

Why voting matters for index investors

The 'one share, one vote' standard has been in place since 1940 but the number of companies with unequal voting rights is on the rise.



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Voting is a powerful tool. It forms the central mechanism by which shareholders exercise their ownership rights and without it, the ability to hold management to account is compromised. Voting ensures shareholders' interests are protected on issues from poor performance to executive pay to climate change.

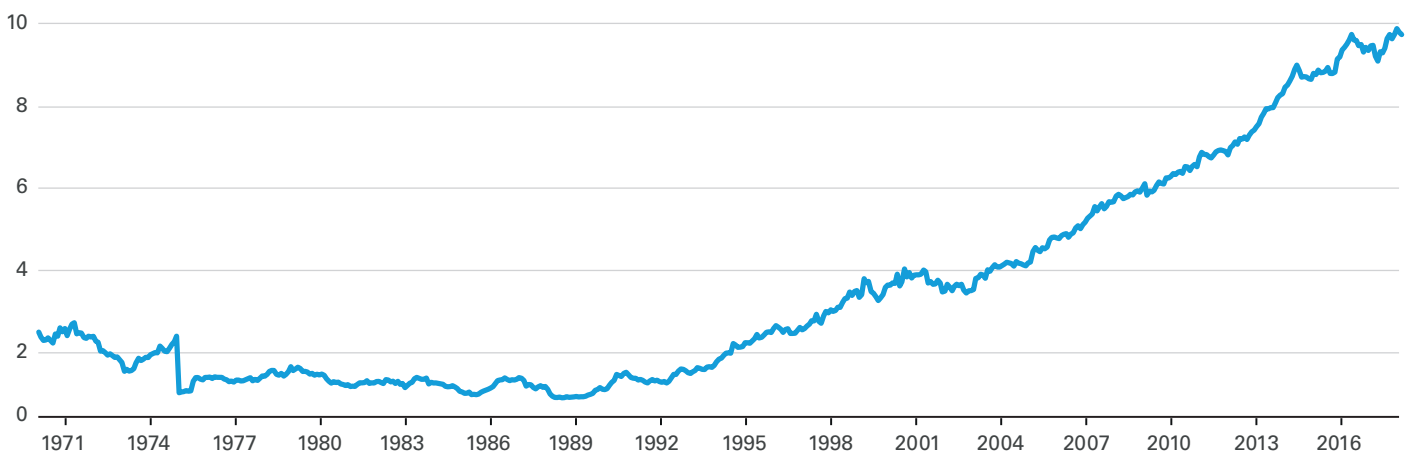
The 'one share, one vote' standard, adopted by the New York Stock Exchange in 1940, rests on the principle that control of the company should be proportional to the commitment of capital. Alternative corporate structures

have been tried in the past, including 'one investor, one vote' where every investor has an equal vote regardless of the holding size, but 'one share, one vote' has generally dominated investment thinking and corporate voting structures.

WHAT HAS CHANGED?

Over the past 20 years, the number of companies issuing stock with reduced voting rights increased from the long-term average. This is largely due to the popularity of multi-class capital structures seen in new technology companies.

Weight of stocks with unequal voting rights in the MSCI World Index (%)



Source: MSCI. Index constituent data as at 1 September 2017, during the period from 31 December 1970 to 31 October 2017.

Corporate management have often argued that multiple share class structures allow companies to innovate and invest for the long-term without outside investor pressure to maximise short-term profits. However, many equity investors see breaking the link between control and commitment of capital as undesirable. Most recently, the initial public offering (IPO) of Snap, whose products include the popular messaging app Snapchat, in 2017 brought this issue to the forefront of investor discourse, when it issued only non-voting common stock for the public market. We collaborated with other international investors and investor associations to engage with index providers to highlight this risk to shareholder rights. FTSE, Standard & Poor's and MSCI issued public consultations on their respective index rules in relation to voting rights. As a result of these consultations and our part in them, Snap has not been included in any of the major investable indices and LGIM did not have to buy shares in Snap through our index funds.

THE IMPACT ON INDEX INVESTORS

Index investors are required to hold all of the companies in the index but are under no obligation to be involved with company management. However, in the wake of the global financial crisis, it was widely accepted that shareholders ought to be doing more to oversee the

companies in which they invest. There was a suggestion that shareholders were acting too much like 'absentee landlords' and that they needed to get more involved in the companies they own.

Since then, many countries globally have adopted 'stewardship codes' or other similar guidance. These look to formally set out the importance and responsibilities of shareholders that also require investors to report on how they are undertaking this responsibility.

However, non- or low-voting share classes now make up a significant proportion of equity indices. Index investors who are forced to hold these companies now find their power reduced as these structures tend to put more control in the hands of founders or management. In the absence of a robust response from stock exchanges or financial regulators, the spotlight has fallen on index providers to respond.

INDEX PROVIDERS: INDEX PROTECTORS?

Returning to our Snapchat example, the changes announced and implemented by S&P and FTSE have sent a clear message to companies that unequal voting structures are not welcomed by the passive investment community. In terms of significant changes to index composition however, it is the MSCI proposal that is

Provider	Summary of Proposal	Effective Date
FTSE	5% minimum voting rights hurdle. This means that 5% of a company's voting rights must be in hands of unrestricted shareholders for company to be eligible for index inclusion	September 2017 5 year grandfathering for existing constituents
Standard & Poor's (S&P)	The S&P Composite 1500® and its component indices (including the S&P 500) will no longer add companies with multiple share class structures	August 2017 Existing index constituents are grandfathered in and are not affected
MSCI	To reduce company weights to reflect unequal voting power	Consultation is still outstanding – results due June 2018

potentially the most far reaching. Simulated turnover for the MSCI World Index as a result of its methodology changes would result in seven deletions and 121 weight decreases. Technology heavyweights such as Alphabet (Google) and Facebook would lose over half of their index weights. With an announcement on the consultation results not due until June 2018 we will have to wait and see however if investors truly have the appetite for these changes.

THE ROLE OTHERS CAN PLAY

There are a number of market participants that also have a responsibility and role to play in ensuring that corporate governance standards and shareholder rights are upheld including index providers, stock exchanges, regulators, companies, and shareholders themselves.

- **Index providers** need to focus on minimum standards for company inclusion in their indices taking into consideration issues such as free float and voting rights
- **Stock exchanges** have not only a responsibility to ensure liquidity but also to guard their reputations in the market. Exchanges do not operate in isolation and

they should interact with the other market participants, potentially sharing objectives with regulators

- **Regulators** such as the UK Financial Reporting Council and the UK Listing Authority are there to protect the public interest and those of shareholders. A set of robust minimum standards consistent across jurisdictions should be the ambition
- **Companies** should allow their shareholders the right to one share, one vote when they come to market. They need to understand the importance of allowing those who provide the capital to have a voice, and that it need not be detrimental to growth and innovation
- **Shareholders** have a responsibility to push all of the above. They need to collaborate with other shareholders and push regulators, exchanges, indices, and companies to set high quality, consistent standards

We have been particularly active as shareholders, engaging with hundreds of companies every year.

LGIM's voting and engagement

	UK	Europe	US and North America	Japan	Asia Pacific	Emerging markets	Total
Number of companies voted at	706	373	691	501	355	1002	3,628
Annual General Meetings (AGM)	628	262	656	496	305	677	3,024
Extraordinary General Meetings (EGM)	141	36	38	5	51	445	716
Total number of votes	11,227	6,285	9,216	6,224	2,498	10,996	46,446

Source: LGIM as at 31 December 2017

LGIM believes that the equal treatment of shareholders by allocating control of a company in proportion to economic interest is vital for a well-functioning market.

We are therefore concerned with the growing number of companies with unequal voting capital structures. Perpetual control of a company without the corresponding capital at risk prevents the mechanisms of the market to hold management and the board to account for their use of capital. LGIM is committed to holding boards to account, creating sustainable value and promoting market resilience on behalf of our clients. Voting forms an integral part of this process.

HONG KONG STOCK EXCHANGE CONSULTATION

The Hong Kong Stock Exchange (HKEX) launched a consultation regarding the development of a new listing segment called the 'New Board.' The purpose of the New Board is to provide a 'lighter approach' to initial listing requirements. This includes allowing issuers to list with weighted voting rights which does not align with the one share, one vote principle.

LGIM provided a formal written response to the HKEX consultation. In addition, through our Hong Kong office, we were able to engage directly with the HKEX regarding our concerns. As members of the Asian Corporate Governance Association, LGIM supported the association's submission, alongside other investors, to push back on the HKEX proposals.

We await the results of the consultation but will continue to push globally, with others, for the fundamental shareholder principles of equal voting rights.

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