HERBERT
SMITH
FREEHILLS

DIFFERENTIAL SHAREHOLDER RIGHTS: A LONG-TERM SOLUTION TO SHORT-TERMISM?

26 August 2015 | Australia, Brisbane, Melbourne, Perth, Sydney
Legal Briefings – By **Baden Furphy** and **Adam Charles**

SUMMARY

- "Short-termism", a focus on short-term performance at the expense of long-term value creation, is widely criticised as contributing to the damage suffered in the GFC and other governance failings

- Corporate governance reform advocates are increasingly arguing for long-term shareholders to be rewarded with greater rights as a means of countering short-termism

INTRODUCTION

The 2007-2008 global financial crisis was the catalyst for another in the long line of sober reviews of corporate governance practices in recent decades. Whilst various macro-economic factors are now widely regarded as having driven the crisis, some companies were clearly more affected than others. Post-crisis analysis has identified corporate governance failures as contributing to company-specific impacts.

Underlying many of the failures was so-called "short-termism" in the investment and corporate communities, a term used to describe an undue focus on short-term returns at the expense of long-term value creation. The list of critics of this behaviour is long and distinguished: Warren Buffett, Jack Vogle (founder of the world's second largest fund house, Vanguard), various global institutional investors (including TIAA-CREF, CalSTRS and Aviva), Professor John Kay (chair of the 2012 Review of UK Equity Markets and Long-Term Decision-Making), the OECD, the International Corporate Governance Network, and Chief Justice Leo Strine of the Delaware Supreme Court, to name just a few.

Since the GFC, various reforms have been implemented to counter short-termism, including the introduction of the European Shareholder Rights Directive. Amendments to the Directive have recently been considered that would require Member States of the European Union to confer one or more of the following rewards on long-term shareholders: additional voting rights, tax incentives, loyalty dividends or loyalty shares. These measures are intended to promote long-term shareholding as a means of countering short-termism.

"SHORT-TERMISM"

Critics contend that overly focusing on short-term returns causes investors and asset managers to be unconcerned with long-term performance. This, it is claimed, reduces investment in long term value creation initiatives including innovation and causes misalignment with the long term investment horizons of the ultimate investors (particularly individual pension fund contributors). In particular, it is argued that a focus by the investment community on quarterly earnings performance and other short-term metrics drives inappropriate corporate risk adoption in an attempt to satisfy the desired short-term returns.

The issue of short-termism also often comes into sharp focus in the context of M&A where controversy around the ability of short-term shareholders to bring on a takeover offer at the alleged expense of long-term shareholders and other constituencies is not new.

SHAREHOLDERS AS MONITORS

Shareholders in listed companies generally have 2 options open to them in response to poor governance: 'voice' or 'exit'.

In most jurisdictions, effective governance is predicated on active shareholder engagement with companies - the "voice" option – although the shareholders' role varies by jurisdiction, with some systems conferring check-and-balance roles on other stakeholders (for example, the unique German two tier corporate governance system with an executives-only management board and a non-executives-only supervisory board where in most German listed companies between 1/3 and 1/2 of directors on supervisory boards must be representatives elected by the employees, depending on the size of the company's workforce. Effective shareholder engagement is generally considered to involve both dialogue between shareholders and companies, and active use of shareholders' rights (particularly voting).

A weakening in shareholder engagement is viewed as a major contributing factor in the governance failings that caused certain companies to be impacted by the GFC worse than others. Various reasons are offered for the lack of effective engagement: inefficient and ineffective shareholder rights at law; the institutionalisation of shareholdings and dispersed ownership; a free-rider problem arising from the costs of engagement and dispersed ownership; the intermediation of share ownership via the contemporary long "investment chain" comprised of asset managers, nominees, custodians, trustees, investment consultants, proxy advisers and others standing between investors and companies; modern portfolio techniques; short-term and relative asset manager performance measures; the decoupling of economic and voting rights via derivatives and share lending; increased cross-border shareholdings, among others.

These factors are often identified as encouraging shareholders to exit, rather than agitate for governance failings to be addressed.

FOSTERING LONG-TERM SHAREHOLDING AS A MEASURE TO COUNTER SHORT-TERMISM

Reform advocates have focussed on both improving shareholder engagement and encouraging a long term focus from shareholders.

In Europe, the Shareholder Rights Directive was implemented to improve and increase shareholders' rights in listed companies. The Directive states that effective shareholder control through shareholder activism is a prerequisite to sound corporate governance and should, therefore, be facilitated and encouraged. This was followed in the US by the Dodd-Frank Act which has introduced two corporate governance reforms designed to confer more authority on shareholders.

The one-share-one-vote principle and the underlying notion of shareholder equality has historically been a fundamental tenet in many corporate law systems. By aligning shareholder voting power with economic exposure to the company, the principle is normally considered to create optimal incentives for efficient shareholder decision-making. However, reform advocates are increasingly arguing in favour of departures from shareholder equality as a means of encouraging shareholder engagement. Many advocates propose that differentiated shareholder rights referable to the length of time invested are an effective means of countering short-termism.

Many European countries have adopted differential voting rights, including Sweden, Finland, Denmark and France (which has introduced the 'Florange law' giving shareholders who have held shares for more than 2 years double voting rights, unless a 2/3s majority votes for one-share-one-vote). Differential rights are also present amongst US companies, with Facebook and Google being two notable examples (in those cases, in the form of both non-voting stock and stock with increased voting rights). The perceived attraction of a primary listing in the US amongst Mainland Chinese companies given the permissibility of differential voting rights structures in that jurisdiction has led the Stock Exchange of Hong Kong Limited to recently issue a consultation paper regarding the introduction of differential voting rights.

DIFFERENTIAL RIGHTS: A GOOD MOVE?

The rationale for rewarding long-term shareholders is, at first blush, attractive: there is an apparent logic to incentivising shareholders to be exposed to long-term company performance in order to facilitate long-term value creation. However, simply conferring additional rights on shareholders that are invested for a prescribed period of time is a blunt instrument for change. Numerous issues arise with the various forms of differential rights, including the following:

- **Investing styles:** the case for differential rights assumes that long-term shareholders in a company are focussed on long term value creation by that company. This ignores the reality that investors employ any number of approaches (e.g. quantitative or fundamental, long or short, active or passive, event driven or value), apply varying investment horizons and degrees of portfolio concentration, and are, in turn, impacted by the unique characteristics of their own investors. Any of these factors may cause even a long term investor's interests to not be completely aligned with long-term value creation.

- **Long term investment does not equate to greater shareholder engagement:** even if shareholders are both long-term shareholders and net long a company, it does not necessarily follow that they will engage to secure long-term value creation. For large scale, passive institutional investors, effective engagement across a portfolio is often inefficient. This is, arguably, borne out by the prices placed on voting rights in share lending transactions: studies of US voting rights prices have found them to be between 0.10% and 0.25% of the market price of the shares.

  Conversely, conferring greater voting rights on long-term shareholders effectively disenfranchises (to varying degrees) investors that have not been invested for the requisite time, irrespective of whether they will employ a long-term perspective and actively engage.

- **Shareholding concentration:** in a concentrated shareholding scenario, an increased concentration of control via enhanced voting rights may well only serve to exacerbate a misalignment of majority and minority interests and do nothing to address (and may even facilitate) short-termism. Moreover, if the interests of a long-term controller are best served by short-term returns, the conferral of greater voting rights will only be counter-productive in achieving long-term value creation.

- **Practical issues:** there are various practical problems inherent in differential voting rights, including: the varying number of voting rights on issue at any particular time; the difficulty in determining entitlement to greater rights due to the intermediated investment chain; volatility in market prices at the time of introduction of the rights; and, the ability of market participants to implement structures that satisfy the criteria for enhanced voting rights yet allow the transfer of economic exposure and voting rights to third parties, among others (for example, through off-market trading in beneficial, rather than legal, ownership of shares).

CONCLUSION

After the European Parliament's Committee on Legal Affairs initially approved amending the Shareholder Rights Directive to reward long-term shareholders with additional voting rights, tax incentives, loyalty dividends or loyalty shares, the European Parliament rejected the amendment.

In the scheme of arrangement involving PCCW Ltd, the Court rejected the argument that an arbitrageur who acquired its shares after the announcement of the scheme and who was "betting on the ultimate privatisation" should either be placed in a separate class or have its votes discounted or disregarded.

In our view, mandating differential voting rights is not the right response to concerns about short termism. In particular, simply mandating additional voting rights for long-term shareholders on the assumption that the shareholders will agitate for improved long term corporate performance ignores the issues outlined above. Rather, the focus of any reforms should be on encouraging constructive engagement by companies with shareholders on long term value creation initiatives.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

BADEN FURPHY
PARTNER,
MELBOURNE
+61 3 9288 1399
Baden.Furphy@hsf.com

LEGAL NOTICE