ICGN Viewpoint

Stewardship does not benefit from differential ownership rights

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Executive Summary

Investors, policy makers and other market participants increasingly recognise that fostering longer-horizon thinking and behaviour in financial markets is critical for sustainable economic success. Former Internal Market and Services Commissioner Michel Barnier of the European Commission has stated: *"The last years have shown time and time again how short-termism damages European companies and the economy"*[1]. Similar concerns exist not just in Europe, but in economies around the world as well. The underlying concern is that an excessive short-term focus by investors can undermine the long-term success and value creation by corporations.

As a policy response, legislative proposals in differing jurisdictions in Europe were introduced in 2014 that seek to encourage long-term shareholding by providing incremental rights to longer-term shareholders. These include granting additional voting rights and dividends for “loyal” shareholders, with loyalty often defined by a two year registered holding in a company’s shares. The ICGN is supportive of promoting longer-term thinking and behaviours by investors. At the same time, however, the ICGN is concerned that the introduction of differential ownership rights is a flawed tactic that carries potentially unintended consequences that can affect not only minority investors, but also the long-term performance of companies. The ICGN ultimately takes the view that the introduction of differential ownership rights should be discouraged—even if the nominal intent to promote long-term thinking is a worthy one.

But if differential ownership rights are not the solution, it is important to present constructive alternatives to encourage long-term thinking by investors. In this context the ICGN supports ongoing efforts to promote robust investor stewardship in many markets, including through stewardship codes, as well as through ensuring that investment management agreements between asset owners and asset managers contain contractual provisions to ensure a long-term focus by investors.

Differential ownership rights: can long-term thinking be mandated through legislation?

Several policy initiatives in continental Europe were introduced or proposed in 2014 seeking to introduce differential ownership rights to promote long-term investment. This includes the “Loi Florange” introduced in France, the Italian Growth Decree, as well the draft report published in December 2014 by Sergio Gaetano Cofferati, rapporteur to the European Parliament’s Legal Affairs Committee with regard to the revised European Shareholder Rights Directive. While each initiative has its own distinct features, they all share the ambition to create rewards and economic incentives for shareholders to maintain long-term

[1] European Commission Press Release, Brussels, 9 April 2014.

investments in companies held in investment portfolios. This long-term holding perspective is meant to temper short-termist pressures from institutional shareholders and enable the company and its board to focus on creating sustainable value and long-term corporate success.

It is fair to say that there are mixed views in the investment community about the pros and cons of differential rights granted through so-called “loyalty” shares. Some investors view enhanced dividends and control rights as attractive features that reward long-term shareholdings. Yet other investors—even those with long-term investment perspectives-- are concerned about potential distortions that may occur through the granting of differential rights.

What are the problems associated with differential ownership rights?

Investor concerns about differential ownership rights are most fundamentally linked to creating classes of common shareholders with voting rights in excess of their economic stake in a company. This is a particular concern in companies with controlling shareholders, where multiple voting rights can serve to entrench the control of significant shareholders and dilute accountability to (if not disenfranchise) minority shareholders—many of whom are the world’s largest global investors. While the legislative intent of loyalty shares is to shift control towards longer-term shareholders it is important to recognise the potential negative consequences, including the entrenchment of management or the effect of multiple voting rights serving as an antitakeover mechanism. Investor concerns are that this can be detrimental at both the individual company level and that it can impact the investment attractiveness of markets where differential voting rights are widespread.

Consequently, ICGN supports the broad principle of “one share, one vote” for ordinary or common shares, a position shared by many institutional investors. This standard ensures that voting rights exercised by shareholders are in line with their economic interests in the company, thus offering an equal treatment to all shareholders. The ICGN Global Governance Principles reaffirm the importance of equal voting rights for all shareholders that are broadly accepted as an international corporate governance best practice standard. [2]

Investors taking action

In early 2015 a group of international investors, including ICGN, mobilised to express these concerns to Italian, French, and EU authorities in opposition to the granting of loyalty rights to long-term shareholders. A consistent theme emphasised in each of the ICGN’s interventions was its opposition to generic mechanisms that lead to voting control that is disproportionate to a shareholder’s economic interest in a company.

In the case of Italy, the investor voice was heard, and the Italian government abandoned plans earlier this year to extend the exemption clause for the Growth Decree, which would have allowed the introduction of double voting rights without supermajority approval. This was a positive public policy outcome for investors. [3]

In France, the Florange Act is a legislative reality, in which double voting rights for long-term shareholders are the legal default option. [4] This means that investor engagement on this issue in France is likely to be at a micro level, rather than at a macro public policy level. Investors will have to discourage the use of double voting rights on a company by company

[2] See ICGN Global Governance Principles, section 9.1: https://www.icgn.org/images/Global_Governance_Principles_2014.pdf
[3] See ICGN letter to Italian government regarding the Growth Decree: https://www.icgn.org/images/28_Jan_Italy_Growth_Decree_ICGN_Prof_Padoan.pdf
[4] See ICGN letter regarding the Florange Act in France: https://www.icgn.org/images/ICGN2_AFG_P_Bollon_French.pdf

basis. For example, a shareholder resolution filed at the 2015 AGM of the French company Vivendi sought to eliminate double voting rights-- and thereby the disproportionate influence of the company's controlling owner.

With regard to the European Shareholder Rights Directive, the ICGN responded to the Cofferati report to the European Parliament with a clear statement of opposition to the double voting rights recommendation in the report.[5] The ICGN encouraged the Parliament to not adopt the introduction of differential voting rights as a tool to stimulate long-term ownership, noting that the credibility and attractiveness of European markets could be adversely affected by introducing legislation that could challenge the rights and fair treatment of minority investors.

Alternatives to differential rights? Promoting responsible stewardship

If differential ownership rights are not the answer to promote long-term investor thinking, then what alternatives exist? ICGN believes that one answer lies in the ongoing development of investor stewardship practices and their integration into the investment management process. Stewardship codes are developing in many markets to establish more responsible investment practices, relating to monitoring, engaging and voting at company AGMs. While the evidence base relating to the practical impact of stewardship codes remains minimal and somewhat inclusive, we believe there is merit in sticking to the course, and we recognise that developing a culture of stewardship can take time.

Both the ICGN Global Governance Principles and the ICGN Statement of Principles for Institutional Investor Responsibilities[6] address the importance of investors assuming the responsibilities for long-term stewardship. These guidance statements outline the importance of investors making effective use of voting rights at shareholder meetings, and to engage intelligently and pro-actively with investee companies on strategy, corporate governance and both financial and non-financial risks related to long-term performance. This in recognition of the fact that both companies and shareholders have a mutual interest in protecting and generating sustainable corporate value over the long term.

A practical way to embed longer-term thinking between asset owners and asset managers is to ensure that investment management agreements contain contractual terms that mandate responsible stewardship practices. In ICGN's Model Mandate Initiative areas of focus for asset owners are identified to provide a better alignment of interest with their investment managers over the long term. Asset owners should fully align the interests of their fund managers with their own obligations to beneficiaries by setting out their expectations in fund management contracts. Key areas of focus for asset managers which are seeking to align the activities of their fund managers more closely with the long-term interest of beneficiaries include among others:

- ensuring that the timescales over which investment risk and opportunity are considered match those of the client;
- aligning interests effectively through fees, pay structures and cultures;
- effectively integrating relevant environmental, social and governance factors into investment decision-making and ongoing management;
- ensuring that portfolio turnover is appropriate to the mandate, in line with expectations and managed effectively.

[5] See ICGN letter to European Parliament: https://www.icgn.org/images/28_Jan_EC_re_SRD_ICGN_Cofferati.pdf
[6] See: https://www.icgn.org/images/ICGN/files/icgn_main/Publications/best_practice/SHREC/ICGN_Principles_Investor_Responsibilities_Guidance_Sept_2013_print.pdf

In summary, it is understandable for regulators and policy makers to encourage more responsible long-term investment practices to promote sustainable corporate performance and economies. But there is no “silver bullet” to achieving this, and the tactic of employing differential voting rights or loyalty shares has the potential to do more harm than good. ICGN believes that continued focus on long-term investor stewardship is likely to achieve the most effective results as responsible investment practices continue to take root in the investment management process. Ultimately there is scope for building trust among both companies and investors. Investors need to gain the trust of companies by demonstrating that their overarching concern is long-term commercial success for companies, not simply short-term.

At the same time, companies need to build trust, particularly amongst their minority investor base, that the rights of all shareholders are respected and that controlling shareholders do not exercise a disproportionate or undue influence in ways that might work against the interests of minority shareholders or the long-term success of the company.

About ICGN Viewpoints

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. ICGN Viewpoints are produced by our member-led Policy Committees and we encourage dialogue by contacting Committee chairs directly or the ICGN Secretariat as follows:

Bram Hendriks, Co-Chair, ICGN Shareholder Rights Committee
Email: Bram.Hendriks@ingim.com

Alexander Juschus, Co-Chair, ICGN Shareholder Rights Committee
Email: alexander.juschus@ivox-europe.com

George Dallas, ICGN Policy Director
Email: george.dallas@icgn.org