

EPFSF Briefing: Shareholder Rights

Background

In May 2003 the Commission published its Communication “Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward”. This Action Plan for Company Law had been invited by the Competitiveness Council in September 2002 and responded to the Final Report of the High Level Group of Company Law Experts chaired by Jaap Winter, presented in November 2002, which had focused on corporate governance in the EU and the modernisation of European Company Law.

The Action Plan identified two key objectives for legislative and non-legislative proposals:

- to strengthen shareholder rights and third party protection, with a proper distinction between categories of companies, and
- to foster the efficiency and competitiveness of business, with special attention to some specific cross-border issues.

Recent Initiatives under the Action Plan

This briefing paper considers three specific initiatives arising from the Action Plan: (1) the proposal for a shareholder rights Directive focussing on participation in Annual General Meetings (AGMs); (2) the creation of a European Corporate Governance Forum and later an Advisory Group; and (3) a consultation on future priorities for the Action Plan.

1. Proposal for a shareholder rights Directive¹

The Commission launched two *public consultations* in September 2004 and May 2005 on facilitating the exercise of basic shareholders' rights in company general meetings and solving problems in the cross-border exercise of such rights, particularly voting rights. On 5 January 2006 the European Commission presented a proposal for a Directive to facilitate the cross-border exercise of shareholders' rights in listed companies whose shares were admitted to regulated markets, through the introduction of “minimum standards”.²

Attached to the proposal, the Commission published an *Impact Assessment* (IA). Within this IA the intended impact (the operational objectives) is described as reducing the cross-border voting costs both so as to increase cross-border voting rates and to increase cross-border share ownership. The underlying economic assumption in the IA based on various studies is that “isolated issuers” have a tendency to enjoy a “quiet life” resulting in declining productivity for the company. Therefore, increasing shareholder participation would permit European companies to reap the full economic benefits of good governance and efficient resource allocation, as facilitated by proxy voting contests which allow disagreements on corporate strategy between incumbent management and shareholders to be aired.

The IA supports the view that a Directive mainly prescribing minimum standards in Member States would be an adequate vehicle for removing the relevant obstacles. It describes this proposal as “a mix of regulation and deregulation”, since it would alter many aspects of the current legal organisation of proxy voting in the Member States. An important part of the costs of the present situation is said to be the opportunity cost of not intervening: the removal of obstacles to cross-border voting is expected significantly to increase the voting record of institutional shareholders and should make cross-border voting for small individual shareholders a real possibility in the near future. Some additional costs were identified to be borne mainly by the issuers or intermediaries.³ The IA further indicates that proxy voting agencies business would be facilitated, and their profitability increased⁴.

¹ COM(2005)686, 05/01/2006 <http://tinyurl.com/o36my>

² http://europa.eu.int/comm/internal_market/company/shareholders/index_en.htm

³ SEC(2006)181, 17/02/2006 <http://tinyurl.com/o3yxs>

⁴ As indicate in the IA, proxy agencies charge global “flat fees” for a client, whatever the specific costs of individual countries they will have to reach for him (cf. p. 13)

1.1 The entitlement to control the voting right (Art.2(c))

The first consultation considered one of the central issues in the Winter Report; the entitlement to control the voting right. The entitlement of shareholders to vote is principally determined by the constitution of a company. It either accrues to the person legally registered with the company as the shareholder, or with the bearer. Where shareholders invest cross-border in shares held through chains of securities intermediaries, the voting right often accrues to the intermediary, rather than to the shareholder. These intermediaries can may be local or global custodians or stockbrokers' omnibus accounts. The consultation asked whether the issue of entitlement to control the voting right has to be addressed by a Directive establishing a framework to identify the person entitled to control the voting right as the last natural or legal person holding a securities account in the "chain" of intermediaries, provided that such person is neither a securities intermediary within the European securities holding systems, nor a custodian.

Respondents to the first consultation strongly supported the principle that the person running the risk of the investment should have the right to direct how his shares are voted, but in its second consultation the Commission pointed out that both this definition and the one of UNIDROIT ("the legal or natural person that holds a securities account for its own account") could be difficult to apply given the breadth and diversity of EU legal and commercial systems and therefore may not help facilitate the cross-border exercise of shareholders rights.

Consistently, the published proposal for the Directive no longer pursues a solution based upon a definition but rather qualifies as a shareholder "any natural person or legal entity governed by private or public law that holds:

- (i) shares of the issuer in its own name and on its own account;
 - (ii) shares of the issuer in its own name, but on behalf of another natural person or legal entity".
- Holders of depositary receipts are excluded from the scope of the proposed Directive and will be dealt with by a specific recommendation.

1.2 Shareholder rights and participation

Taking stock of the results of the two consultations on the dissemination of information pre and post AGM, the admission and participation in the AGM and the shareholders' rights in AGMs, the Commission has now proposed the following minimum standards which are designed to eliminate the main obstacles in the cross-border voting process and enhance certain other rights of shareholders:

- AGMs should be convened with at least one month's notice. All relevant information should be available on that date at the latest, and posted on the issuer's website. The meeting notice should contain the minimum necessary information, as identified by the proposed Directive. (Art. 5)
- In some countries, shareholders wishing to vote currently must block their shares, for instance by depositing them with a designated depositary shortly before the date of the AGM (usually one week). This share blocking requirement is to be abolished and replaced at most by a record date system, where the record date should be set no earlier than 30 days before the meeting. (Art. 7)
- Requirements and constraints that would act as a barrier to electronic participation in meetings-voting and asking questions - are to be removed. The Commission has explained however that this leaves the decision whether to enable participation by electronic means to the companies' discretion (Art. 8)
- The right to ask questions should be accessible to all shareholders, also by post or electronically prior to the AGM, but can be limited in order "to ensure the good order of general meetings and their preparation and the protection of confidentiality and business interest of issuers" (Art. 9).
- The maximum shareholding thresholds to benefit from the right to add items to the agenda and table draft resolutions should not exceed the lowest of 5% of the share capital or € 10 million, in order to grant this right to a greater number of shareholders while preserving the good order of general meetings. (Art. 6)

- Proxy voting should not be subject to excessive administrative requirements, nor should it be unduly restricted. Shareholders should have a choice of methods for distance voting. (Art.10 - Art.13)
- Voting results and answers to all questions should be available to all shareholders and posted on the issuer's website. (Art. 15 and Art.9(3))

The Commission has stated that reactions during the consultations were not favourable to extending the scope of any EU legislation to securities other than shares. Nevertheless, Member States would be free to extend the scope of application of their transposition measures to holders of other securities (e.g. holders of certain bonds) which give a right to take part in Special Meetings.

1.3 Industry Responses

Responses from industry to the Commission's proposals (both as regards 1.1 and 1.2) reflect a mix of (i) technical concerns, which are likely to be addressed through drafting amendments; (ii) technological challenges relating to electronic participation and to whether the proposals are realistic; and (iii) concerns on the potentially risky interaction of the proposed Directive with the existing domestic legal systems of Member States.

For example, the wide legal definition of "shareholder" as one which holds shares on behalf of someone else would allow any intermediary to qualify as a shareholder and to fully exercise any aspect of their rights, including in the absence of any instruction (or knowledge) from the underlying shareholder.

Another legal concern raised by some respondents is that the proposed directive does not put in place any means to ensure that proxy holders receive a mandate and instructions, transmit and respect them. In the current proposed directive, the proxy holder and proxy ballot processing do not have any obligation of traceability or transparency, which would facilitate proxy rights led by corporate raiders.

2. Creation of the European Corporate Governance Forum and the Advisory Group

2.1 Corporate Governance Forum

In October 2004 the Commission announced that it was to set up a European Corporate Governance Forum to examine best practices in Member States with a view to enhancing the convergence of national corporate governance codes and providing advice to the Commission. The Forum comprises fifteen senior experts from various professions with experience and knowledge of corporate governance.

2.2 Advisory Group

In April 2005, the Commission set up an expert advisory group, comprising twenty non-governmental experts from various professional backgrounds, to provide detailed technical advice on drafting corporate governance and company law measures.

In its November 2005 meeting a number of the members of the Advisory Group stressed, *inter alia*, the need to pay continued attention to (1) SMEs in the context of the Lisbon Agenda; (2) the need to ensure that protections for shareholders do not lead to unworkable or over burdensome situations; (3) the right for shareholders to add items to the agenda for AGMs only; (4) the importance of not only facilitating cross-border voting, but also of putting the mechanisms in place to make the voting policies of institutional investors more transparent in order to tackle the problem of rational apathy.

3. Consultation on future priorities for the Action Plan

In December 2005, the Commission launched a public consultation on future priorities for the Action Plan for response by 31 March 2006. Before the Commission moves too far into the medium and long term measures, and having regard to the Lisbon agenda and the better regulation initiative, the consultation seeks to evaluate the overall aim and context for future priorities, as set out in the Commission's Action Plan on "Modernising Company Law and enhancing Corporate Governance in

the EU” published in May 2003, with the intent of ensuring companies are well run and competitive. Notable themes concerning shareholders’ rights include:

- The one share, one vote principle: A variety of exceptions to this principle exist, whether in the form of multiple voting rights, voting right ceilings, preference shares, depositary receipts or non voting shares. These exceptions enable shareholders to control companies without bearing the financial risk embedded into proportional shareholding. In some countries the principle is the exception rather than the rule.
- What constitute basic shareholder rights, including the right to nominate and dismiss directors; the right for shareholders to communicate with one another to co-ordinate voting; and the right to require an investigation into the conduct of company affairs.
- The appropriateness of requiring institutional investors to disclose their policies with respect to the voting rights in companies in which they invest and also to disclose to their beneficial holders, on request, how these rights have been exercised in a particular case.

It is in the context of better regulation that the Commission will decide whether to table a further legislative proposal focusing on the content and scope of shareholders’ rights, rather than the technicalities of their exercise in the context of AGMs. In the former case the multiplicity of company laws and business cultures, not least the important difference between monist and dual board structures and the question of stakeholders’ rights such as employee representation, could conflict with the aim of defining common rights and processes in the EU.

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Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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