

Position paper: Hermes' approach to loyalty dividends

There has been increased attention paid to the concept of the so-called 'loyalty dividend', which would offer an increment to the company's dividend for those shareholders who have held the stock for a certain period of time.

This is an idea – in existence in France for some time – which has gained some currency in recent years, particularly in the Netherlands. This position paper suggests Hermes' general approach to such proposals.

Arguments for a loyalty dividend

1. Incentive to long-termism

The basic argument for a loyalty dividend is that it recompenses long-term holders for being long-term investors. It provides compensation for revenue that might otherwise be earned from stocklending, and provides a revenue stream that could be reinvested in long-term ownership activities such as Hermes Equity Ownership Services.

2. Encouragement to transparency

The argument that has been made by companies is more about transparency of ownership. In the context of a system generally reliant on bearer shares, investors would need to register their shareholding in order to qualify for a loyalty dividend. This would avoid situations of creeping control and enable companies to have more direct contact with its investors – and know the scale of investors' shareholdings more readily.

Arguments against a loyalty dividend

1. Breach of principle of equality of treatment

The fundamental argument against such loyalty dividends is that they breach the principle of equality of rights and treatment between members of a single class of shares. In effect, those shareholders which invested in the short-term or chose not to register their shares would be subsidising the investment of others.

2. Danger that this system automatically discriminates against institutional investors

Because of the complexity of the ownership chain between the beneficial owner and the company – with fund managers, custodians and sub-custodians acting as intermediaries – and the administrative changes which occur among these intermediaries, a beneficial owner who has indeed held shares for more than three years may often not qualify for purely technical reasons. For example, a beneficial owner may change its fund manager and yet continue as a shareholder; this may well register as a change as far as the company is concerned. The administrative complexity of institutional ownership will mean such changes occur more often for them and so there will be a discrimination against such investors in favour of retail holders.

3. Better ways to encourage transparency

Those investors which wish to stay invisible for their own reasons will have the scope to stay as bearer shareholders. If they believe the value of secrecy outweighs the enhancement to the dividend – which it seems likely those investors that companies

are most concerned about will – they will not register their shares and will happily forego the loyalty dividend. If a company is concerned to create greater transparency, it should in its articles – or through encouraging legislative change – seek to replace the archaic bearer share system with registered shares. We would certainly happily support such a change.

4. Unintended consequences

A loyalty dividend may encourage the creation new structures which lack transparency. For example, it may encourage more trading of instruments like contracts for difference, with the prime broker holding a float of shares – perhaps long-term enough to qualify for the loyalty dividend – but with the underlying beneficial ownership happening without any transparency in another instrument.

It may distort the market for the company's shares. Its advocates suggest a loyalty dividend will not do so because the shares would always trade ex-loyalty dividend so fungibility should not be affected. However, if the loyalty dividend has any impact on investment behaviour at all – which must be the intention – it will reduce liquidity in the shares, as long-term holders hang on, and trading decisions become delayed around the point of qualifying for the dividend. This seems likely to make the shares less liquid and the share price stickier but more prone to abrupt and larger changes rather than moving in a smoother, less volatile way. It will also increase the interest paid for stocklending. If this increase is sufficient to outweigh the loyalty dividend, no significant benefit will have been added in return for the additional cost burden on the company.

Proposed Hermes position

On balance, we will oppose proposals to introduce unequal treatment of shareholders through loyalty dividends.

Instead, we would encourage the following:

- For companies to look forward to the benefits of the Transparency Directive playing out in greater knowledge of the shareholder base for companies and the market as a whole.
- A greater use of mechanisms such as proxy solicitation as long-term investors will be happy to provide information on their shareholdings.
- The replacement of archaic bearer share systems with registered shares, to drive greater transparency.
- Greater disclosure obligations on contracts for difference and other derivative positions
- Institutional investors recognising that ownership activity has a value which significantly outweighs the cost, rather than relying on individual companies to point this out.