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New PIRC report on Democratic Deficit in Stewardship

Investor stewardship in relation to mergers and acquisitions is a "black hole" in the UK's governance framework, according to analysis by PIRC. Our report, *Democratic Deficit: Takeovers, Derivatives and Stewardship*, highlights the role of derivatives and its impact on voter turnout during mergers and acquisitions (M&A).

Having reviewed shareholder voting at company meetings held during a takeover, PIRC has found turnout dropping by an average of almost 25%. At a string of company meetings, less than half the shares were voted even when the meeting was seeking approval to proceed with the takeover. In three cases, less than a third of shares were voted.

The sharply reduced turnout appears to be a side effect of the large derivative positions built up by some funds that trade around takeovers. It appears that counterparties acquire the underlying equity but do not typically vote it. However, as neither the funds nor their counterparties disclose policies on the exercise of voting rights, the true picture is unclear.

The use of derivatives to gain exposure to companies that are subject to takeovers can lead to very large total positions. By compiling filings issued during takeovers PIRC established that in some cases the total derivative positions in the shares of targets have exceeded 40%.

Despite the significant economic interest that funds acquire in companies during takeovers a number of the major players state that they have chosen not to comply with the Stewardship Code. More generally, despite investors producing ever greater reporting on Responsible Investment and stewardship, commentary on their approach to changes in company ownership is limited.

Tom Powdrill, PIRC's Head of Stewardship, said: "Changes in ownership and control represent one of the most fundamental transformations that companies go through. It ought therefore to be an area of heightened stewardship activity. Instead, we see that turnout typically falls dramatically, leaving a black hole in stewardship. This deserves proper attention from investors and regulators."

In response to its findings, PIRC has made a number of recommendations:

1. The Takeover Panel should undertake a further review of the role of derivatives in takeovers, taking specific account of the impact on voting turnout, with a view to issuing further guidance.
2. The FRC/ARGA should review stewardship issues relating to M&A activity with a view incorporating guidance for more commentary on these topics in the next iteration of the Stewardship Code.

3. Investors that regularly utilise derivatives during takeovers should be required to state their approach to a) interacting with management of target companies b) the acquisition and utilisation of voting rights.
4. Counterparties to derivative holders should be required to state their approach to the utilisation of voting rights where they hold the equity at the time of a meeting.
5. In the event of a significant reduction in voting turnout (upwards of 20%) companies should be required to issue a statement setting out their understanding of why this has occurred. This statement should identify shareholders with interests of 1% or more that are known to have not voted. This need not apply only to companies in a takeover process.
6. The Investment Association should expand its register of ‘significant votes’ to include ‘significant turnout issues’. Any company recording turnout of under 50% should be added to this list. Again, this need not apply only to takeover-related meetings

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Pensions & Investment Research Consultants Ltd (PIRC) is Europe’s largest independent corporate governance and shareholder advisory consultancy with over 25 years’ experience in providing proxy research services to institutional investors on governance and other ESG issues. Our clients encompass major institutional shareholders, faith-based investors, trade unions and other responsible investors.

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