



## Key considerations in the debate on differentiated voting rights

Shareholder control-enhancing mechanisms such as differentiated voting rights (DVR) have been much discussed in the recent years as regulators and listed companies look for solutions to the perceived short-termism of corporate governance actors, including shareholders. In this paper, BlackRock revisits some of the assumptions behind justifications for DVR, and proposes alternative solutions to reinforce long-termism.

While the “one share, one vote” system has gained widespread acceptance by investors globally as best practice, this principle is not the rule around the world, and multiple forms of voting differentiation exist, including:

- Time-phased voting rights (also known as loyalty shares): Shareholders who have held the stock for a given period of time are given additional voting rights. This mechanism currently exists in Italy, the Netherlands and France, and is under discussion in Belgium;
- Multiple share classes: Under this structure, each class of shareholders can be granted a different level of voting rights, or even no voting rights. This structure is more common in the United States, in the Nordic markets and the Netherlands in Europe, and has been introduced in Singapore and Hong-Kong in Asia.

As policymakers consider granting DVR with the intention of promoting long-term investing, we believe it is necessary to reiterate our support for the “one share, one vote” proportionality principle.

### The proportionality principle

The proportionality principle is based on two premises:

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

It is a fundamental principle of corporate governance that to reduce the principle-agent problem of potentially divergent or conflicting interests, shareholders must 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 the rights of shareholders, particularly those of minority shareholders, by promoting the proportionality principle. Permitting DVR can result in an over-concentration of power in the hands of a majority shareholder or group of shareholders, disenfranchising other shareholders. This amplifies the risk of majority shareholder(s) extracting private benefits.

### Revisiting assumptions

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

Research and anecdotal evidence suggest that changing a company’s 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 that company.<sup>i</sup> Rather, these measures are simply control mechanisms and may be counterproductive, entrenching a core group of shareholders to the detriment of minority shareholders.

Dual-class companies usually have a lower proportion of institutional shareholders, and even fewer long-term investors, than other companies.<sup>ii</sup> This discrepancy disappears when these companies unify the different classes of shares.<sup>iii</sup>

Companies with an entrenched, core group of shareholders tend to engage less frequently and with fewer shareholders, and be less attractive from an investment perspective,<sup>iv</sup> raising their cost of capital. In our

experience, the foundation for a long-term relationship between companies and investors is transparency and meaningful engagement.

**#2: “All shareholders can benefit from tenure-based voting.”**

Tenure-based voting rights are usually attached to shares owned by 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 that they are entitled to. For example, in France, there is a separate process for voting shares with multiple voting rights as the shareholders’ registrars are not integrated in the voting chain or connected to international voting platforms. This requires additional *ad hoc* processes to be implemented, adding significant cost and risk.

In most cases, effectively only domestic shareholders can be granted tenure-based voting rights, which may result in a lack of equal treatment and opportunity between domestic and cross-border shareholders. This may decrease the willingness of investors to provide funds to those companies, contrary to the objective of incentivizing shareholders to hold their shares for a longer period. Operational complexities create an advantage for certain groups of shareholders, favouring controlling and reference shareholders’ rights, and dilute the board and management’s accountability to minority shareholders.

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

Deviations from the proportionality principle can negatively impact the value of shares.<sup>v</sup> Indeed, institutional investors (referring both to asset owners, and asset managers acting on their behalf) tend to divest from companies and markets with weaker shareholder rights. A discount is usually applied to companies that do not offer proportionate voting rights, due to the dilution of certain shareholders’ voting power, and the risk of controlling shareholders extracting private benefits. A survey of investors indicated that a discount of up to 30% is applied to companies displaying shareholder control-enhancing mechanisms.<sup>vi</sup> A firm’s cost of capital may also be higher when deviations from the proportionality principle 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.”**

Cross-border institutional investors are, for the most part, long-term. The technical obstacles they encounter in markets allowing DVR are material, and have precluded some from accessing the benefits of DVR and loyalty dividends.

Index investment strategies are by definition long-term, as index investors will hold the shares of a company for as long as it is included in the index associated with a particular investment mandate.

Regarding active asset managers, a widespread misconception exists that they are incentivized to turn portfolios, and therefore manage them with a short-term focus that may be to the detriment of their clients. References to industry-level portfolio turnover and standard length of ownership in the past have aggregated proprietary trading by banks and high frequency traders with institutional investor holdings, and so provide a misleading view of actual holding periods by institutional investors.<sup>vii</sup>

**#5: “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 the case of a multi-class share structure, incentivize the controlling shareholder to sell its stake at a premium to a potential acquirer. These operations do not allow other shareholders to opine on the change of control or to offer their shares, creating significant investment risks.

## #6: “Differentiated voting rights allow corporate managers to focus on the long-term.”

Some argue that DVR can create stability for nascent businesses, which could explain the trend of adoption of dual share class structures among recent IPOs of technology companies in the United States. The price to pay for this stability is the lack of counter-balance to the power of the founder, as the board could be removed at their instigation. In our experience, successful companies do not need to rely on practices that disenfranchise minority shareholders. For companies coming to public markets, there may be a case to have a dual class share structure for a limited initial period, say 5 – 7 years, as the company establishes itself with unaffiliated shareholders.

The “one share, one vote” principle is a result of market evolution since the end of the 19<sup>th</sup> century. History has taught us that investors need sufficient rights to sanction poor practices or performance by managers: the proportionality principle is the best method to make this monitoring and oversight effective.

### Proposed solutions

To reinforce long-termism by corporate governance actors, without creating an uneven playing field between shareholders, we recommend:

- Resolving the existing inefficiencies and opacity in the proxy voting process, to build trust in the system. Better cross-border execution of voting rights would also ensure all shareholders are treated equally.
- Companies with DVR should receive shareholder approval of their capital structure on a periodic basis via a management proposal on the company’s proxy. As part of the proposal, the board should explain why the current capital structure is best for the company and its shareholders. The proposal should give shareholders the opportunity to affirm the current structure or convert it to a “one share, one vote” framework.
- Transparency is an effective lever regulators can employ, with long-term effect, as it raises the bar across the governance chain. In the European Union, the new Shareholder Rights Directive (SRD) promotes increased transparency, e.g., by asking shareholders to disclose their engagement policy and their voting practices.
- Improving the quality of company communication on long-term strategy and corporate governance practices as well as their reporting on material environmental and social issues will help investors make better informed decisions.
- Reinforcing the dialogue and engagement between long-term shareholders and board members as a way to create trust and a better understanding between investors and listed companies.

### Additional reading

- Letter sent by BlackRock’s Chairman and CEO, Larry Fink, to corporate CEOs in 2018: <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>
- Open Letter Regarding Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes, April 2018: <https://www.blackrock.com/corporate/literature/publication/open-letter-treatment-of-unequal-voting-structures-msci-equity-indexes-041918.pdf>
- ViewPoint: The Investment Stewardship Ecosystem, July 2018: <https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-investment-stewardship-ecosystem-july-2018.pdf>

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<sup>1</sup> A study on French companies after the adoption of the Loi Florange, the legislation generalizing tenure-based voting, found there is no significant difference in the average holding periods between companies with and without loyalty shares before and after the Loi Florange, Becht et al., Loyalty Shares with Tenure Voting - A Coasian Bargain? Evidence from the Loi Florange Experiment, April 2018. See also: Stikeman Elliott, and The Generation Foundation, Building a long-term shareholder base: assessing the potential of loyalty-driven securities, 2013.

<sup>ii</sup> K. Li et al., Do Voting Rights Affect Institutional Investment Decisions? Evidence from Dual-Class Firms, Financial Management, Volume 37, Issue 4, Winter 2008

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- <sup>iii</sup> Scott B. Smart et al., What's in a Vote? The Short- and Long-Run Impact of Dual-Class Equity on IPO Firm Value, *Journal of Accounting and Economics*, 45, 2008. Jason W. Howell, No More Share Classes: A Study of U.S. Dual Class Stock Unifications, Terry College of Business, University of Georgia, 2008.
- <sup>iv</sup> IRRC Institute and ISS, Controlled Companies in the Standard and Poor's 1500: A Ten Year Performance and Risk Review, 2012.
- <sup>v</sup> M. Bennedsen and K. M. Nielsen, Incentive and Entrenchment Effects in European Ownership, *Journal of Banking & Finance*, 2010. ISS and IRRC, Controlled Companies in the Standard & Poor's 1500: A Ten Year Performance and Risk Review, 2012. R.W. Masulis et al., Agency Problems at Dual-Class Companies, *Journal of Finance*, Volume 64 Issue 4, 2009.
- <sup>vi</sup> European Commission External Study by ISS, Sherman & Sterling and ECGI, Report on the Proportionality Principle in the European Union, 2006.
- <sup>vii</sup> Investment Management Association, Understanding Equity Turnover Data: Initial Findings from IMA Research Submitted to the Kay Review, available at [http://www.investmentfunds.org.uk/assets/files/consultations/2011/20111128\\_IMATurnoverResearch-InitialFindings.pdf](http://www.investmentfunds.org.uk/assets/files/consultations/2011/20111128_IMATurnoverResearch-InitialFindings.pdf)