Differential ownership rights - A suitable tool to stimulate long-term share ownership with negative consequences?

Topic of the month September 2015

By: Bram Hendriks, Senior Corporate Governance Specialist and member of the ESG Board at NN Investment Partners (NN IP).

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. An excessive short-term focus by investors is believed to undermine corporations' long-term success and value creation. Former Internal Market and Services Commissioner Michel Barnier of the European Commission stated in April 2014 that „the last years have shown time and time again how short-termism damages European companies and the economy"[1]. Similar concerns exist around the world. In response to those concerns the European Commission has presented a proposal for the revision of the Shareholder Rights Directive to tackle corporate governance short comings related to among others the behaviour of companies and their boards as well as shareholders. These proposals should help ensure that shareholders become more engaged; better hold the management of the company to account and act in the long-term interests of the company. At the same time there has been a debate in various European member states about the question whether long term share ownership can also be stimulated by providing differential ownership rights to longer term shareholders.[2] This includes among others additional voting rights and dividend for shareholders that own a company's shares for a certain period of time. While NN IP is supportive of the European Commission's proposal to stimulate long-term shareholder engagement, we question differential ownership rights as a tool to stimulate long term ownership.

Legislative proposals in some European jurisdictions during the past year have attempted to address the problem of short-termism by allowing various forms of differential ownership rights. These proposals would award investors for holding shares for longer periods. Examples of such rewards are the allocation of additional voting rights or the payment of an extra dividends to longer-term investors.

'Are differential ownership rights a means of promoting stewardship?'

Legislation has recently been adopted in France and Italy that enables companies to allocate double voting rights to longer-term shareholders. In each instance longer-term share ownership is defined as a period of two years. This legislation includes the Florange law in France and Italy's Growth Decree. The question of whether policy measures should be introduced to allow companies to grant double voting rights is also being debated at the European Union level. Such measures have been introduced as a provision in 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.

What are the problems associated with differential ownership rights?

In a recent document published by the International Corporate Governance Network, (“Stewardship Does Not Benefit From Differential Ownership Rights”[3]), several concerns are identified with regard to differential ownership rights for longer term shareholders NN IP provided an active contribution to this document and agrees with all identified concerns. These relate specifically to double voting rights and, more broadly, to the creation of classes of common shareholders whose voting rights exceed their economic stake in companies. Extra voting rights can be especially worrisome in the case of companies that have controlling shareholders. Such rights can serve to entrench the control of significant shareholders and dilute accountability to minority shareholders, or even disenfranchise them.

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. Investors are concerned that this can be detrimental at the company level and that it can reduce the investment attractiveness of markets where differential voting rights are widespread.

NN IP supports the principle of “one share, one vote” for ordinary or common shares, a position shared by many institutional investors. This standard ensures that shareholders’ voting rights are in line with their economic interests, thus offering an equal treatment to all shareholders.

Active involvement by NN Investment Partners

NN IP joined other international investors in early 2015 in voicing these concerns to Italian, French and EU authorities. Our opposition to generic mechanisms that lead to disproportionate voting power was a consistent theme in each of these interventions.

In Italy we were part of a group of institutional investors and leading academics that sent a letter to the Minister of Finance to voice our concerns about provisions in the Growth Decree. The letter’s signatories voiced strong opposition to the government’s attempt to disable a key provision in Italian law that requires companies to obtain a two-thirds majority of shareholder votes in order to amend their statutes.

The introduction of double voting rights in a company’s statutes normally requires the support of at least 66% of the shareholders. However, in July 2014 the Italian government enacted a temporary exemption that allowed listed companies to introduce Loyalty Shares, with double voting rights, by securing a simple majority of votes, rather than the standard supermajority. As a result only 50% of the shareholders voting at the shareholder meeting were needed to approve the introduction of the Loyalty Shares.

The exemption expired in January 2015 and through our letter we urged the government to abandon the exemption. The Italian government abandoned plans earlier this year to extend the exemption clause for the Loyalty Shares. This was a positive public policy outcome for investors.

In France, the Florange law introduced automatic double voting rights for shareholders that hold their shares in a company for more than two years. The main difference with the situation in Italy is that French companies need not

change their statutes to introduce double voting rights. In fact, French companies that want to maintain the one share, one vote standard must specifically include this in their statutes.

NN IP sent letters in early 2015 to the chairmen of French companies asking them to introduce the “one share, one vote” principle in their company’s statutes. Many of these companies responded positively and put the statutes amendment on the agenda of the Annual General Meeting (AGM).

The AGM outcomes were in some instances positive. At the shareholder meeting of the beauty company L‘Oreal, an overwhelming 99.8 % of the shareholders voted in favour of a resolution to maintain the company’s “one share, one vote” standard. At Renault’s AGM, however, shareholders approved double-voting rights, blocking Chief Executive Carlos Ghosn’s efforts to maintain “one share, one vote” and potentially boosting the French government‘s influence over the carmaker.

We are of the opinion that differential ownership rights mainly benefit a company’s controlling shareholder(s) to the detriment of the minority shareholders. Therefore NN IP will continue to argue against differential ownership rights as a tool to stimulate longer term shareholdings. This includes the dialogue with the boards of investee companies that consider to introduce double voting rights and / or loyalty dividend. At the same time NN IP will also continue to voice its concerns to policy makers.

Footnote and References:

1) http://europa.eu/rapid/press-release_IP-14-396_en.htm?locale=en
2) http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2014:213:FIN
3) https://www.icgn.org/sites/default/files/Stewardship%20does%20not%20benefit%20from%20differential%20ownership%20rights.pdf

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