Key Considerations in the Debate on Differentiated Voting Rights

Shareholder control-enhancing mechanisms such as differentiated voting rights (DVR) are not new to Europe but are regaining momentum as regulators look for solutions against the perceived short termism of corporate governance actors, including shareholders. In this paper, BlackRock revisits certain assumptions justifying the need for DVR, outlines its view of the unintended consequences should DVR be introduced and proposes alternative solutions to reinforce long termism. As European policymakers are considering introducing the granting of DVR in order to promote long-term investing, we believe it is necessary to express our support to the proportionality principle, also known as the ‘one share, one vote’ principle.

Background

In France, the Florange Act adopted in 2014 introduced the automatic granting of double voting rights to shareholders registered on the shareholders’ registrar for at least 24 months. In Italy issuers have been offered the opportunity to amend their bylaws to grant double voting rights to their “loyal shareholders”.

The proportionality principle

The proportionality principle is based on two premises:

1. Shareholders as the residual claimants have the strongest interest in maximising firm value; and,
2. Voting power should match economic exposure.

It is at the core of corporate governance that to reduce the agency problem, all shareholders need to effectively monitor companies. As regulators call on investors to further engage with issuers in a deeper and more responsible way, we believe they equally should protect shareholders’ rights, particularly those of minority shareholders, by promoting the proportionality principle. Indeed, the granting of DVR can result in an over-concentration of power in the hands of a majority shareholder(s), thus disenfranchising other shareholders and amplifying the risks of extraction of private benefits by the majority shareholder(s).

Revising assumptions

#1: “Differentiated voting rights promote long-term investing.”

Anecdotal evidence and research\(^1\) suggest that changing companies’ share structure by introducing enhanced voting rights or dividends based on the duration of ownership will not lead to a material change to the time-horizon of investment in companies. Rather, these measures could well be counterproductive by entrenching a core group of shareholders to the detriment of minority shareholders.

Entrenched companies tend to engage less frequently and with fewer shareholders and to be less attractive on the market from an investment perspective\(^2\) thus raising their cost of capital. In our experience, the foundation for a long-term relationship between companies and investors is transparency and meaningful engagement with shareholders.

#2: “All shareholders can benefit from differentiated voting rights.”

DVR are usually attached to shares which are owned by the shareholders who have been on a shareholders’ registrar for a certain period of time (e.g. 24 months). The operational and administrative complexities of the registration process can prevent cross-border investors from receiving the enhanced voting rights to which they are entitled. For example in France, voting would become a manual process as the shareholders’ registrars are not integrated in the voting chain or connected to international voting platforms, thus creating significant costs and risks as new additional ad hoc processes need to be implemented. In most cases, only domestic shareholders can effectively be granted DVR, which may result in a lack of equal treatment and opportunities between domestic and cross-border shareholders. This may decrease the willingness of investors to provide funds to the companies which in itself is contrary to the objective of incentivising shareholders to hold their shares for a longer period.

#3: “Differentiated voting rights positively impact the company’s value.”

Deviations from the proportionality principle can affect the value of shares negatively. Indeed, institutional investors (i.e. asset owners and asset managers) tend to divest from companies and from markets with
weaker shareholder rights. A discount is usually applied to companies which do not offer proportionate voting rights, due to the dilution of certain shareholders’ voting power and the risk of an excessive extraction of private benefits by controlling shareholders. A survey of investors showed that a discount of up to 30% is applied to companies displaying shareholder control-enhancing mechanisms. Moreover, a firm’s cost of capital could be higher when deviations are possible, which may lead to inefficient levels of investment and capital misallocation.

#4: “Institutional investors are short-term and should not benefit from differentiated voting rights anyway.”

Passive investment is by definition long-term, as index investors will hold shares of the company for as long as it is part of the index. Passive strategies across the UK-managed asset base have continued to gain momentum, from 17% in 2006 to 22% in 2013 according to the Investment Association (IA). Regarding active investment, a 2012 survey by the IA shows that the average holding period of UK stocks by its members was at least four years.

A widespread misbelief exists that active asset managers are incentivised to turn portfolios, and therefore manage them with a short-term focus to the detriment of their clients. This ignores the fact that the investment performance the client receives is directly aligned with the revenues a fund manager receives. Fund managers are paid as a portion of the fund’s assets under management (AUM). Transactions that would decrease the AUM would be both to the detriment of the clients and of the fund manager.

References to industry-level portfolio turnover levels and standard length of ownership levels in the past have also aggregated proprietary trading by banks with institutional investor holdings and so provide a misleading view of actual holding period by institutional investors.

Cross-border institutional investors are, for the most part, long-term and should not be considered short-term on the basis of a flawed premise.

#5: “Differentiated voting rights are supported by most non-Anglo-Saxon markets participants.”

The proportionality principle is a widely-supported principle recognised as a core concept of corporate governance and shareholder democracy by the vast majority of institutional investors across Europe. What’s more, in France the Florange Act introducing an automatic granting of double voting rights to all listed companies received negative comments by the market regulator (AMF), French investors (AFG), issuers (ANSA), as well as French academics.

#6: “Differentiated voting rights can defend companies against hostile takeovers.”

On the contrary, the existence of DVR may actually increase the risk of a creeping takeover and, in case of a multi-class share structure, incentivise the controlling shareholder to sell its stake with a premium to a potential acquirer. These operations do not allow other shareholders to voice on the change of control or to offer their shares and thus creates significant investment risks.

#7: “Differentiated voting rights are already the norm.”

Empirical studies demonstrate that whereas enhanced shareholder control mechanisms are widely available in most countries, the number of companies that actually use these mechanisms is more limited, especially in the most recently listed companies. As issuers are progressively improving their corporate governance practices and adopting the proportionality principle, regulators would be sending the wrong message by promoting DVR.

Proposed solutions

Our proposed solutions to reinforce long termism of corporate governance actors without creating an uneven playing field between domestic and cross-border shareholders are as follows:

- Transparency is an effective mechanism regulators can put in place with a long-term effect as it raises the bar across the governance chain. The currently discussed Shareholder Rights Directive (SRD) proposal promotes increased shareholder transparency, e.g., by asking shareholders to disclose their engagement policy and their voting.
- Better cross-border execution of voting rights – which the SRD proposal seeks to achieve.

Additional readings

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