OWNERSHIP FORMS & GOVERNANCE CONTROL

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EXECUTIVE SUMMARY

This report examines ownership & control, the most fundamental dimension of governance risk. A clear understanding of the relative strengths and weaknesses of the various ownership models and control structures presented by listed companies is an essential precursor to evaluating all other aspects of a company's corporate governance.

- The MSCI ACWI Index includes a wide range of ownership forms, just as it includes a wide range of sectors and domiciles, and each of these forms contributes its own unique combination of governance risks that can impact performance.
- Principle-agent concerns are primarily applicable to widely held companies with highly dispersed ownership, which currently comprise approximately 37% of the MSCI ACWI by company count and nearly half its total market cap.
- For closely held companies, however, governance risk is primarily a function of the identity and degree of control wielded by a company's dominant shareholder.
- Passive investing does not mandate passive ownership, as indicated by a growing commitment on the part of global asset owners and managers to both passive index investing and active shareholder engagement.

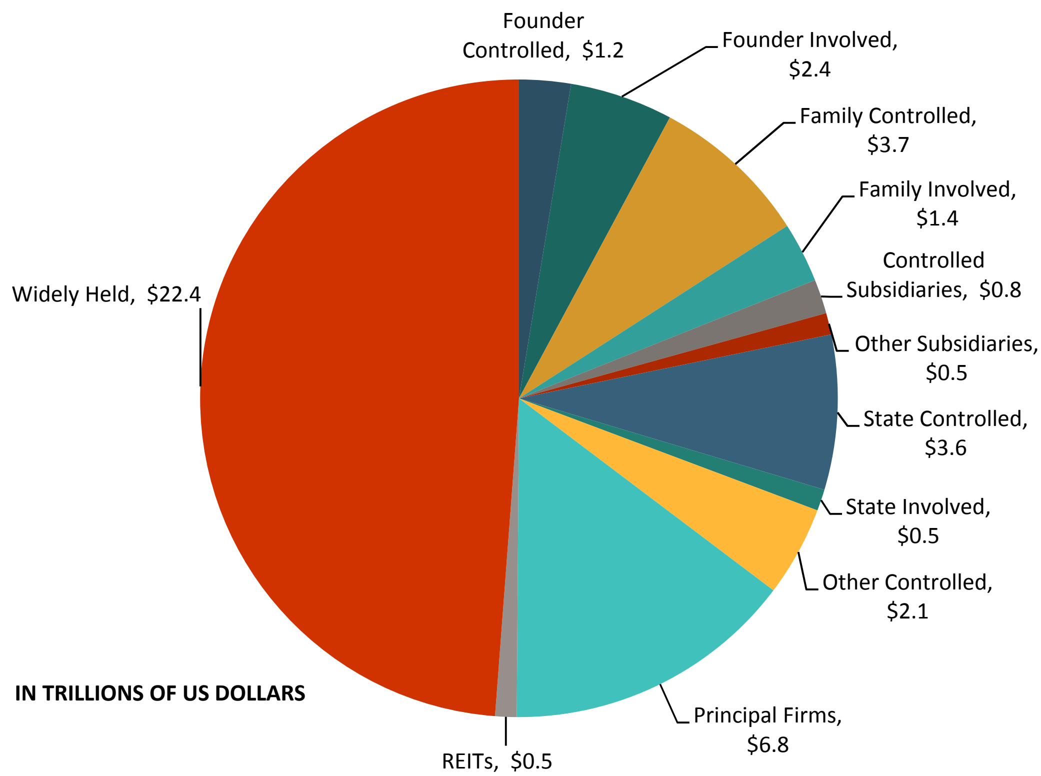
INTRODUCTION

Too often when researchers write about 'governance risk' what they really mean is, 'how far short of best practices?' But this approach tends to ignore the potential reward side of the governance risk equation. Minority investors in controlled founder or family companies understand implicitly that there is a higher degree of risk involved, but they may also believe that the potential upside is greater as well.

Just as MSCI ACWI includes companies representative of a diversity of industries and equity markets (see Appendix I), it also includes a diversity of ownership forms, ranging from fully controlled companies to those companies that are so widely held that their largest shareholder owns no more than 2% of shares. Figure 1 highlights this diversity as a percentage of current market capitalization.

Corporate governance practices at these companies are equally diverse. While the prevailing governance standards document, the OECD *Principles of Corporate Governance*[1], is most easily and consistently applied to widely held companies, it also acknowledges the need for exception and variation based on a company's market and ownership context, as does the "comply or explain" approach to governance regulation and disclosure. Much of this diversity has its basis in local history, and the prevalence of certain ownership forms and related structures in certain markets is well known among global investors. There are dominant family firms in certain European and other key markets, state owned enterprises in both China and Russia, *stichting* structures in the Netherlands, the Japanese *keiretsu* and Korean *chaebol*, the high prevalence of limited partnerships and other complex holding company forms in various 'offshore' jurisdictions, management and employee controlled companies, and even mutual or cooperative structures as well.

Figure 1: MSCI ACWI Ownership Groups by Market Cap (trillion USD)



Appendix II provides a more detailed list of the ownership forms listed in Figure 1.

Some of these structures, such as cross-shareholding networks and stichtings, are more properly considered control mechanisms or takeover defenses than ownership models *per* *se*, but the differences in the underlying agent-principle relationships involved in each of these ownership related structures present investors with varying degrees of governance risk, and dramatically increase the complexity of assessing and comparing the effectiveness of their corporate governance.

Different ownership and control models – one dimension of corporate governance - can be viewed as presenting investors with an entire range of risk/reward opportunities. Overlay that range with a second dimension, such as board skills and experience, and certain combinations will consistently be more effective than others, regardless of adherence to the generalized case of best practices. Table 1 highlights the key governance risks associated with each of the ownership forms surveyed here.

Board independence; director skills and diversity; executive pay alignment with sustainable, long-term goals; shareholder voting rights; and takeover defenses are all important indicators of corporate governance effectiveness at widely held companies. But the most important indicators are different for closely held companies. Multiple share class structures and disparate voting rights, cross-shareholdings, related party transactions with dominant owners, and the alignment of interests within the dominant shareholder group itself will all be of far more importance at companies with a controlling shareholder.

In the context of assessing governance risk such differences are of critical importance.

Table 1: The MSCI Ownership Risk Framework [2]

Control	Ownership Form	Key Governance Risks
Closely Held	Founder Controlled	Strategic focus of the founder(s) Related party transactions Cross-shareholding & other control enhancing structures
Closely Held	Family Controlled	Internal family alignment & strategic focus Related party transactions Cross-shareholding structures
Closely Held	Controlled Subsidiaries	Governance & strategic focus of the parent company Cross-shareholding structures
Closely Held	State Controlled	Political stability & sovereign risk Quality of management & strategic focus
Closely Held	Other Controlled Companies	Ownership structure Cross-shareholding structures Quality of management & strategic focus Related party transactions
Widely Held	Founder Involved	Degree of founder control or influence Board independence, skills & diversity Entrenched board or management Related party transactions
Widely Held	Family Involved	Degree of family control or influence Board independence, skills & diversity Entrenched board or management Related party transactions
Widely Held	State Involved	Political stability & sovereign risk Quality of management & strategic focus
Widely Held	Other Subsidiaries	Governance & strategic focus of the parent company Cross-shareholding structures
Widely Held	Real Estate Investment Trusts (REITs)	Board independence External management fees and other related party transactions
Widely Held	Principal Firms	Full range of principal-agent concerns Board independence Board skills & diversity
Widely Held	Widely Held Firms	Full range of principal-agent concerns Board independence Board skills & diversity Entrenched board or management Shareholder passivity

Appendix II provides additional information regarding each of these ownership forms and their representation in MSCI ACWI.

FOUNDER FIRMS

The five largest *founder controlled* firms in the MSCI ACWI, and their currently active founders:

- **Facebook Inc** (United States)
  Founded by Mark Zuckerberg, CEO & Chairman
- **Tencent Holdings Ltd** (Cayman Islands / Hong Kong)
  Founded by Huateng Ma, CEO & Chairman
- **Google Inc** (United States)
  Co-founded by Larry Page, CEO, and Sergey Brin, Director
- **Industria de Diseño Textil, S.A. (Inditex)** (Spain)
  Founded by Amancio Ortega Gaona, Director
- **Sun Pharmaceutical Industries Limited** (India)
  Founded by Dilip S. Shanghvi, Managing Director

The five largest widely held *founder involved* firms in the MSCI ACWI, and their currently active founders:

- **Microsoft Corporation** (United States)
  Co-founded by William H. Gates III, Director
- **Oracle Corporation** (United States)
  Founded by Lawrence J. Ellison, Executive Chairman and Chief Technology Officer
- **Amazon.com, Inc.** (United States)
  Founded by Jeffrey P. Bezos, CEO & Chairman
- **Kinder Morgan, Inc.** (United States)
  Co-founded by Richard D. Kinder, Executive Chairman
- **SAP SE** (Germany)
  Co-founded by Hasso Plattner, Chairman

Founder firms typically benefit from the active involvement of a visionary founder, but the specifics of this involvement vary considerably. The founder may serve as CEO, or often as both CEO and Chairman, or they may defer the oversight of day-to-day operations to a separate CEO and play a more strategically focused role as company Chairman or simply director. Executive Chairmen are also common in this group, and acknowledge the central role of the founder as strategic leader. At many of these companies the founder will also maintain a controlling percentage of the company's voting shares.

In the case of multiple co-founders, a combination of roles and degree of control is possible. At Google, for example, co-founder Larry Page serves as CEO, while fellow co-founder Sergey Brin holds a seat on the board, and while neither individual alone holds a controlling stake in the company, in combination they hold just over 54%.

At Microsoft, the role of co-founder Bill Gates has evolved over the past 34 years from CEO/Chairman to Chairman and now finally as director, in parallel with a gradual reduction in the percentage of the shares he has held in the company, from a high of 49% at the time of Microsoft's IPO in 1986 to fewer than 4%. Over time the company has transitioned from closely held founder firm to widely held, but at the same time Gates remains a key member of the Microsoft board, unlike former CEO Steve Ballmer, who actually owns more shares than co-founder Gates.

Classified here as a *founder involved* company, absent the continued involvement of Mr. Gates, Microsoft could qualify equally well as *widely held*.

At some firms the transition from closely held IPO to widely held status is carefully orchestrated, with one or more venture capital or private equity firms maintaining effective control via shareholder agreement over the first few years of the newly listed firm's existence, which is then lifted once those holdings have been reduced to some pre-defined level. As with all closely held companies, assessing the corporate governance practices at these companies must take into consideration the transitional nature of their ownership status.

Many founder firms will also transition into yet another ownership form, the family firm. These companies gain yet another key benefit from their ownership status, which may well be the most important, value-enhancing benefit of all: the benefit of long-term owner commitment.

Founder firms may very well represent the ultimate in terms of strategic focus and clarity, but they also tend to be concentrated in certain industries and markets, where the opportunities for both innovation and rapid growth are especially high.

Controlled founder firms present outside investors with a very high degree of risk as well, beginning with limited or no voting rights, but the highest risks associated with such companies occur when the focus of the controlling founder or founders is on personal enrichment over sustainable profits. Investors must be particularly wary of founder firms where the ownership structure is overly complex and convoluted, or where there are multiple related party transactions involving the controlling founder. Management contracts between the company and the controlling owners, or between the company and some other entity owned and controlled by the same controlling individual, should be considered an especially strong negative signal.

FAMILY FIRMS

The five largest *family controlled* firms in the MSCI ACWI, and their active family owners:

- **Wal-Mart Stores, Inc.** (United States)
  The Walton Family
- **Roche Holding AG** (Switzerland)
  The Hoffman Family
- **Samsung Electronics Co.Ltd** (South Korea)
  The Lee Family
- **Comcast Corporation** (United States)
  The Roberts Family
- **L'Oreal SA** (France)
  The Bettencourt Meyers Family

The five largest *family involved* firms in the MSCI ACWI, and their active family owners:

- **Danaher Corporation** (United States)
  The Rales Family
- **Hyundai Motor Company** (South Korea)
  The Chung Family
- **Bridgestone Corporation** (Japan)
  The Ishibashi Family
- **Pernod Ricard SA** (France)
  The Ricard Family
- **V.F. Corporation** (United States)
  The Barbey Family

Family firms are typically former founder firms, where a second or third generation of descendants of the company's original founder has taken over some or all of the founder's holdings. As with company founders, family shareholders may or may not hold a controlling percentage of the company's voting shares, but effective control is often maintained through other mechanisms. Family representatives generally hold one or more seats on the board; in many cases they may also serve the company as CEO, Chairman, or both, particularly in the case of second generation family firms. In a few cases the CEO and Chairman positions are passed from one generation to the next as a matter of inheritance.

In some markets, such as France, Italy and Switzerland, the family firm is the dominant model for listed companies, and many of the corporate governance practices that are unique to those markets have their origin in the needs and priorities of the family firm model. Over time this market dominance has resulted in close alignment with those countries' political interests as well.

Cross-shareholding arrangements are also common among these companies, and have traditionally provided these companies with a degree of stability and security that is generally missing in other markets, but which carries its own unique risks as well. The dominant Korean chaebol groups comprise one of the most extreme examples of family control and influence via cross-shareholdings, and many also maintain corporate leadership inheritance as well. But many of these groups are now actively converting to a simpler holding company structure, with direct line parent-subsidiary relationships clearly defined, as the performance risks associated with cross-shareholdings continue to fall out of favor politically in that country.

The family firm presents other unique risks and challenges to outside investors. One of the most difficult and potentially damaging risks at family firms is the potential for internal strife within the controlling family, or between the family and the company's independent directors or professional managers. Such conflicts were most recently demonstrated by the board and controlling family at Swiss chemical company Sika AG, which at this time of this reporting is still in the throes of a bitterly disputed battle for control.

CORPORATE SUBSIDIARIES

The five largest subsidiary firms in the MSCI ACWI, and their corporate parents:

- **Wal-Mart de Mexico, SAB de CV** (Mexico)
  Wal-Mart Stores, Inc. (The Walton Family)

- **Imperial Oil Limited** (Canada)
  Exxon Mobil Corporation

- **VMware, Inc.** (United States)
  EMC Corporation

- **Sands China Ltd.** (Cayman Islands / Hong Kong)
  Las Vegas Sands Corp. (Sheldon G. Adelson & Adelson Family Interests)

- **Hindustan Unilever Limited** (India)
  Unilever PLC

There are 68 MSCI ACWI constituents identified as *controlled subsidiaries*, one of which, Alibaba Pictures Group Limited, is wholly owned, in which case the parent company controls 100% of the subsidiary's voting shares. Another 16 ACWI companies are classified as *other subsidiaries*, where the parent company's holdings fall short of majority control but are at least 10%.

It is common practice that these firms share one or more directors with the parent company, and the subsidiary CEO is often a member of the parent's board as well. Corporate governance practices at these companies nearly always reflect the standards of the corporate parent; it is virtually impossible for a controlled subsidiary to diverge from or improve upon the corporate governance standards of its parent.

STATE OWNED ENTERPRISES

The five largest state controlled or state involved enterprises in the MSCI ACWI:

- **China Mobile Limited** (Hong Kong)
- **China Construction Bank Corporation** (China)
- **Deutsche Telekom AG** (Germany)
- **CNOOC Limited** (Hong Kong)
- **Industrial and Commercial Bank of China Limited** (China)

The most salient feature of state owned enterprises (SOEs) is their explicit obligation to a much wider group of stakeholders than other listed companies, including customers (low prices), employees (higher wages and benefits, and long-term employment security), and to what might best be characterized as "the public good." SOEs are often public utilities or central banks, and are by definition heavily dependent on local political priorities. They also tend to proliferate in industries that the government of that particular nation perceives as 'strategically important,' which can vary widely between countries.

Government holdings at the companies identified here as SOEs range from a low of 10% to a high of 100%, falling below 50% for 70 of the 226 companies included, below 30% for just 30 companies, and below 20% for just 16.

Evaluating governance practices at SOEs can be especially difficult. While equity investments in such companies are generally low risk due to the explicit backing and support of government, regardless of their corporate governance practices, these companies also tend to be low reward, as shown by the five-year total return figures in Figure 3, below. Quality of management, overall board skills and effectiveness, combined with strong internal controls and accounting transparency, are by far the most important corporate governance considerations at state owned enterprises.

There is currently an effort underway in China to reduce or even eliminate altogether the percentage of state ownership for many of these companies. Such transitions present their own unique opportunities and challenges for investors, and increase the need for strong corporate governance at these companies.

OTHER CONTROLLED FIRMS

The five largest firms in the MSCI ACWI that fall into this ownership category, and their controlling shareholders:

- **Novo Nordisk A/S** (Denmark)
  Novo Nordisk Foundation
- **NK LUKOIL OAO** (Russian Federation)
  Company Management
- **Credit Agricole SA** (France)
  SAS Rue La Boétie
- **Great-West Lifeco Inc.** (Canada)
  Power Financial Corporation (The Desmarais Family)
- **Hilton Worldwide Holdings Inc** (United States)
  Blackstone

The companies included in this group cover a wide range of ownership forms with effective control being the only common feature. Some are mutually held or cooperative companies, while others have been organized around employee or management ownership. Each must be evaluated on the basis of their individual circumstances, but given the involvement of a controlling shareholder the emphasis should be on the same areas of concern as noted above for controlled founder firms, namely multiple share class structures and disparate voting rights; cross-shareholdings; related party transactions with dominant owners; and the alignment of interests within the dominant shareholder group itself.

PRINCIPAL FIRMS

The five largest principal firms in the MSCI ACWI, and their largest shareholders:

- **The Home Depot, Inc.** (United States)
  Capital World Investors - 7.80%
- **Amgen, Inc.** (United States)
  Capital Research Global Investors - 12.29%
- **The Boeing Company** (United States)
  State Street Corporation - 11.20%
- **United Technologies Corporation** (United States)
  State Street Corporation - 11.60%
- **Biogen Inc.** (United States)
  FMR LLC – 8.41%

Principal firms are widely held but retain the benefit of having one or more sizeable shareholders. Principal shareholders in companies as large as the MSCI ACWI constituents are most often large institutional investors, asset managers or private equity firms.

REAL ESTATE INVESTMENT TRUSTS

The five largest REITs in the MSCI ACWI:

- **Simon Property Group, Inc.** (United States)
- **American Tower Corporation** (United States)
- **Equity Residential** (United States)
- **General Growth Properties, Inc.** (United States)
- **Prologis, Inc.** (United States)

Real Estate Investment Trusts (REITs) are the most tightly regulated group included here, and by definition must conform to a number of key capital management and financial reporting standards, all of have which have a tendency towards reducing risks and stabilizing returns. Even though highly regulated, the individuals who control these entities may not be accountable to the shareholder public because of their legal structure – a trust structure – which corporate regulation has mandated as a valid form of aggregating investors to invest large sums in specific assets, in this case real estate. Such trust structures are typically shielded from the need to pay taxes, and there are no votes from beneficiaries of a trust structure as to which trustee gets picked to manage the trust's assets on their behalf, in turn fostering a culture of non-disclosure and non-accountability. Minimum corporate governance standards are not effectively mandated in many markets, and entrenched boards and extensive related party transaction, often with complex and less than fully transparent tax implications, can be a problem at these companies. Many such firms also have external managers, rather than executive directors, and some of these firms channel administration, custody or other fees towards other related entities.

Because of these factors, the REITs as a group may be uniquely high in risk relative to investment returns.

WIDELY HELD FIRMS

The five largest widely held firms in the MSCI ACWI:

- **Apple Inc.** (United States)
- **Exxon Mobil Corporation** (United States)
- **Wells Fargo & Company** (United States)
- **Johnson & Johnson** (United States)
- **Novartis AG** (Switzerland)

The companies categorized here as *widely held* are in fact so widely held that they lack even a single principal shareholder, and total insider holdings are nearly always well under five percent.

This is by far the largest ownership group included in the MSCI ACWI, by both count and total market cap, with an average market cap of USD 26 billion, versus just USD 16 billion for all other companies. US based companies comprise well under half of this group by count, but almost exactly half by total market cap, with an average market cap of USD 44 billion.

This is relatively new ownership group, which owes its current market dominance to a confluence of five relatively recent economic trends, the first and most obvious of which is the trend towards passive, index-based investing itself. Such investment vehicles simply did not exist prior to 1976.

The second major trend is accelerating globalization, a trend which, according to the World Trade Organization [3], also began in the mid-seventies.

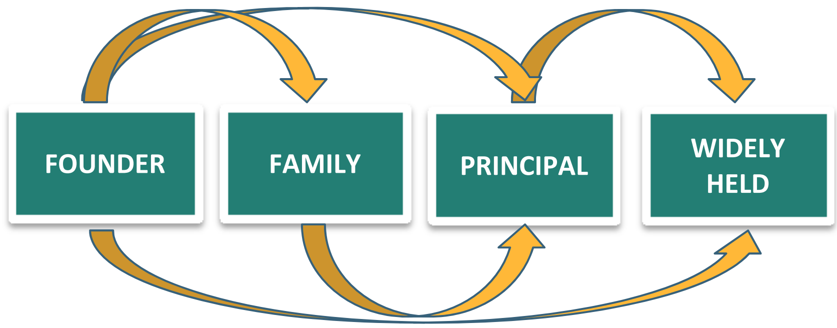
Globalization led in turn to a third major trend towards corporate consolidation, via a rapidly growing number of mergers and acquisitions that began in the early nineties and did not peak until the mortgage crisis in 2008. The trend towards ever larger multinational firms resulted in a significant rise in the average market cap of those companies most likely to be included in the rapidly growing range and diversity of index fund offerings of this same period.

A fourth major trend involved a rapidly growing degree of banking and securities deregulation efforts, which began in earnest in the United States in 1980 with the election of President Reagan, and reached its peak under President Clinton in 1999, when the repeal of Glass–Steagall removed the last major regulatory barrier to consolidation of the American financial industry.

The fifth and final trend that contributed to the rise of this ownership model is the sudden rise in the use of stock options as the most important form of executive incentive pay, beginning with the passage of FAS 123 in the United States, which explicitly permitted these awards without requiring they be expensed, a practice which opened the door to a very rapid rise in executive pay levels in the United States, ostensibly commensurate with the steady increase in corporate size and complexity.

Just as founder firms tend to evolve naturally into family held firms over time, principal and other widely held firms have evolved increasing into widely held firms, and to such a degree that they are currently the dominant form. Figure 2 illustrates this natural evolution from greater to lesser control.

Figure 2: The Evolution of Ownership & Control over Time



For the most part these companies represent the ultimate form of the widely held company, with the broadest possible access to public capital. Run by highly qualified and experienced professional managers, the relative loss of owner involvement and oversight raises the bar considerably for potential governance risk at these companies. As noted above, the core principles of the OECD and other most influential corporate governance standards documents have been optimized for widely held companies.

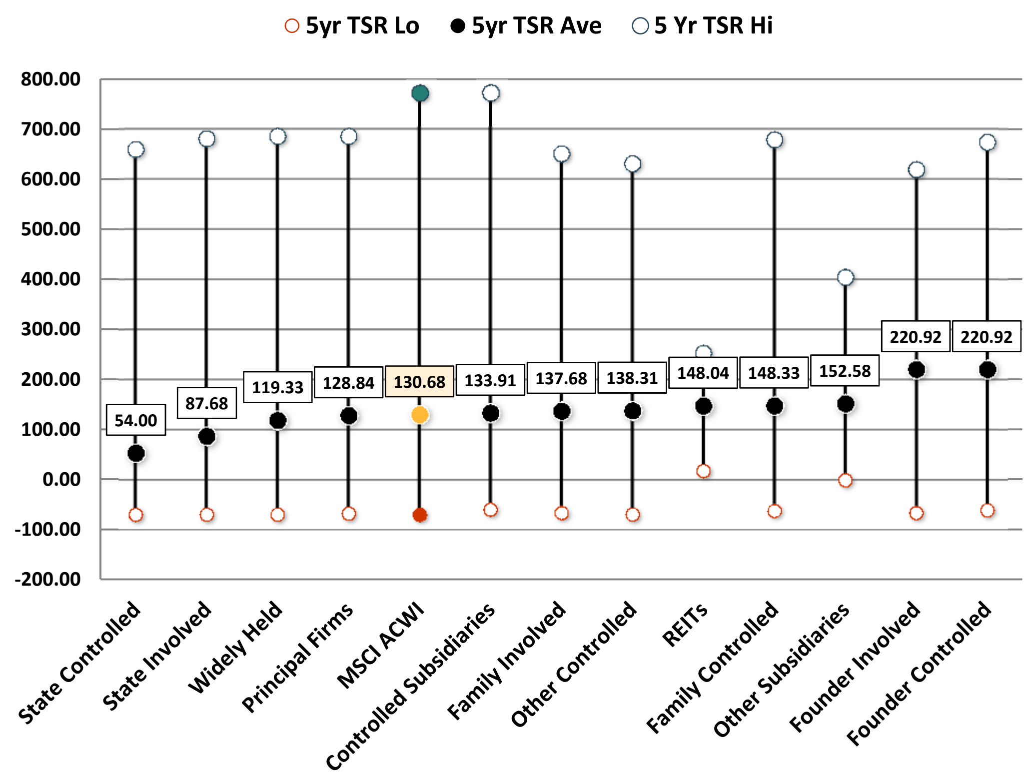
"Most fundamental of all," wrote Berle and Means [4], "the position of ownership has changed from that of an active to that of a passive agent." In the absence of active principals, the line between agent and principle can become blurred, and management at these companies sometimes behave as if they were not just agent but also principal, from populating and leading the board to playing an active role in determining their own pay.

It is the highly dispersed ownership at these companies that enables this degree of management / board control, and the larger, more powerful and economically important the company, the greater the likelihood of this sort of displacement occurring.

OWNERSHIP & CONTROL AND PERFORMANCE

Ownership is just one of many different factors that are reflected in the stock market performance of individual companies, but the differences in total return averages and performance spreads among these various groups do suggest the need for additional, more in-depth study and analysis. Five-year returns for the current MSCI ACWI constituents are shown in Figure 3, below.

Figure 3 Five-Year Average Total Shareholder Returns by Ownership Form



Five-year total shareholder return figures are market cap weighted

SHAREHOLDER ENGAGEMENT

Between November 2014, and March 2015, MSCI ESG Research conducted an extensive round of research into the stewardship practices of a wide range of the largest global asset owners. One of the most resounding themes encountered in the course of this work was the extent to which nearly all of these asset owners have publicly committed to the principles of active stewardship, including a commitment to active engagement. Nearly all are UN-PRI signatories.

Most of these asset owners have also acknowledged their belief that engagement can and does have a positive effect on their long-term equity returns, and active engagement is on the rise, mainly in the form of active proxy voting and ongoing constructive dialog between companies and shareholders.

And yet we also found that a majority of these same asset owners and investors have allocated a significant portion of their equity investments to passive index funds, and have plans to expand their passive allocations even further in the future. In virtually all cases the need to reduce management fees and other related costs was cited as a key driver.

But **passive investing does not mandate passive ownership**, as our work with these very global asset owners made clear. If anything the opposite is true, and the growing proliferation of widely held companies is likely the primary motivation for the growing sense of commitment to active stewardship and engagement that we discovered among these investors, and to the increasingly strong interest in corporate governance reform and improvement in a number of key markets, including both Japan and the United States.

We will explore these trends further in a series of future reports.

APPENDIX I – MSCI ACWI SECTOR AND MARKET DIVERSITY

Figure 4: MSCI ACWI Sector Diversity [5]

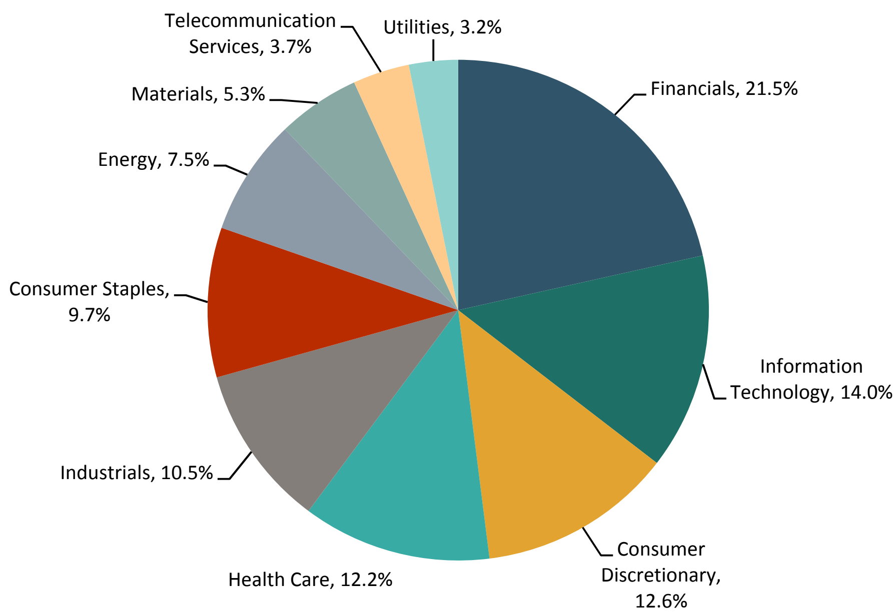
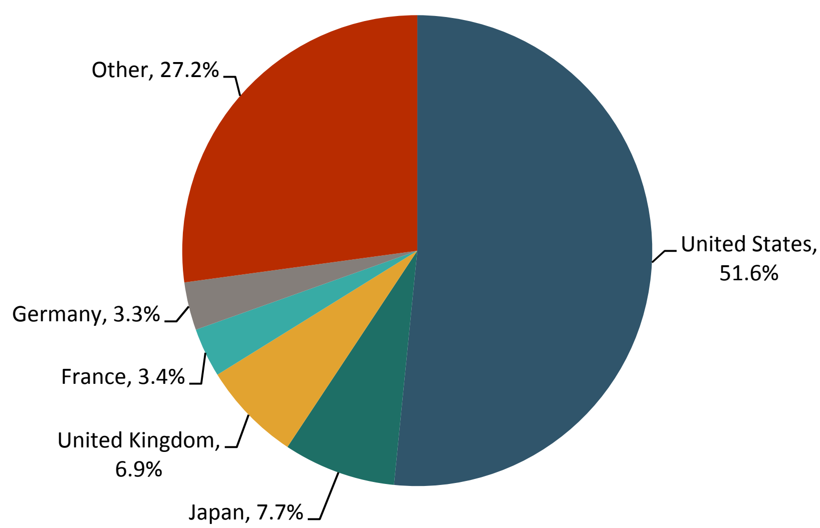


Figure 5: MSCI ACWIDiversity by Major Domicile Country



APPENDIX II – OWNERSHIP & CONTROL CLASSIFICATIONS

Group	Count	Total Market Cap (USD)	Average Market Cap (USD)	Definition
Founder Controlled	50	$ 1,172,997,710,000	$ 23,938,728,776	A company founder is CEO, Chairman or director, and also holds majority control.
Founder Involved	96	$ 2,420,033,620,000	$ 25,208,683,542	A company founder is CEO, Chairman or director, but does not hold majority control.
Family Controlled	202	$ 3,666,883,660,000	$ 18,243,202,289	A family member is CEO or Chairman, or family interests are actively represented on board, and the family also holds majority control
Family Involved	104	$ 1,420,845,890,000	$ 14,067,781,089	Family member is CEO or Chairman, or family interests are actively represented on board, but the family does not hold majority control.
Controlled Subsidiaries	68	$ 824,965,300,000	$ 12,691,773,846	A parent company holds majority control.
Other Subsidiaries	16	$ 477,301,700,000	$ 31,820,113,333	A parent company holds at least a principal interest, but does not hold majority control.
State Controlled	198	$ 3,618,390,410,000	$ 18,944,452,408	A sovereign government holds majority control.
State Involved	35	$ 508,898,170,000	$ 15,421,156,667	A sovereign government holds at least a principal interest, but does not hold majority control.
Other Controlled Companies	250	$ 2,148,134,070,000	$ 9,180,060,128	Has a controlling shareholder block but doesn't meet other definitions above; includes mutual and cooperative structures, certain limited partnerships, management or employee controlled companies, and companies controlled by private equity entities.
Principal Firms	466	$ 6,815,858,780,000	$ 15,248,006,219	One or more shareholders hold a principal (10%-30%) position, but no shareholder holds majority control.
Real Estate Investment Trusts (REITs)	46	$ 544,353,950,000	$ 11,833,781,522	As legally defined, widely held.
Widely Held Firms	902	$ 22,418,908,240,000	$ 26,159,752,905	A company where no single shareholder holds 10% or more, and insider holdings are less than 5%
ALL MSCI ACWI COMPANIES	**2433**	**$ 46,037,571,500,000**	**$ 19,716,304,711**	**Based on MSCI's governance coverage as of 5/15/2015**

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