ICGN
International Corporate Governance Network
Inspiring good governance & stewardship

ICGN Investor Viewpoint

The governance of controlled companies

June 2024

ICGN Investor Viewpoint

The governance of controlled companies

1. Introduction

There are a number of different models of company equity ownership; while many companies are widely held by a large number of different shareholders, many others have more concentrated ownership. According to the Organisation for Economic Co-operation and Development (OECD), today's equity markets have two key characteristics: the prevalence of concentrated ownership in listed companies and a wide variety of ownership structures across countries; […] the ownership landscape has changed into something that no longer fits the assumption of a dispersedly owned equity."[1]

Companies with concentrated ownership, or "controlled companies", are primarily owned by a single shareholder or a small group of connected shareholders, rather than a dispersed shareholder group. They have an entity or individuals that hold majority ownership in the company, allowing them to dictate key decisions, strategies, and policies of the company. Controlled companies should have consideration for the significant economic stake held by minority shareholders and advance strong governance practices, for the benefit of the company and all its owners.

In this Viewpoint, we will describe the different types of controlled companies and the specific factors that affect them, and then highlight good governance practices that are essential to protect minority shareholders and ensure the long-term success of these companies.

2. Different types of 'controlled companies'

There are different types of controlled companies and important variations in ownership composition across markets. This Viewpoint focuses on the following categories: state-owned enterprises, family-owned businesses, company groups, and companies with multi-class share structures.

State-owned enterprises

Over the last two decades, the share of state-owned enterprises (SOEs) among the top 500 global companies has tripled.[2] As of 2023, 11% of global stock market capitalisation was held by the public sector, making this investment category the second largest, after assets held by institutional investors other than sovereign wealth funds.[3] SOEs are widespread in China, as well as in Middle Eastern and Latin American countries, and are present in every sector, particularly energy, critical minerals, essential infrastructure, technology, and finance. According to a 2020 International Monetary Fund study, in the last ten years, SOEs have increased to rival the world's largest corporations: at $45 trillion, their assets are now 50% of total global GDP, playing a key role in most economies.[4]

There are key considerations for investors when a state is the majority shareholder or owner of a company. The state's involvement may be driven by strategic objectives that go beyond financial returns - such as public welfare, economic development, or national security - and this may have an impact on the company's long-term performance. Some of the principal

[1] Medina, A., A. de la Cruz and Y. Tang (2022), "Corporate ownership and concentration", OECD Corporate Governance Working Papers, No. 27
[2] Di Noia, C., (2023) An increasing role of state-owned enterprises in the global economy calls for better governance, OECD Forum Network
[3] OECD (2023), "OECD Corporate Governance Factbook 2023", OECD Publishing, Paris
[4] IMF (2020), "Fiscal Monitor, April 2020: Policies to Support People During the COVID-19 Pandemic"

risks faced by investors include: limited rights as minority shareholders, differing views on performance objectives, limited disclosures, and barriers to effective engagement.

Family-owned businesses

Family-owned businesses (FOBs) are particularly prevalent in Asian, Continental European, and Latin American countries and can play an important role in economic growth. These businesses tend to pursue long-term strategies to pass the business on to future generations and may have close relationships with their stakeholders and local communities. These characteristics can be favorable for investors.

At the same time, the structures of FOBs can be complex due to interconnected businesses and ownership differences among family members. Investors need to ensure that the company is not managed as an extension of the founder or majority shareholder(s)'s personal property. As ownership transfers from one generation to the next, passing on a well-run organisation depends on strong governance practices, effective risk management and clear succession planning.

Globalisation, digitalisation, and the energy transition have brought challenges for some FOBs, particularly as they may be looking to mature, innovate, or proceed towards IPOs. Unforeseen disruptions can potentially impact their performance if they are not properly anticipated and managed. Minority investors can be a catalyst to help FOBs adopt innovative approaches and remain successful in the long-term.

Company groups

Corporate consolidation, through global mergers and acquisitions, has created larger multinational firms with subsidiaries, resulting in a significant rise in the market capitalisation of these companies.[5] Corporate structures have become more complex, being held not only through parent-subsidiary relationships but also by common controlling interests (often families or the state). A parent company may own enough of the subsidiary to exercise majority control over it, making decisions such as appointing the board of directors or setting important business policies. The governance structures of company groups may include interlocked board members and dominant parent companies that exercise control over subsidiaries. Investors should be aware of the dynamics within company groups and find ways to protect their rights.

In many cases, the same directors sit on both parent and subsidiary boards and they are not always independent directors of either board. Senior executives from the parent company may sit on the board of the subsidiary company, leading to potential conflicts of interests due to their multiple roles. In some markets, the directors of the subsidiary company may have legal duties and liabilities which might conflict with their roles as executives of the parent company.[6] They are expected to report to the parent company on matters arising at meetings of the subsidiary board or its committees that they deem important and are of interest to the parent company board or its committees. Investors may question whether the appointment of directors serving both on the boards of the parent company and the subsidiary promotes transparency or creates conflicts of interest.

As explained in the ICGN Viewpoint "Duties of Boards in Company Groups",[7] understanding a group's set of legal entities, their business functions and risk profiles can be difficult. This interconnected business framework can translate into higher risks for investors and reinforces the need for robust corporate governance policies at every level.

---

[5] Numerous studies and research have examined the impact of globalisation on corporate consolidation and market capitalisation. For example, Verbeke, A., Coeurderoy, R., and Matt, T., (2018), "The future of international business research on corporate globalization that never was", Journal of International Business Studies, Vol.49

[6] UK Companies Act 2006

[7] ICGN (2020), Viewpoint 'Duties of Boards in Company Groups'

Companies with multi-class share structures

Some markets allow 'multi-class shares' with unequal voting rights, allowing some shareholders more voting rights than others, disproportionate to their economic interest. Multi-class share structures can be used to give a company's founders or early investors more control, allowing them to implement their vision without perceived obstacles whilst raising equity capital.

With outsized voting rights and seats on the boards, founders or early investors can control the boards' agendas - without the need to consider minority shareholders' views. The disproportionately small impact of minority shareholders' votes mean it is very difficult to achieve a majority vote against a management proposal or garner enough support for a shareholder proposal to gain attention from the board.

Unequal voting rights are problematic because they dilute the voice of minority shareholders. They may serve to entrench management and allow founders and controlling shareholders to monopolise the decision-making, potentially putting minority shareholder interests at risk. In extremis, such structures create opportunities for expropriation, with the controlling shareholder(s) gaining private benefits of control at the expense of minority shareholders.

3. Good governance practices in controlled companies

As controlled companies present unique challenges for minority investors, we highlight key good governance practices that can help address these concerns effectively.

Board independence

Controlling shareholders have the power to elect the board of directors and to make major decisions about the company's strategy and operations. To ensure effective board oversight, it is particularly important to have a majority of independent directors on the board. Investors expect independent directors to be appointed to the audit, remuneration, related party transactions, and nomination committees to further support the governance system. Nomination processes should be well-structured, merit-based, and transparent.

National approaches to defining director 'independence' vary. The ICGN Global Governance Principles provide a useful reference for global best practice, highlighting conditions that may impair a director's independence.

Managing conflicts of interest

Companies should establish policies that ensure transparency, fairness, integrity, and accountability in decision-making. By implementing the following measures, investors will be more confident that controlled companies are effectively managing conflicts of interest and ensuring that decisions are made in the best interest of the company, its investors, and stakeholders:

- Policies and procedures on conflicts of interest should be established, disclosed, understood, and implemented by directors, management, employees, and other relevant parties, including members of related business groups.
- Regular audits and risk assessments should be conducted to identify potential conflicts of interest and mitigate them.
- Directors should declare potential conflicts of interest to the rest of the board, abstain from influencing any decisions for which they have conflicts and be prepared to resign from the board in cases where conflicts are structural and could become detrimental.
- The roles of CEO and chair of the board should be separated, to prevent one person from having too much power and influence over the company's decisions.

- There should be relationship agreements with controlling shareholders to ensure that real or potential conflicts of interest are avoided or mitigated.[8]
- A related party transactions policy should define a robust process for approving, reviewing, and monitoring these transactions.[9] The company should have a committee overseeing related party transactions, composed of independent directors.
- SOEs should ensure that transactions between the state and SOEs, and between SOEs, take place on market consistent terms.

Effective succession planning

Effective succession planning supports business continuity, resilience, and sustainable value creation.[10] CEO transition planning is a crucial matter that requires a strategic approach by the board. A nomination committee should be established, with independent members overseeing the discussions on the succession plan.

Succession planning presents several challenges for controlled companies and their minority shareholders. A succession plan that only considers insiders may lead to the entrenchment of the controlling shareholders and their preferred candidate(s). This can limit the opportunity for minority shareholders to have a voice in the selection process and reduce the chances of independent or outside candidates being considered for leadership positions.

In the case of FOBs, effective succession planning is particularly important to uphold the heritage, culture, and long-term vision that have been integral to a company's success but goes beyond a single individual. Appointing a family member for an executive role must be tied to their skills and capabilities. By proactively identifying and developing potential successors, a FOB can mitigate some of the risks associated with sudden leadership changes and conflicts among family members, which can harm investors.

Voting rights

According to corporate governance best practices, when a shareholder holds one share, they get one vote (the 'one share, one vote' standard).[11] Their influence on the company's decision-making is proportionate to their economic exposure. This standard ensures equal treatment of all shareholders, increases the board's accountability, and alleviates conflicts of interest around major transactions.

If a company decides to go public using a multi-class share structure, strong investor protection safeguards should be in place, such as:

- Sunset clauses - Any multi-class share mechanisms should automatically lapse after a certain period or events, or their continuation should be supported by a majority vote of independent shareholders after five to seven years, and subject to annual approval thereafter. Empirical research shows that any benefits of multi-class share structures seem to dissipate after five to ten years.[12]
- Voting ratio - The maximum enhanced voting ratio that can be attached to superior voting rights shares should be limited.

---

[8] ICGN (2021), 'Global Governance Principles' p. 34

[9] ICGN (2018), Viewpoint 'Related Party Transactions: How to ensure adequate protection of minority shareholders'

[10] ICGN (2018), Viewpoint 'Ensuring effective board succession planning'

[11] ICGN (2021), 'Global Governance Principles'

[12] Bebchuk L. and Kastiel K., "The Untenable Case for Perpetual Dual-Class Stock", 103 Va. L. Rev. 585- 631 (April 2017); Cremers M., Lauterbach B. and Pajuste A., "The Life Cycle of Dual-Class Firms" (November 2017); Crowe J. "Dual-class structures and classified boards: Evidence from 2018-2023" (August 2023); US SEC Commissioner Jackson, Speech *Perpetual Dual-Class Stock: The Case Against Corporate Royalty* (February 2018); Investor Coalition for Equal Votes, "Undermining the shareholder voice" (2023)

- No transfer - Only a director of the company should be allowed to have superior voting rights, and these should automatically convert to ordinary shares upon the holder ceasing to be a director of the company. If the rationale for allowing superior voting rights is to enable the founders of the company to implement their vision without obstacles, investors do not see why these shares should be transferred to third parties.
- Key decisions - Minority shareholders should, at a minimum, have the right to an equitable say in decisions that can materially impact the investment case for the company (e.g., major mergers and acquisitions transactions, change of control).

Specific disclosures

Depending on the type of controlled company, additional disclosures might be necessary.

- Investors expect SOEs to have a publicly disclosed ownership policy, explaining the rationales for state ownership, as recommended in the OECD Guidelines on Corporate Governance of State-Owned Enterprises. SOEs should observe a high degree of transparency, including equal and simultaneous disclosure of information to all shareholders, regardless of the ownership stake.[13]
- In FOBs, a shareholders' agreement should be in place, outlining how family members and other shareholders will interact with the company, covering aspects such as the acquisition and disposal of shares, major decisions, dividends and voting rights, conflicts of interest and related party transactions.
- In the case of company groups, investors expect comprehensive disclosure of group structures (including the identity of all group companies and all forms of common controlling interests and crossholdings) and transparency about the role of the company within the group. Investors also want to know if the boards have authorised a ‘delegation of authority' legal document that reflects which board within the group makes certain decisions and what information needs to be reported to whom and how often.
- When multi-class shares are in place, the company should explain why it has chosen such a structure, how the rights of minority shareholders are protected, whether a sunset provision is in place or will be considered.

4. Conclusion

Controlled companies need to adopt robust corporate governance practices, which support the achievement of two objectives: the ability of all shareholders to express their views on the future of the company; and the ability of management to deliver on the long term corporate objectives, using the best resources available, in full accordance with the principles of accountability, transparency and appropriate checks-and-balances.

Investors expect all companies - regardless of their ownership structure - to implement corporate governance best practices, in line with the OECD/G20 Corporate Governance Principles, the ICGN Global Governance Principles and national corporate governance codes. In this Viewpoint, we emphasise key elements that are particularly relevant for controlled companies, including board independence, management of conflicts of interest, succession planning, voting rights, and disclosures that protect the rights of minority shareholders.

[13] OECD (2015) ‘Guidelines on Corporate Governance of State-Owned Enterprises', 2024 Edition, OECD Publishing, Paris

About this Viewpoint

This Viewpoint was prepared by ICGN's Global Governance Committee, chaired by Cristina Ungureanu. 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. We encourage dialogue by contacting Severine Neervoort, Global Policy Director, severine.neervoort@icgn.org, or Carol Nolan Drake, Senior Policy Manager, carol.nolandrake@icgn.org.