founders to dominate or even dictate the decision-making process in the general meeting at the expense of other shareholders. It becomes more difficult, or even impossible, for other shareholders to block decisions that negatively affect their interests and to hold board members to account. Please note that the International Corporate Governance Network is also not in favour of granting extra voting rights to specific shareholders.<sup>5</sup>

*6) Do you agree that the votes per share should be zero in cases where voting rights are restricted? (page 10)*

Eumedion response:

We agree. Share classes with restricted voting rights pose a significant governance risk and should for the purpose of calculation index weights be considered to have no voting rights. If an individual company finds this outcome to be disproportional, we consider it up to the company to propose to eliminate such restrictions.

The Dutch government is in the process of drafting a bill that allows Dutch listed companies under siege to invoke a temporary 'standstill' period of 250 days in which shareholders are deprived of some fundamental rights, namely the right to request to organising an extraordinary general meeting and the right to submit a resolution to dismiss one or more members of the Managing and/or Supervisory Board. This could imply that none of the share classes contain shares with voting rights with respect to these two fundamental rights. Technically, the lack of voting rights remains equal amongst all share classes. We suggest that MSCI clarifies how to deal with such situations. From a governance perspective, we can imagine that the shares of a company that invokes this standstill period are considered to have no qualifying voting rights during that period and that the index weight of such shares be adjusted to zero accordingly.

*7) Do you agree with the proposed exceptions? (page 10)*

*7a) The votes per share would not be adjusted to zero in cases where a share class imposes partial restrictions on the election of Directors (see Appendix for more details)*

Eumedion response:

We do not agree. Being able to vote on the election of all directors irrespective of the share class owned is a major factor in good corporate governance. Proposals to lift such restrictions are at the

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<sup>5</sup> International Corporate Governance Network, *Viewpoint Differential share ownership structures*, February 2017.

discretion of the company. Companies that keep these unequal voting structures after the grace period should not be eligible for inclusion in MSCI indexes.

*7b) Special purpose non-voting instruments, such as NVDRs in Thailand or CPOs in Mexico would not be subject to voting power adjustment*

*7c) The existence of limits on the aggregated voting rights that can be held by foreign investors would not be considered in the voting power calculation, unless the limit is zero (i.e., foreign investors are fully restricted from voting)*

Eumedion response:

Insofar we can observe, it seems that both the CPOs in Mexico and the NVDRs in Thailand de facto are non-voting shares in companies that also issue voting shares<sup>6</sup>. The foreign ownership of voting shares seems prohibited by law in these countries. CPOs and the predominant types of NVDRs appear to severely violate the proportionality principle and should be regarded as having zero votes. One way to be lenient to these cases is to assume that the local non-strategic shareholders of the voting shares do effectively function as minority shareholders from a governance perspective, even if these shares cannot be owned by foreign investors. Using the proposed (company level) method this would then not result in a weight of zero of the non-voting shares.

*7d) The existence of "loyalty shares", which reward additional voting rights to investors who hold their shares beyond a given period of time, would not be considered in the voting power calculation*

Eumedion response:

Loyalty shares are created at the discretion of companies and do result in unequal (voting) rights among shareholders. Eumedion is, together with the International Corporate Governance Network, a strong opponent of loyalty shares.<sup>7</sup> We urge MSCI not to exempt loyalty shares.

#### *DISCUSSION POINTS: IMPLEMENTATION*

*8) Is it appropriate to grant a grace period for current constituents?*

*9) Is a three-year grace period sufficient or should more time be given?*

Eumedion response:

Yes, we can imagine that the current constituents are offered a grace period that is sufficient long to allow the Board and existing (majority) shareholders to propose changes in their shareholding structure. We support the proposed grace period of three years.

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<sup>6</sup> Source NVDR: <https://thaishares.com/nvdr/>

Source CPO: <http://www.luxcsd.com/clearstream-en/products-and-services/market-coverage/americas/mexico/investment-regulation---mexico/8688>

<sup>7</sup> <http://bit.ly/1yLU0h1>.



*10) Are the proposed index maintenance rules for the Vote Adjusted Security Free Float appropriate?*

Eumedion response:

We agree with the mentioned proposed maintenance rules. However, we would like to exempt temporary defence structures as long as they are dissolved as soon as the hostile situation is over, in principle within six months. Such defence structures are typically activated if a company becomes under siege of a hostile public bid or in an effort to extort or replace members of the Managing Board or members of the Supervisory Board. In these turbulent times for a company, it is our experience that long-term investors play an active role in safeguarding that the focus of management remains on long-term value creation. These long-term investors often use equity indexes as a starting point of their portfolio construction and risk management. If the index weight were to be reduced as a consequence from the activation of a temporary defence measure, this could instigate a forced partial sale. Investors that focus on taking significant positions in companies under siege tend to have a much shorter horizon and can be expected to vote accordingly. Eumedion considers it not in the interest of long-term value creation that index weight adjustments would lead to forced sales by long-term investors at such critical time for a company under siege. The suggested six month horizon is in line with Eumedion's Corporate Governance Manual 2017.<sup>8</sup>

*11) Should MSCI implement the changes for current index constituents in one step or would a multiple step transition be appropriate? Please refer to the next section for the simulated impact.*

Eumedion response:

We understand that some of the index changes are quite substantial. However, it is not uncommon for index changes to be substantial. We suggest that MSCI aims to effectuate the change after the grace period in the shortest possible time, given that the risk of prolonged market disorder is limited.

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<sup>8</sup> <https://www.eumedion.nl/en/public/knowledgenetwork/manual/2017-manual-corporate-governance.pdf>, page 45, paragraph g) iv.