5th January 2021

Via email: ListingsReview@hmtreasury.gov.uk

Dear Lord Hill,

RPMI Railpen (Railpen) response to HM Treasury's *Call for Evidence – UK Listings Review*

About Railpen

RPMI Railpen (Railpen) is the investment manager for the railways pension schemes, and is responsible for managing c. £30 billion of assets. Railpen is authorised and regulated by the Financial Conduct Authority (FCA). The Trustee's mission is to pay the pensions of its 350,000 members securely, affordably and sustainably. The Trustee, and its subsidiary Railpen, undertake responsibilities attributed to asset owners and asset managers, and we have answered the issues raised in the *Call for Evidence* in a way which reflects the breadth of our responsibilities.

Unlike many UK Defined Benefit (DB) schemes, the railways pension schemes include many open DB sections, which means that the Trustee expects to be paying the pension of an eighteen-year-old who is their first job today out to 2100 and beyond. We therefore continue allocate a significant proportion of our assets under management to growth assets such as equities.

Introduction

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

Differential voting rights (or dual class share structures (DCSS)) dilute the ability of minority 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.

We have strongly welcomed this government's clear and continued commitment to supporting institutional investors to act as engaged stewards of their assets. This includes recent work by HM Treasury's *Asset Management Taskforce Stewardship Working Group* on *Placing Stewardship at the Heart of Sustainable Growth* as well as the 2018 and the 2019 changes by the Department for Work and Pensions (DWP) to the *Occupational Pension Schemes (Investment) Regulations 2005* to support pension schemes in acting as responsible investors.

We believe that any move to allow dual-class voting structures would be detrimental to the kind of effective stewardship by institutional investors which the government has been laudably keen to encourage through these and other initiatives. This would in turn damage the global reputation of the UK as a market where investors enjoy structured protections and ownership rights.

Our response, below, focuses both on the potential damage from a shift to allowing differential voting rights, as well as the potential opportunity afforded by this Review to instead underline the UK government's commitment to enhancing investor stewardship through increasing the proportion of the free float requirement to 30% or, at the very least, keeping it unchanged at 25%.

Our response

We support the government's intention, through this *Call for Evidence,* to enhance the UK's attractiveness as a global financial centre and recognition that the UK "needs to maintain the highest global standards". The UK's financial services sector is a world leader, and we believe that key to its success is the robust and well-regarded regulatory system which supports high standards of corporate governance and includes strong protections for minority shareholders.

Dual-class share structures (DCSS)

We have strongly welcomed the government's commitment, and activity elsewhere, to support institutional investors to act as effective stewards of their assets – including, but not limited to, their equity holdings[1]. Long-term investors, like Railpen, use a range of tools to help us influence the behaviour of our portfolio companies in a way which supports long-term value creation in beneficiaries' best interests. 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].

As the paper recognises, a move to DCSS provides the owners of certain share classes with superior voting rights, giving them voting control over a company which 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 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 minority shareholders – is diminished and 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].

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[1] This includes the 2018 and 2019 changes to the *Occupational Pension Schemes (Investment) Regulations 2005* and the *Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013*, as well as the work of the Pensions Climate Risk Industry Group (PCRIG) on climate stewardship guidance for schemes and the recent recommendations of HM Treasury's *Asset Management Taskforce* on stewardship.
[2] For further details on our approach to stewardship and ESG integration, please see our *Sustainable Ownership Annual Report*s which 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

The consultation paper notes that DCSS is currently allowed in other jurisdictions. However, there is a growing body of evidence from these countries which demonstrates that companies with DCSS structures underperform companies with dispersed voting rights over the long-term[5]. We believe that the implications for the UK from allowing DCSS would be to reduce the attractiveness of UK-listed companies to investors and this would ultimately have a detrimental impact on the availability of the kind of long-term, patient capital the government is keen to encourage and, in turn, on the UK economy.

We believe that holding to the principle of one-share, one-vote has been a fundamental ingredient in the UK's success as a global financial market, which allows for effective and robust investor oversight of and influence on companies, and we strongly urge HM Treasury not to permit dual-class share structures in the Premium-listed Segment of the London Stock Exchange.

<u>Alternative approaches</u>

The *Call for Evidence* asks whether there are other ways of "ensuring London's high standards of corporate governance are maintained while allowing DCSS in the Premium segment". Although our strong preference is to continue with one-vote, one-share, we briefly highlight some developments which might, if designed well and carefully implemented, mitigate some of the key risks associated with DCSS.

- <u>Mandatory time-based sunsets</u>. This mechanism would mean that those shares with superior voting rights would automatically convert to regular voting rights on a one-share, one-vote basis after a specific and pre-agreed period. We are conscious that there is currently a debate around the appropriate maximum period for such sunsets. We think that a staggered withdrawal across a 3-5 year time horizon with, say, a move to close at least 50% of this gap within 3 years and a further 2 years to convert the remainder, would be a suitable compromise.

  We think that a 'hard-stop' maximum of 5 years would be sufficient given that many issuers are coming to the market at a later point in their lifecycle, and are usually large and established by the time they list on an exchange. The effectiveness of this mechanism could be maximised through additional protections, such as:

  a) A limitation on the maximum allowable voting differential;
  b) A reversion to one-share, one-vote on Related Party Transactions (RPTs) and large transactions which have the ability to fundamentally impact business operations; and
  c) Requirements for companies with DCSS to implement remedial measures in response to significant shareholder dissent on key votes from those without superior voting rights (20% in line with current practice).

- <u>Index inclusion</u>. It is reasonable to assume, given the risks to passive investors outlined above, that in the event of a shift to permitting DCSS, long-term investors would seek to re-open recent debates on index inclusion including a discussion as to whether those shares with reduced voting rights should have their weighting in the index reduced by a commensurate amount. MSCI,

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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.*

S&P/Dow Jones and FTSE Russell have all undertaken consultations in recent years on this and related issues[6]. While some small changes were made, there was no fundamental reform of the kind which might be necessary with a move to permitting DCSS. Were this to happen, we think that there would be merit in re-considering these or similar proposals in recognition of the importance of voting rights to investors.

Free Float Requirements

We believe that the current free float requirement is calibrated at around the right level at 25%. We think that any less would give too much influence to controlling shareholders and dilute the potential capacity for influence by minority shareholders in a way which would be detrimental to long-term corporate success, as per our views on DCSS structures above. There is also evidence to demonstrate that the increase in minimum UK FTSE free float requirements in 2011, from 15% to 25%, had a positive impact on stock liquidity[7].

However, if a change were to be made, we believe that using this opportunity to increase the proportion of the required free float to, for instance, 30% could be a powerful signal of the government's commitment to supporting shareholders to act as engaged stewards of their assets and further enhance the UK's attractiveness to global investors.

Conclusion

The UK is an attractive place to invest, in large part because of its investor-friendly approach, with a robust regulatory regime which includes strong protection for minority shareholder rights. We do not believe that either the UK economy or its financial services sector is best served in the long-term by seeking to dilute these protections in a "race to the bottom".

In a world where the benefits of long-term, responsible investment are becoming increasingly clear, and where the current UK government has committed to supporting institutional investors to act as engaged and long-term stewards of their assets, it does not make sense to change the regulations in a way which fundamentally diminishes the impact of the key tools we require to do so.

We hope that the views and the evidence we present here have been helpful. We would welcome the opportunity to continue the conversation – please do get in touch if this would be of interest.

Yours sincerely,

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[6] Please see "Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes" (MSCI, 2018).
[7] Please see academic evidence cited (El Nader (2018)) in *Annex 1.*

Annex 1 – Summary of relevant academic evidence

We aim to provide a very brief summary of the available academic research on dual-class share structures here. We hope that this gives a flavour of the evidence.

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.