Railpen
100 Liverpool Street, London EC2M 2AT

www.railpen.com

European Commission
Av. D'Auderghem 45
1040 Bruxelles
Belgium

Via the European Commission feedback portal

Date: 28 March 2023

Dear Members of the European Commission

Railpen response: Proposal for a Directive of the European Parliament and of the Council on multiple-vote share structures in companies that seek the admission to trading of their shares on an SME growth market

About Railpen

Railpen is the trading name of Railway Pension Investments Limited, which is authorised and regulated by the Financial Conduct Authority (FCA). Railpen acts as the investment manager for the main railways pension schemes in the UK and is responsible for c. £35 billion of assets on behalf of over 350,000 members. A significant proportion of these assets are invested in companies based in EU Member State jurisdictions.

Sustainable Ownership is Railpen's approach to incorporating sustainability considerations into the investments it manages on behalf of members. Railpen's work is enabled by one of the Trustee's investment beliefs that focuses specifically on this work: "Incorporating and acting upon climate risk and other environmental, social and governance factors is a significant driver of investment outcomes and part of our fiduciary duty."

As a responsible investor, we recognise our duty to act as an engaged steward of our assets. We thoughtfully and intelligently exercise our voting rights – alongside constructive engagement with portfolio companies – to support the Trustee's objective of enhancing the long-term investment return for its beneficiaries.

Differential voting rights dilute the ability of independent shareholders – including Railpen and others in the responsible investment community with a long-term perspective – to effectively hold companies to account. We believe it is a fundamental tenet for any financial market or system which seeks to promote long-term corporate success that shareholder voting rights are directly linked to the shareholder's economic stake[1]. We therefore believe that any steps to further enable multiple-vote share structures (MVSS) would run counter to the rest of the European Commission's laudable and very welcome work to support investors as effective stewards of their assets.

This paper builds on our previous submissions on multiple (or dual-) class share structures (DCSS) in response to the UK Government's *Call for Evidence – UK Listings Review (Hill Review)* in 2021 as well as the UK Financial Conduct Authority's follow-up *Request for Views*

[1] In this we are aligned with the work of the Council of Institutional Investors (CII) and the International Corporate Governance Network (ICGN), including the latter's Global Governance Principles and Global Stewardship Principles.

on the Hill Review on Primary Markets Effectiveness. It also aligns with our role in setting up and chairing the Investor Coalition for Equal Votes (ICEV) together with the Council of Institutional Investors (CII) and US pension funds with around $2trn of global assets under management. We respond here to some of the broader issues raised in the paper and provide summaries of some of the available evidence on MVSS and its long-term implications for both investor stewardship and shareholder value.

<u>Our response</u>

The impact of MVSS on shareholder value

Long-term investors, like Railpen, use a range of tools to help us positively influence the behaviour of our portfolio companies in a way that supports long-term value creation for our beneficiaries. This includes engagement – both direct and working together with other asset owners, managers and civil society groups – and the thoughtful exercise of our voting rights as minority shareholders, which can be a powerful tool for demonstrating either sanction or support[2].

A move to MVSS provides the owners of certain share classes with superior voting rights, giving them voting control over a company that is disproportionate to their equity shareholding. This 'gap' between ownership of a company and control skews the incentive structure for the founder or entrepreneur (who in recent years has usually been the beneficiary of share classes with superior voting rights) while diluting market discipline, i.e. the influence of other shareholders.

Nicholas and Marsh (2017)[3] describe DCSS (or MVSS) as creating a "bulwark for managerial entrenchment", and while this may not be an issue while company management is making effective decisions, where there is company mismanagement, the impact and discipline of the usual market mechanism – i.e. engagement (or voting) by independent shareholders – is diminished. There is little shareholders can do by way of response except divest their holding. Of course, this avenue is not open to passive investors, who are forced to maintain their exposure and bear the risks[4].

Furthermore, there is a growing body of evidence from countries that already allow MVSS demonstrating that companies with such structures underperform companies with dispersed voting rights over the long-term[5]. By further enabling MVSS, we believe the EU would create an environment that would reduce the attractiveness of EU-listed companies (where Member States adopt multi-vote share structures in the wake of these proposals) to investors.This would ultimately have a detrimental impact on the availability of the kind of long-term, patient capital we know European policymakers are keen to attract.

---

[2] For further details on our approach to stewardship and ESG integration, please see our *Stewardship Reports* that are on our website.
[3] *Dual-Class: The Consequences of Depriving Institutional Investors of Corporate Voting Rights* (2017)
[4] There is also evidence that investors are discouraged by investing in companies with DCSS. Borveau et al (2019) also found that French firms which adopted double voting rights by default under the *Loi Florange* regime in force from 2016 experienced a decrease in foreign institutional ownership and an increase in the cost of capital relative to other firms. It could also be argued that the current significant discount (at around 35%) of Schroders non-voting shares trade to Schroders voting shares is at least in part owing to the lack of voting rights – and related liquidity issues.
[5] Please see academic evidence cited in *Annex 1.*

Time-based sunset clauses and other investor protections

We note the EU's requirement for a sunset provision that would serve as a blanket requirement for all Member States. Although the apex of investor protection on capital structure is one-share, one-vote, our fundamental priority is to mitigate long-term misalignment between capital and voting rights. This is particularly the case given that academic evidence shows that any benefits that may derive from MVSS dissipate between five and seven years after listing[6]. If a sunset clause is to be implemented, we would prefer to see it set at no more than seven years after listing.

We would also urge the EU to consider the approach to MVSS taken by the FCA in its *Policy Statement 21/22: Feedback and final changes to the Listing Rules* – and in particular the conditions it placed upon the use of MVSS by companies, in particular that weighted voting rights:

- May only be held by directors of the company or beneficiaries of such a director's estate;
- Are only available in two limited circumstances: 1) a vote on the removal of the holder as a director and 2) (following a change of control) in relation to a vote on any matter "to operate as a strong deterrent to a takeover".

We also think that any maximum weighted voting rights ratio should be no more than 10:1 (it is worth noting that the 10:1 limit is currently in practice in Singapore and Hong Kong).

Finally, we believe that all protections should be harmonised by Member States to ensure that the impact on investors remains limited over time and provides a consistent standard for all relevant investments in EU jurisdictions.

Conclusion

We are grateful to the European Commission for the opportunity to comment on this consultation. However, we do not believe that the long-term interests of companies that list in Member States, or those of institutional investors and the savers on whose behalf we invest, are best served by further enabling capital structures that fundamentally diminish the impact of what are important stewardship tools.

We hope that our response has been helpful and we would welcome the opportunity to discuss further.

Yours faithfully,

Caroline Escott
Senior Investment Manager, Sustainable Ownership
Caroline.escott@railpen.com

Michael Marshall
Head of Investment Risk and Sustainable Ownership

---

[6] Please see academic evidence cited in *Annex 1.*

Annex 1 – Summary of relevant academic evidence

We provide here a very brief summary of the available academic research on dual-class share structures here. This is not intended to be exhaustive, but we hope that this gives a flavour of the research that has been undertaken on this issue. We also note the extensive resources and research provided by CII, the International Corporate Governance Network (ICGN) and the European Corporate Governance Institute (ECGI).

Bebchuk and Kastiel (2017): *The Untenable Case for Perpetual Dual-Class Stock*

The authors' analysis shows that any potential advantages of dual-class share structures tend to recede after a few years and that controlling owners have perverse incentives to retain dual-class structures even when these become inefficient over time.

Bebchuk and Hamdani (2017): *Independent Directors and Controlling Shareholders*

This found that independent directors are incentivised to submit to the views and decisions of controlling shareholders because these shareholders are more likely to have significantly greater influence on the election and retention of the directors.

Becht, Kamisarenka and Pajuste (2018): *Loyalty Shares with Tenure Voting – A Coasian Bargain? Evidence from the Loi Florange Experiment*

In 2014, the default rule for French listings under the *Loi Florange* changed from one-share, one-vote to loyalty shares whereby companies issued shares that conferred two votes per share after a holding period of at least two years. This study of French listed companies found that those companies which did not convert to a dual-class share structure had a significantly higher market-to-book ratio than those companies forced into a dual-class regime.

Borveau, Brochet and Garel (2019): *The Effect of Tenure-Based Voting Rights on Stock Market Attractiveness: Evidence from the Florange Act*

Another study of the impact of the *Loi Florange*, the authors found that those firms which defaulted into dual-class share structures (and particularly those with a large block holder) were faced with an increase in the cost of capital relative to other firms. They also found that the market reacted positively to successful opt-out votes (i.e. refusal to move to a dual-class share structure).

El Nader (2018): *Stock Liquidity and free float: Evidence from the UK*

The author's analysis of UK firms in the wake of the increase in minimum free float requirements from 15% to 25% (announced by FTSE in 2011) suggested that stocks with higher levels of free float are associated with higher levels of liquidity.

Gompers, Ischii and Metrick (2010): *Extreme Governance: An Analysis of Dual Class Firm sin the United States*

This study focused on dual-class share structures in the US and concluded that firm value was "negatively associated" with insiders' voting rights as well as with the wedge between insiders' voting rights and insiders' cashflow rights.

Lukomnik and Quinn (2012): *Controlled Companies in the Standard & Poor's 1500: A Ten Year Performance and Risk Review*

This study looked at firms in the S&P Composite Index found that firms controlled by a concentrated ownership structure, including those with DCSS, tended to underperform over the longer-term. The author also found that those companies with DCSS tended to show some characteristics of weak corporate governance, including weaknesses in accounting controls and frequent related-party transactions (RPTs).

Matos (2017): *An Assessment of Dual-Class Shares in Brazil: Evidence from the Novo Mercado*

DCSS structures used to be common in Brazil, but in 2000 the Novo Mercado reform provided a voluntary listed segment with enhanced investor protections which included a one-share, one-vote structure. It found that firms which moved to this new Novo Mercado structure experienced higher firm performance which included market outperformance, higher return on assets and a higher market-to-book ratio.