WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

QUARTERLY COMMENTARY

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COMMENTARY

Given the often vexed public debate around matters ESG in the United States, a conference attended by institutional investors from across the country – both red states and blue – might have been expected to be a somewhat combative affair. Instead, the Council for Institutional Investors' fall gathering in Los Angeles was refreshingly non-partisan. Rather than highlight division and discord, three days of debate and discussion suggested that most participants shared, if not identical views on every issue, then at least a philosophical approach to ESG. Namely, that consideration of *all* financially material risks and opportunities is entirely consistent with fiduciary duty. Having watched the increasing weaponization of ESG – on both sides of the political spectrum – with some dismay, we welcome this insight into the way that asset owners are really thinking, which reflects our own understanding and approach.

Titled 'Next Frontiers for Governance' the conference traversed a range of issues, from the high-level – diversity, geopolitics – to the more granular. There were also some fascinating tidbits, one favourite being the fact that 89% of directors of S&P 500 companies believe that at least one of their fellow directors should be replaced!

One topic of discussion that felt particularly apposite given the California setting was the increasing number of dual-class share structures, a trend which has in great part been driven by the tech sector. According to data compiled by Jay R. Ritter, Cordell Professor of Finance at the University of Florida, 50% of tech companies that listed in 2022 opted for a dual-class share structure, up from 47% the previous year and a mere 15% ten years prior.

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Granting some shareholders superior voting rights, dual-class share structures typically prove popular with founder-led companies, enabling those individuals to access capital markets without ceding effective control of the company. As a firm, our preference, which aligns with that of the broader investment management industry, is for a 'one share, one vote' voting structure for ordinary or common shares, and we discourage structures that give certain shareholders influence or control disproportionate to their economic interests.

For many years, this view was shared by numerous exchanges – the New York Stock Exchange and NASDAQ being longstanding exceptions – and index providers. Cracks in this relatively united front have started to appear in recent years, however, with the Hong Kong and Singapore exchanges relaxing their rules in 2018 in an attempt to stem the flight of tech companies to the US. In April of this year, Standard & Poor's decision to allow companies with unequal shareholder voting rights into its indices was met with fierce criticism, including from the Council of Institutional Investors.

During the conference session, participants cited evidence to suggest that whilst the dual-class structure offers some benefits in the years immediately following an initial public offering, trust and value creation starts to decline after a period of around seven years. Furthermore, it was argued that management teams of companies with these structures in place can be less likely to engage with shareholders and be harder to hold to account. Examples of 'cronyism' at board level are also more prevalent where power is concentrated in the hands of a single person or a narrow group of individuals.

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From our perspective, these are all valid concerns and help in part to explain our preference for 'one share, one vote'. Certainly, the declining utility of dual-class structures over time is why we favour 'sunset' mechanisms where such structures already exist. Overall, however, we approach the issue on a case-by-case basis, researching the detail of the structure in place and engaging with management where appropriate to gain a comprehensive overview of its rationale and implementation, whilst at the same time outlining our preferences and expectations.

Nike, for example, established a dual-class structure when the company went public in the 1980s. Publicly traded Class B shares elect 25% of the Nike board, whilst the non-public Class A shares elect the remainder. This difference aside, both share classes have identical voting and economic rights. Nike believes this structure allows it to focus on long-term strategic goals without being buffeted by short-term interests and to preserve its longstanding culture.

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Importantly from our perspective, there is no sense of a misalignment of interests between the two share classes. All directors, regardless of which class elected them, have fiduciary duties to act in the best interests of all Nike shareholders. In addition, all directors are subject to the same nomination and evaluation processes. The directors elected by class B shareholders, as well as six out of nine of the directors elected by class A shareholders, are independent. This alignment of interests and the voice that the current structure gives to its publicly traded shares go some distance to allaying the traditional concerns around the dual-class approach.

A pragmatic approach to the issue of dual-class share structures is, we believe, the most appropriate one. Whilst it is right to have a clearly defined stance on what good looks like and to communicate that view to companies, it would be wrong to have a hard 'red line' on an issue often marked by significant nuance. Not all dual-class structures are inherently inimical to the interests of minority shareholders. It is for us as responsible stewards of our clients assets to assess and understand the risks involved and to proceed accordingly.

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