

Paper of the European Corporate Governance Forum Working Group on Proportionality

Executive summary

The relevant EU objectives

Any assessment of the need for regulatory intervention by the Commission should be made against the background of the overarching EU policy objectives. One of the key policy objectives set by the Council of Ministers and the Commission in this area is to remove the remaining economically significant barriers so financial services can be provided and capital can circulate freely throughout the EU at the lowest possible cost. In addition the objective is to create wider conditions for an optimal single financial market, including an efficient and transparent legal system for corporate governance and favourable conditions for the emergence of a European market for corporate control. In terms of regulatory approach, the Council recently reiterated the need to enhance the "better regulation" agenda to create a more dynamic business environment.

The empirical and analytical academic research conducted so far into the effect of disproportionate structures on the value of the firm do not provide conclusive evidence on the effect of such structures on the stated policy objectives. Hence the need for an objective framework for further analysis which this paper aims to offer.

Deviations from the proportionality principle

This paper begins by making a distinction between different disproportionality dimensions, distinguishing between (i) a first ring of mechanisms included in the company's constitutional documents directly affecting the of voting right attached to each share, (ii) a second ring of mechanisms included in the company's constitutional documents not affecting the voting rights per share but creating specific rights reducing or inhibiting the proportionate exercise of voting rights, (iii) a third ring of mechanisms included in the company's constitutional documents reducing or inhibiting the exercise of control through the exercise of voting rights and (iv) a fourth ring of mechanisms not included in the company's constitution but developed in the market and affecting the effective exercise of proportionate voting rights. Examples of the latter category include the decoupling of voting rights and economic ownership through market instruments such as securities lending, contracts for difference and call/put options.

A distinction along these lines could serve as a framework for analysis of the various disproportionate control mechanisms and their specific objectives and effects. Only such a granular approach can help to get a sufficient understanding of the differences in objectives and effects of the various mechanisms; differences which may be of decisive importance in setting policy responses. The final report of the ISS Study contains an inventory and explanation of the various disproportionate control mechanisms applied in the EU and could serve as a useful starting point for such a detailed analysis on the basis of which firm conclusions could perhaps be drawn.

Assessment of the merits of various mechanisms

The 2002 report of the High Level Group of Company Law Experts on takeover bids took the position that proportionality between ultimate economic risk and control means that share capital which has an unlimited right to participate in the profits of the company or in the residue on liquidation, and only such share capital, should normally carry control rights in proportion to the risk carried, as the holders of these rights to the residual profits and assets of the company are best equipped to decide on the affairs of the company because the ultimate effects of their decisions will be borne by them. This illustrates why, in general, proportionality is sensible, and deviations from the principle deserve to be reviewed critically. Such deviations may, however, (also) serve to attain competing policy objectives. Accordingly, an assessment is needed of the merits on balance of the relevant mechanisms. The outcome of such assessment may be different for each mechanism, and cost-benefit analysis could show that in some cases the benefits of pursuing competing policy objectives outweigh the benefits of adhering strictly to the proportionality principle. It therefore does not appear to be justified to conclude that the mere fact that certain mechanisms deviate from the proportionality principle, should cause such mechanisms to be judged negatively. Notably, the concept of the company as a “shareholder democracy” does not constitute a compelling argument.

This means that we should investigate the specific effects and behaviours caused or facilitated by deviations from the proportionality principle, in order to assess whether such deviations are problematic. This paper discusses four key areas of concern: (i) board entrenchment; where deviations allow for full board entrenchment this would be unacceptable from a corporate governance perspective, (ii) extraction of private benefits by the controlling shareholder; deviations may offer increased incentives to the controlling shareholder to extract private benefits to the detriment of other shareholders, (iii) incontestability of corporate control; deviations reduce the contestability of corporate control, obstructing the operation of market judgements and (iv) ineffectiveness of corporate governance codes based on comply or explain; deviations facilitate the avoidance by the controlling shareholder of the full effect of a corporate governance code and the comply or explain mechanism.

Competing objectives

While assessing the deviations from the proportionality principle in light of these concerns, we should consider competing objectives that may be furthered by such deviations and whether such objectives provide a justification. The deviations should be suitable to achieve the objectives and proportionate to achieving such objectives. The following competing objectives have been suggested: (i) monitoring by the controlling shareholder; there may be merit in this monitoring role but deviations nonetheless become problematic when the extraction of private benefits exceeds the benefits to other shareholders generated by such monitoring, specifically when control is entrenched by such deviations, (ii) access to capital markets; deviations from the proportionality principle may provide an incentive to entrepreneurs to list their companies on a stock exchange in order to have access to additional capital while retaining control, but the trend appears to be to a reduced use of deviations at initial public offerings, (iii) long term and stakeholder protection; the objectives put forward in this area are often sincere but there is doubt as to whether the means to further these objectives are always proper and justified and sometimes they may be in breach of free movement of capital and freedom of establishment and (iv) freedom of contract and efficient competition; these arguments rightly place the onus on those who plead for regulatory intervention to justify it.

General considerations for a regulatory response

In determining whether the mechanisms which are judged negatively on balance warrant regulatory intervention, some general considerations should be taken into account. First, the feasibility of regulatory intervention depends to some extent on the nature of the disproportionate mechanisms deployed. For example, this is difficult to determine in the case of “decoupling” mechanisms that allow for the exercise of voting rights without a corresponding economic ownership through the use of derivative securities. Second, any regulatory response should be proportionate to the problem observed and in particular a less intrusive response should be preferred. Third, developments on the global stage should be duly considered when considering a regulatory response in the EU; but ultimately EU policy in this respect should primarily be driven by the policy objectives for its own integrated capital markets. In short, the case for intervention depends on the strength and character of the policy concerns in the particular case and the availability of proportionate regulatory tools which are apt to address them.

Possible regulatory tools

If (i) certain mechanisms are to be judged negatively on balance, (ii) such mechanisms inhibit the achievement of EU policy objectives and (iii) regulatory intervention at EU level is desirable, the question arises which measures would be appropriate. This paper discusses some possible regulatory tools in order of intrusiveness, and argues that the focus of any regulatory intervention should first be directed to disclosure. Disclosure obligations could be imposed in different forms and at different levels, see our summary Recommendations below.

Other, more far-reaching measures could include (i) specific rules to prevent or correct inappropriate use of control, (ii) incidental application of mandatory proportionality, (iii) periodic application of mandatory proportionality and ultimately (iv) full mandatory proportionality.

Recommendations

Short term: improvement of disclosure obligations, targeting of obvious problems

We believe there is a strong case for the Commission in the short term to initiate measures that would improve the transparency of mechanisms that deviate from the proportionality principle and their application in practice. Improved disclosure requirements would facilitate markets in making better judgements and valuations of these deviations, which may result in a move away from the more detrimental mechanisms. It would also enhance our understanding of the mechanisms applied and their effects at a more granular level. We recommend the following elements of an enhanced disclosure regime:

- Companies should, in addition to the disclosure obligations pursuant to article 10 of the EC Directive on Takeover Bids and the disclosures under the Transparency Directive, be required to provide more detailed transparency on disproportionate mechanisms applied by them. Such disclosure obligations could in particular include the obligation to provide for a reasoned explanation of the objectives and effects of the mechanisms applied, and the suitability and proportionality of the mechanisms applied to achieve such objectives.
- Shareholders who derive a voting position from such mechanisms exceeding a certain threshold, say 10% of the total votes that can be cast in a meeting, or hold specific control rights, such as the right to make binding nominations for board positions, should also be required to provide insight into the size and nature of their shareholdings as their policy on the exercise of the relevant powers. While we acknowledge that policies may change, disclosure will make them subject to public and market criticism and may have the effect (albeit slight) of raising the bar for policy changes. Some explanations will be unacceptable in market and even legal terms. Such explanations may also be relevant where “public interest” policies are invoked (see below). Such additional disclosure by shareholders would also be relevant in the context of the parallel agenda on investor responsibility referred to in section 6 (i).
- Companies and shareholders should also be required to provide more transparency on the actual usage of disproportionate mechanisms. For instance, in addition to the existing obligations to disclose related party transactions in annual accounts pursuant to IFRS, ad-hoc disclosure obligations should be imposed in respect of specific related party transactions, e.g. any related party transaction not entered into on an arm’s length basis or any related party transaction in excess of certain balance sheet or revenue criteria. Disclosure should also be required on the effect of deviations on the outcome of voting by shareholders in case of certain key resolutions. Ideally, one would also like to impose a requirement to disclose any non-monetary private benefit extracted by a controlling shareholder, but a meaningful disclosure of

such benefits may be difficult to achieve.

- In addition to disclosure by companies and shareholders and building on such disclosures, the Commission should require Member States to provide the Commission annually with comparable information regarding application of disproportionate structures in their jurisdiction to the extent they have been disclosed. Such an obligation could build on the obligation of Member States to provide the Commission with information on takeover bids that have occurred and their results, see article 20 of the Takeover Bids Directive. Member States could also be asked to explain to what extent their company laws or securities laws contain any countervailing measures addressing the concerns raised by the use of disproportionate mechanisms generally, to make judgements on their effectiveness and to indicate what measures they are considering where they find that the measures in place are not sufficiently effective. Member States should specifically be asked what mechanisms are applied that offer the ability to create incontestable board entrenchment and what measures, if any, they intend to take in order to remove that ability.
- Public or semi-public agencies or private entities which as shareholders make use of disproportionate mechanisms in order to further public interest objectives, should be required to provide more transparency on the public objectives they seek to achieve and the mechanisms applied, including an explanation of their suitability and proportionality in view of their accountability to other shareholders and the market.
- Specific disclosure obligations should be considered in respect of the use of mechanisms decoupling voting rights and economic ownership in derivatives markets as referred to above. Such obligations could be imposed either generally whenever shareholders are invited to vote on resolutions, or specifically when certain corporate events occur, such as the announcement of a takeover offer. Shareholders holding in excess of a certain percentage of outstanding share capital, say 1 or 3%, should be required to disclose to what extent and by what means they have reduced or increased their economic risk resulting from the shareholding.

In addition to increased disclosure we believe four issues warrant a more substantial approach on the short term.

- Instances where full board entrenchment is achieved. The Commission should communicate the view that full board entrenchment is unacceptable from a corporate governance perspective in a Recommendation to Member States.
- Instances where public, semi-public or private entities as shareholders use disproportionate control rights to further public objectives or, more generally, for purposes which are not aligned with shareholders' typical primary interests. This paper argues that the law on free movement of capital and, to the extent relevant, freedom of establishment, may offer a fruitful avenue to be explored in order to restrict the use of disproportionate mechanisms applied to further

public objectives to limits which are acceptable under the Treaty.

- Concerns raised by decoupling of voting rights and economic ownership through market instruments such as securities lending, contracts for difference and call/put options, which mechanisms may affect the effective exercise of proportionate voting rights.
- In addition to further disclosure requirements, the EU should focus efforts on the technicalities surrounding the voting architecture, such as the role of securities intermediaries in the voting process on behalf of their clients. The voting architecture in the EU is seriously underdeveloped, as a result of which companies are unable to identify their shareholders, and shareholders cannot efficiently exercise their voting rights across borders. Companies and their shareholders as a result are vulnerable to exercise of significant voting rights by just a few shareholders. The role of securities intermediaries is crucial in this respect. This role has only partially been addressed in the Shareholders' Rights Directive and requires further attention as a matter of urgency. The role of investors is crucial, too. There is a case to be made that institutional investors have a duty of their own to exercise their rights attaching to shares in a responsible manner on behalf of the beneficiary. In this regard, improved disclosure on e.g. size and nature of shareholdings and voting policy and practices will contribute to enabling beneficiaries and market participants in general to monitor institutional investors' behaviour.

Longer term: obtaining more data and further analysis

From our preliminary analysis it is clear that there are many elements that require further analysis before meaningful conclusions can be drawn. While we appreciate that full certainty will never be achieved, we believe that our current information and understanding are simply insufficient to justify further or more general substantive regulatory intervention.

The enhanced disclosure that could be imposed on the short term would help to get meaningful data as a basis for further analysis. This paper concludes by providing an indication of the issues that should be addressed as part of such analysis.

**Paper of the European Corporate Governance Forum
Working Group on Proportionality**

1. Introduction

The EU Commission has commissioned a Study into the application of the so called proportionality principle, i.e. the principle of proportionality between ultimate economic risk and control in the sense that share capital which has an unlimited right to participate in the profits of the company or in the residue on liquidation, and only such share capital, should normally carry control rights, in proportion to the risk carried. The Study was intended to identify existing deviations from the proportionality principle across EU listed companies, to analyse the relevant regulatory framework at Member State level, and to evaluate the economic significance of such deviations and whether they have an impact on EU financial investors. The final report of the Study has been submitted to the Commission and published in May 2007.

Commissioner McCreevy has indicated to the Forum that he considers the impact of a Recommendation to Member States on, amongst others, the issue of proportionality in the course of 2007.

The Forum has set up a working group to prepare this discussion paper. The group consists of three Forum members, José Garrido Garcia, Jaap Winter and Eddy Wymeersch, and three members of the former High Level Group of Company Law Experts, Klaus Hopt, Jonathan Rickford and Jan Schans Christensen. A preliminary version of this paper has been discussed among Commissioner McCreevy and some Forum members during a meeting which was held in March 2007. The Forum discussed the preliminary and final versions of the paper in its meeting on April 12 and June 19, 2007. The views expressed in this paper are the views of the members of the working group and not necessarily the views of the Forum as such. It is up to the Forum to adopt these views in whole or in part or not.

The proportionality principle and the question of regulatory intervention in order to either impose or further its application are complex and contentious matters. The primary purpose of this paper is to set out an objective framework for analysis that could be used properly to distinguish the relevant issues and arguments and evaluate them, to understand where further analysis or information is required before conclusions can be drawn and to make recommendations on what can and should be done in the short term and what requires further investigation and analysis.

This paper proceeds as follows. It first enumerates the relevant high level objectives of the EU and the way EU company law and securities law can further these objectives in this context (section 2). It then discusses the deviations from the proportionality principle as observed at company level in Member States (section 3), followed by a framework for the assessment of merits and problems of such deviations. This framework first set out the concerns caused by deviations from the proportionality principle (section 4) and then describes certain competing policy objectives that may be furthered by such deviations (section 5). The paper then discusses certain general considerations that should be taken into account in determining whether the problems identified in section 4 warrant regulatory intervention (section 6) and the possible regulatory tools available (section 7). It concludes with recommendations (section 8).

This paper is, like the Study, restricted to the proportionality principle and its application to companies incorporated in the EU and listed on an EU stock exchange.

2. The relevant EU objectives

The Commission's efforts in the area of company law and financial services are based on freedom of establishment, freedom to provide cross border services, and free movement of capital as set out in articles 43, 49 and 56, respectively, of the Treaty establishing the European Community. On this basis, the Commission has set several policy objectives on different occasions over the recent years, of which the following appear particularly relevant in the context of the present analysis:

EU Company Law Action Plan (2003)

- 'facilitating freedom of establishment of companies: the harmonisation of a number of minimum requirements makes it easier for companies to establish themselves in other Member States where the regulatory framework is similar'
- 'guaranteeing legal certainty in intra-Community operations, where the presence of a number of common safeguards is key for the creation of trust in cross-border economic relationships'
- 'strengthening shareholders rights and third parties' protection', inter alia to enable companies to raise capital at the lowest possible cost
- 'fostering efficiency and competitiveness of business'

Financial Services Action Plan (1999)

'a single EU wholesale market', in order, in particular, to 'enable corporate issuers to raise finance on competitive terms on an EU-wide basis'

- 'to create wider conditions for an optimal single financial market', including 'an efficient and transparent legal system for corporate governance'

White Paper on Financial Services Policy (2005-2010);

- to 'consolidate dynamically towards an integrated, open, inclusive, competitive, and economically efficient EU financial market'
- to 'remove the remaining economically significant barriers so financial services can be provided and capital can circulate freely throughout the EU at the lowest possible cost'

Lisbon Strategy / 2005 Community Lisbon Programme

- 'to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth, with more and better jobs and greater social cohesion'
- 'full integration of financial markets', contributing to raising output and employment 'by allowing more efficient allocation of capital and creating better conditions for business finance'

Commission's vision for the single market of the 21st century (February 2007)

- to make the internal market work better in the interest of, amongst others, a sustainable Europe, recognising 'the social and environmental aspects of the single market' in order to gain public confidence

Presidency Conclusions (March 2007) / Commission's strategic review of Better Regulation in the European Union (November 2006)

- 'enhance the better regulation agenda to create a more dynamic business environment'

Market for corporate control

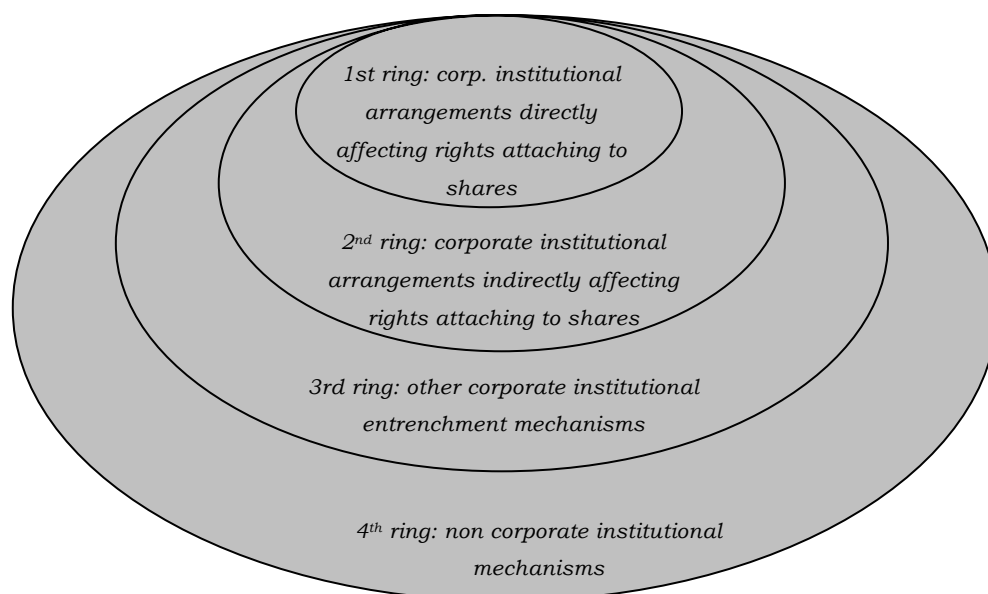
These objectives involve the facilitating of the market for corporate control. Indeed, the principle of contestability of control is reflected in the EC Directive on Takeover Bids, in particular recitals 16 (no frustration of bid), and 19 (offeror must be able to acquire control) and general principle (c) in Article 3(1) (board to act in interests of company and not to deny shareholders the opportunity to decide on the merits). By making control over listed companies contestable, companies are enabled to restructure efficiently and to develop to optimal size and scope of activities in light of EU and global markets. In addition, the mere existence of a market for corporate control (specifically, the threat of a takeover bid in case of underperformance) has a disciplining effect on management. Accordingly, the creation of a market for corporate control would be consistent with, and could contribute to realisation of, the aforementioned policy objectives. The Commission reconfirmed its view in the recent working paper on the implementation of the Takeover Bids Directive (21-02-2007), acknowledging that takeovers 'discipline management and stimulate competition', and that the aim of the Commission's proposal was 'to promote integration of European capital markets by creating favourable conditions for the emergence of a European market for corporate control'.

As far as we are aware, there is no conclusive empirical academic research available demonstrating that the existence of deviations from the proportionality principle negatively affects the stated

objectives, in particular of creating competitive capital markets with access to capital against attractive costs of capital. Nor does the empirical and analytical economic and financial research conducted so far into the effect of deviating structures on the value of the firm provide evidence that such effect is always or mostly negative. Rather the desktop study conducted by the ECGI as part of the Study indicates that the prevailing evidence is inconclusive. We are not aware of any research indicating any positive or negative effect of the use of these structures on the stated policy objectives as such.

3. Deviations from the proportionality principle

A description of deviations from the proportionality principle would need to start with a conceptual understanding of what would constitute such a deviation. Various disproportionality dimensions can be distinguished, as is illustrated in the following figure:



These rings reflect the range of disproportionate control mechanisms directly impacting on the proportionality principle at the centre, the more remote rings representing other deviations with less direct impact. There may be some overlap between the various rings and certain mechanisms or particular variations could be classified in different rings. Nevertheless, a distinction between different disproportionality dimensions along these lines could serve as an analytical framework to obtain a better understanding on the nature of, and relationship between, the various disproportionate control mechanisms.

The various rings cover a number of different mechanisms:

- The first ring covers those mechanisms that are included in the constitutional documents of the company and that directly affect the voting rights attached to shares in a disproportionate way, such as multiple voting rights, non voting shares and voting ceilings.
- The second ring covers mechanisms that are included in the constitutional documents of the company and do not affect the voting right attached to each separate share as such but create specific rights that reduce or inhibit the ability to exercise voting rights proportionally. Examples are “priority” shares (such as shares conferring exclusive rights to nominate board members) and depository receipts sponsored by the company (reserving voting rights to depository institutions that may or may not be subject to board influence).
- The third ring is further remote from the proportional distribution of voting rights and consists of mechanisms included in the constitutional documents of the company that reduce or inhibit the exercise of control through the exercise of voting rights. Examples are share transfer restrictions, staggered board provisions, and certain codetermination arrangements.
- Finally the fourth ring consists of mechanisms which are not part of the company’s constitution but affect the effective exercise of proportionate voting rights in the company. Examples are pyramids and cross-shareholdings, as well as market techniques that allow for decoupling of voting rights from cash flow rights, resulting, for example in votes being exercisable without any economic equity investment ("empty voting").

In addition to the examples offered here, [Annex I](#) enumerates some examples of disproportionate control mechanisms which appear particularly relevant. The various mechanisms often have very different objectives and effects. Just by way of example, the category of multiple voting rights shares consists of at least three types of arrangements which each operate differently:

- The Nordic dual class arrangement is set up and operates to ensure an enhanced voting position for controlling shareholders (holding multiple voting shares). Both types of shares are frequently listed on the stock exchange, but with little or no liquidity in the shares with multiple voting rights.
 - Dutch voting preference shares are either used to issue equity to financial investors subject to corporate income tax at low cost (at a preferred dividend at a market interest rate and no entitlement to any further dividend) in order for them to enjoy the Dutch tax participation exemption. In such case the voting right is only of secondary importance and in practice hardly ever exercised. The preference share structure is also used as a specific defensive measure against a hostile takeover attempt, in which case preference shares are issued to a foundation.
 - The French double voting right, based on the French Companies Act, entitles every holder of shares to a double voting right after having held the shares for more than two years (provided they have been registered). In a concentrated ownership situation this enhances the position of the controlling block holder, sometimes specifically the State. By contrast, in a dispersed
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situation this might contribute to entrench management when shares are held for longer periods by parties closely related to management.

These examples show that only a granular approach, on a mechanism by mechanism basis, can help to get a sufficient understanding of the differences in objectives and effects of the various deviating mechanisms; differences which may be of decisive importance in setting policy responses. We are not aware of any existing structured attempt to describe the objectives and effects of deviations from the proportionality principle on a mechanism by mechanism basis. Only with such a structured description of the various mechanisms on a detailed level, can we begin to understand the merits and problems of these mechanisms. The final report of the ISS Study contains a broad inventory and explanation of the various disproportionate control mechanisms applied in the EU and could serve as a useful starting point for such a detailed analysis on the basis of which firm conclusions could perhaps be drawn.

4. Assessment of the merits of various mechanisms

An assessment of the merits of the various mechanisms requires

- (i) consideration of whether the effects of these mechanisms, and the behaviour of relevant parties resulting from them, are to be judged as positive or negative, and
- (ii) setting of the criteria on the basis of which such judgement is to be made.

This assessment is the heart of the matter. Only in this way can we identify whether there is a problem that needs to be solved. We have not made an elaborate analysis in this direction but in this section identify some concerns caused by deviations from the proportionality principle. The next section deals with competing policy objectives that may be served by these deviations.

In the 2002 report of the High Level Group of Company Law Experts on issues related to Takeover Bids, it was stated that

"In the Group's view, proportionality between ultimate economic risk and control means that share capital which has an unlimited right to participate in the profits of the company or in the residue on liquidation, and only such share capital, should normally carry control rights. All such capital should carry control rights in proportion to the risk carried. The holders of these rights to the residual profits and assets of the company are best equipped to decide on the affairs of the company as the ultimate effects of their decisions will be borne by them"

This illustrates why, in general, proportionality is sensible. Indeed, disproportionate structures can be problematic, as is further explained below. Deviations from the principle of proportionality therefore deserve to be reviewed critically. Such deviations may, however, serve to attain

competing policy objectives, as is explained in section 5 below. Accordingly, an assessment is needed of the merits on balance of the relevant mechanisms. The outcome of such assessment may be different for each mechanism, and cost-benefit analysis could show that in some cases the benefits of pursuing competing policy objectives outweigh the benefits of adhering strictly to the proportionality principle. It therefore does not appear to be justified to conclude that the mere fact that certain mechanisms deviate from the proportionality principle, should cause such mechanisms to be judged negatively.

We have been unable to identify any other arguments which would justify the conclusion that certain mechanisms should be judged negatively because of the mere fact that they deviate from the proportionality principle. Notably, the concept of the company as a “shareholder democracy” does not constitute a compelling argument. Such a concept is vague and has little explanatory power on the matter of proportionality. The analogy with democracy as a political concept is misleading, in the sense that nobody would object to a fully proportionate arrangement where a holder of 50% of the share capital exercises ten times more votes than the holder of 5% of the share capital. The principle that shareholders can buy additional votes by buying more shares is a basic element of company law but deviates from the normal notion of democracy. The notion behind the phrase “shareholder democracy” is probably a notion of fairness. However, fairness is not suitable as a guiding principle to determine in a general sense what the balance of rights and opportunities and obligations and risks should be in private legal relationships and specifically corporate relationships. There is not one and one only balance that can be deemed fair generally. Fairness as a concept in private and company law seems mainly useful to delineate what is unfair in specific circumstances. Where an unfair situation is observed, law is concerned with redressing that situation, e.g. through minority protection rules, or compensating for damage caused by unfair conduct.

This means that we should investigate the specific effects and behaviours caused or facilitated by deviations from the proportionality principle, in order to assess whether such deviations are problematic. We have identified four key areas of concern:

- (i) board entrenchment
- (ii) extraction of private benefits by the controlling shareholder
- (iii) incontestability of corporate control
- (iv) ineffectiveness of corporate governance codes based on the “comply or explain” approach.

We make some comments on each of these concerns.

(i) Board entrenchment

Some of the mechanisms that deviate from the proportionality principle have as their main objective and effect that the board of the company is entrenched. In such cases, rights to discipline or remove the board are effectively controlled or strongly influenced by the board itself. The result of such

arrangements is that the board becomes less accountable or practically unaccountable to shareholders for its management of the company.

An example of such entrenchment is the priority share arrangement applied by some Dutch companies where priority shares are held by a foundation and the board of such foundation consists of executive and/or non-executive or supervisory directors. Such priority shares may carry exclusive rights such as the right to make binding nominations for appointment to the managing and supervisory boards by the general meeting, thus effectively entrenching the board(s).

To be sure, some of the mechanisms concerned do not have the exclusive objective of entrenching the board and may not result in board self-entrenchment. Where special nomination rights are held by a controlling shareholder, entrenchment of the board coincides with and is subject to the enhanced control of the controlling shareholder. Other mechanisms only contribute to board entrenchment in specific circumstances (compare the French double voting rights in a situation of dispersed ownership). Also, the level of board entrenchment may vary in different structures.

These factors caution against a generalised approach condemning all forms and shades of board entrenchment. However, we believe that mechanisms which create effectively incontestable board self-entrenchment, or the potential for it, are unacceptable from a corporate governance point of view. The position on the board of a company is a position of trust. It is not held to further the board members' own interests. Full entrenchment however allows board members to extract private benefits to the detriment of shareholders and fully negates the agency relationship. Shareholders of the company must be able to hold the board accountable for the management of the company. They must be able to determine the composition of the board by a company law mechanism (as opposed to judicial decision being, as a practical matter, the sole means to achieve this). Complete disenfranchisement of shareholders thwarts realisation of the stated EU policy objectives to an extent that cannot be justified by competing policy objectives, if any. Mechanisms which facilitate this are therefore always to be judged negatively.

(ii) Extraction of private benefits

A key concern triggered by deviations from the proportionality principle is the ability they may offer the controlling shareholder to extract private benefits from the company. By private benefits we mean benefits which are in excess of the shareholder's financial entitlement on the basis of his shareholding. Such benefits can consist of direct monetary benefits produced by commercial transactions on terms beneficial to the controlling shareholder (related party transactions), by share transactions while in possession of insider information or by increased remuneration received in the position of director of the company. They can also consist of indirect monetary benefits from exploitation of corporate opportunities by the controlling shareholder or by his affiliates. Further,

they may consist of non-monetary benefits in the form of reputation and social position for the controlling shareholder, or public or semi-public benefits if the controlling shareholder is a government or governmental agency or a private institution concerned with public objectives.

We note that the extraction of private benefits is not only a concern when disproportionate control mechanisms are applied. The risk of a controlling shareholder extracting private benefits also exists when such holder derives proportionate control from his holding of, say 51%. Such a holder is able to determine the terms of commercial transactions between himself and the company, use company information to gain private benefits, exploit the company's opportunities, derive reputational and other social benefits from his position, etcetera.

However, the point with mechanisms that enhance control on a disproportional basis is that they give the controlling shareholder an increased incentive to extract private benefits. The reason for this is that the costs of such extraction will be lower for the controlling shareholder if he enjoys a divergence from the proportionality principle as more of these costs are then effectively borne by the other shareholders. Notably, if the controlling shareholder has effectively hedged or divested his financial risk as shareholder he may even be able to extract private benefits at no cost to him (compare the single golden share). Consequently, the likelihood of the occurrence of extraction of private benefits to the detriment of other shareholders may be higher where control is leveraged by deviation from the proportionality principle.

The existing research on extraction of private benefits in Member States indicates the likelihood of different levels of private benefits extraction in different Member States. It is not clear whether and to what extent these differences are caused by the different nature of the disproportionate mechanisms deployed in different Member States, by different company and securities law environments that offer different levels of countervailing measures and/or by different cultural factors, or by other circumstances. The final report of the Study offers a certain amount of background information on the regulatory environment within which disproportionate mechanisms operate but its scope does not extend to offering explanations on seemingly different levels of private benefits extraction. A better understanding of these data and the causes for any differences observed is required before it can be determined whether and to what extent the various mechanisms deviating from the proportionality principle actually do result in problematic extraction of private benefits.

(iii) Incontestability of corporate control

As we have set out under 2 above, facilitating a market for corporate control in the EU is consistent with the Treaty Freedoms and a stated policy objective of the Commission, as is clear from the 13th Takeover Bids Directive. The rules of article 9 (shareholder decision) and article 11 (break-through rule) of the Directive were designed to further this objective. However, in the final Directive the

Council and the Parliament have agreed not to make these rules mandatory, but to allow Member States to opt-out of the rules on the condition that companies can voluntarily opt back into them, see article 12 of the Directive. The Commission staff working document on the implementation of the Takeover Bids Directive of 21 February 2007 shows that Member States are making extensive use of the opt-outs. Only 18 Member States impose the board neutrality rule (or are likely to do so), and five of them allow companies not to apply them in case of a bid by a party who is not itself subject to the rule (reciprocity rule of article 12 (3)). Only the Baltic States appear to be imposing the breakthrough rule. The result is that, at best, the contestability of corporate control can be expected not to increase significantly on implementation of the Directive and that major differences between Member States will continue to exist.

Many of the mechanisms deviating from the proportionality principle in more or less direct ways reduce the contestability of corporate control. They may concentrate the decision on the success of a takeover bid in the hands of the controlling shareholder who would not be able effectively to stop a takeover bid from being successful without such mechanism. Other mechanisms may facilitate board entrenchment which prevents the bidder from acquiring effective control. This effect adds to the concerns described above. When reviewing the need for or desirability of regulatory intervention and deciding what form any intervention should take, the effect of disproportionate mechanisms on the contestability of corporate control should be taken into account.

(iv) Ineffectiveness of corporate governance codes based on comply or explain

The primary response of the EU to the corporate governance crisis that has emerged at the start of this century is to stimulate Member States to set up national corporate governance codes that are to be applied on a “comply or explain” basis. Listed companies should comply with the principles and best practices described in the code but are free to deviate if they explain to what extent and for what reasons they do so. An obligation for EU listed companies to comply or explain in respect of such a national corporate governance code is now included in article 46a the fourth Company Law Directive, as amended by Directive 2006/46/EC. This ensures appropriate governance structures and practices primarily by relying on shareholders to enforce their rights if they are not satisfied with the manner or level of compliance, or explanations provided by the board for non-compliance. This may not be as effective, and a reduced incentive to strive for good corporate governance practices may arise, where a controlling shareholder applying mechanisms deviating from the proportionality principle controls the board and the shareholders’ meeting. Such a controlling shareholder effectively sets the corporate governance policy, and in fact basically explains to itself to what extent the governance code is complied with. Notwithstanding that the market may criticise the policy adopted, outside shareholders cannot effectively change the policy adopted by the controlling shareholder. Again, as explained in relation to private benefits above, this effect also occurs where a controlling shareholder derives proportionate control from his holdings of say 51% of the company's share capital.

However, deviations from the proportionality principle further facilitate this avoidance of the full effect of the corporate governance code and comply or explain by allowing the controlling shareholder to explain-to-itself with a relatively smaller shareholding.

5. Competing Objectives

While assessing the deviations from the proportionality principle in light of these concerns, we should consider competing objectives that may be furthered by such deviations. In doing so, we must judge whether such objectives justify the specific deviations. The deviations should be suitable to achieve the objectives and proportionate to achieving such objectives.

The following competing objectives have been suggested.

(i) Monitoring by the controlling shareholder

The argument is made that a controlling shareholder monitors the board of the company both for himself and also on behalf of minority shareholders. This may reduce the agency costs of board monitoring, to the benefit of all shareholders. A controlling shareholder can do so more cheaply, the argument goes, if he can apply structures deviating from the proportionality principle as his investment would not need to be as high as otherwise needed for the exercise of control. In addition, the deviating structures provide some assurance that the controlling shareholder will be able to continue to monitor. Without such assurance, the controlling shareholder would not, it is argued, engage so intensely in monitoring activities.

There is little or no research on the value of such monitoring by a controlling shareholder as compared to the monitoring of management by the market and by institutional and activist shareholders, aided by an independent non-executive board and a market for corporate control. It all depends on the type and behaviour of a controlling shareholder and the type and behaviour of outside shareholders and this varies from company to company. There may be merit in the monitoring role of controlling shareholders but nonetheless the proposition made has its weaknesses. The point cannot be disregarded that where the private benefits extracted by the controlling shareholder exceed the benefits to minority shareholders produced by the monitoring efforts of (and possibly other relational benefits to the company from) the controlling shareholder, the role of the controlling shareholder is on balance detrimental to minority shareholders. Furthermore, some would argue that if the controlling shareholder indeed produces benefits to minority shareholders as a result of increased monitoring, why would the controlling shareholder then need to enhance his control by disproportionate measures? The minority shareholders should be happy for the controlling shareholder to continue to monitor on their behalf. Thus, the problem arises when the controlling shareholder no longer, on balance and over time, delivers the benefit of better monitoring to minority shareholders. In such a case the disproportionate mechanism may

result in the controlling shareholder itself having become entrenched. In other words, it is debatable whether the improved monitoring by the controlling shareholder in all circumstances justifies the entrenchment created by mechanisms that deviate from the proportionality principle.

In order to assess the monitoring argument we need to have a better understanding of the value of monitoring by controlling shareholders, in relation to the potential or actual extraction of private benefits. The nature, scope, focus and effect of monitoring by controlling shareholders should also be analysed, compared to the nature, scope, focus and effect of monitoring by the market and, mainly, institutional and activist investors in a relatively dispersed environment where collective action problems have to be addressed.

(ii) Access to capital markets

The ability to strengthen a control position by mechanisms deviating from the proportionality principle may provide an incentive to entrepreneurs to list their companies on a stock exchange in order to have access to additional capital while retaining control of their enterprise. If such mechanisms were not available the entrepreneur would need to retain a relatively high proportion of the share capital in order to avoid the risk of losing control over his venture after listing. By applying a mechanism deviating from the proportionality principle the entrepreneur can leverage his control, float a bigger stake in the company and as a result have access to more capital, while overall liquidity increases to the benefit of the market as a whole.

The final report of the Study indicates that there is a downward trend in the application of mechanisms deviating from the proportionality principle by companies that are recently listed. More empirical and analytical research is required to understand what the trade-offs are in this respect, for example to what extent the application of such mechanisms has a negative effect on the price at which shares can be listed, increasing the cost of capital, and to distinguish between various mechanisms and preferences in markets in the different Member States.

A key question here is also whether a greater access to capital markets justifies permanent application of such mechanisms after the initial public offering or whether such application could sensibly and should be limited to a certain period of time, say a period of five years following the initial public offering. At present, there is insufficient evidence for either supporting or opposing such a conclusion. One preliminary observation is that time limitation is likely to trigger questions of compensation for loss of rights by the controlling shareholder.

More generally we note that the relative attractiveness of capital markets as a source of finance for companies is changing as result of increased regulatory burdens for listed companies and the availability of alternative sources of finance and corporate governance such as private equity

ownership. This should generally caution against excessive burdens and restrictions for listed companies.

(iii) Long term and stakeholder protection

It is sometimes argued that controlling shareholders, or entrenched boards, would focus more on long term sustainable corporate development. Thus controlling shareholders would compensate for 'market myopia', the alleged tendency of capital markets to be short-sighted due to investors not properly valuing the short term and long term value of their investments, making short-term decisions at the expense of long-term gains. Controlling shareholders thus, it is argued, contribute to mitigating the effects of a market failure.

The need to focus on the long term is often linked to the objective of furthering different stakeholder or societal interests. Applying mechanisms that deviate from the proportionality principle, in this line of reasoning, would offer benefits both to shareholders and to other stakeholders, like employees and suppliers, and deliver societal benefits such as the retention, or "continuity", of employment, head-office function and related revenues, R&D functions etcetera in a Member State or region within a Member State. In some cases we see foundations acting as the controlling shareholder explicitly charged with applying these mechanisms in order to achieve such objectives.

While we appreciate the sincerity with which such objectives are put forward, we doubt whether the means used to further these objectives are always proper and justified. Where such mechanisms lead to a situation where either the board of the company is practically fully entrenched or a controlling shareholder himself is capable of extracting private benefits, or more specifically where such controlling shareholder is not sensitive to normal market pressures, there are grounds for concern. This may be the case for those foundations or self-perpetuating board structures where the controlling share block is effectively held in a 'dead hand', which, while perhaps not per se problematic, sometimes has as a result that there is no chance for change in the corporate structure and that the foundation or the board cannot effectively be held accountable for disregarding the interests of other shareholders.

Also, we question the justification of the application of such mechanisms where they seek to further objectives that are in fact "purely economic" in the sense that they are designed to serve national, or even nationalistic, economic policy objectives. The fundamental freedoms of movement of capital and, to the extent relevant, of establishment, as interpreted by the European Court of Justice, may offer a fruitful avenue that can be explored to restrict the use of disproportionate mechanisms to situations which are acceptable under the Treaty. The analogy with the Golden Shares case law is strong and could justify extending the application of the free movement of capital principles beyond the purely public sphere of a state agency using state measures to semi-public or private entities using private measures to further public objectives.

(iv) Freedom of contract and efficient competition

Another key argument is that limiting the ability to apply mechanisms that deviate from the proportionality principle would breach the freedom of contract and related property rights that are at the basis of our political, economic and legal systems. This argument is both an argument of principle and an efficiency argument.

Our society is built on the principle that people have free will and should be allowed to make free choices in as wide a range of fields as possible. Their choices should be acknowledged in law and particularly where such choices involve property rights, law should protect their justified expectations. This argument is not absolute. In fact, mandatory provisions of company law at Member State and EU level are by definition restrictions on this freedom. For listed companies in particular mandatory restrictions may be warranted in light of the need to protect investors and ensure an adequate functioning of capital markets. But the argument does ensure that the onus is on those who seek to limit freedom of contract to justify this limitation with convincing arguments. We believe that indeed restrictions on the freedom to apply mechanisms that deviate from the proportionality principle should only be imposed to the extent they are clearly justified either to solve specific, identifiable and sufficiently serious problems or to further other, generally accepted objectives. Again we note that particular restrictions may be justifiable more easily in respect of listed companies in view of the objectives of investor protection and adequate functioning of capital markets. However, in the absence of such justification, freedom of contract should prevail, as a matter of principle. Where a justification for intervention exists, the need to protect justified expectations regarding existing property rights may cause an obligation of compensation.

There are various aspects to the efficiency argument for freedom of contract and related property rights. It is argued that such freedom furthers diversity of solutions and thereby innovation, and thus efficient competition. Only with variation and innovation in corporate control mechanisms and practices will we be able to develop superior performance and adapt to ever changing circumstances. If variation and innovation are restricted by law, only changes in law will allow us to achieve this. The argument is that the market and market practices are much better suited to create beneficial variations and innovations than is the legislator. We support this argument. As with the argument of principle this puts the onus on those who plead for regulatory intervention to justify it.

A further efficiency argument is that the freedom to apply different mechanisms that deviate from the proportionality principle accommodates both the desires of companies to issue shares with different mixes of cash flow and control rights and the desires of investors to invest in shares with such different mixes. These different mixes are simply different forms of property rights that should be left untouched. This argument typically is based on the assumption that the market will be able properly and efficiently to value the different instruments applied. As a result, there is no harm

done to anyone.

The obvious question here is whether markets are indeed able to properly and efficiently value the different instruments and whether they actually do so in practice both when the structures are first put in place and over time and in changing circumstances. The research in this area does not yet deliver firm conclusions. One observation is that where the market is simply not offered a real choice between investments with and without such deviations, but is only offered investments with different shapes and forms of deviations, its ability to make proper valuations may be impaired. To the extent the market is able to make proper valuations, such valuations may then indicate a lower value of all available instruments, evidencing an increased cost of capital. This may indicate a problem of externalities in light of the stated EU policy objectives, but final conclusions would require additional research in this area.

6. General considerations for a regulatory response

In determining whether the mechanisms which are judged negatively on balance warrant regulatory intervention, some general considerations should be taken into account. As a preliminary note, we comment on three of these. First, the feasibility of regulatory intervention depends to some extent on the nature of the disproportionate mechanisms deployed. Second, any regulatory response should be proportionate to the problem observed and in particular, when different responses are possible, a less intrusive one should be preferred. Third, developments on the global stage should be duly considered when considering a regulatory response in the EU.

(i) Adequacy of regulatory response

Given the complexity of the issue, even where mechanisms are judged negatively on balance there may not always be regulatory tools available which are in practice adequate to solve the problem identified. In assessing whether particular regulatory tools are adequate, the framework for analysis of the merits of disproportionate control mechanisms offered in section 3 could provide some insight. The mechanisms referred to in the first ring can be fairly specifically targeted as they concern corporate institutional arrangements which can be influenced directly by initiating changes in Member States' company laws or in listing rules. Because such arrangements directly affect voting rights attaching to shares, their disproportionate nature can be clearly established and the main elements to be taken into account in performing a risk – reward analysis can in principle be identified.

By contrast, the arrangements referred to in the fourth ring of the figure in section 3, which encompasses disproportionate mechanisms which do not exist by virtue of corporate institutional arrangements but through ownership structures and the use of derivative instruments, appear more complicated to target in a specific manner. Because such mechanisms derive from

circumstances outside the realm of the company and are related to ownership structures and market functioning, the issues that need to be taken into account when considering regulatory intervention become much wider. Consider, for instance, the application of sophisticated financial techniques based on securities lending, derivatives and hedges of specific financial risks. Such techniques can be used for perfectly normal and acceptable market purposes, but may also be used to achieve decoupling of voting rights from the corresponding economic ownership, thus enabling the leveraging of control rights by allowing exercise of 'empty votes'. Such financial techniques may be constantly evolving and therefore difficult to capture. As a result, developing a tailor-made regulatory response for these types of mechanisms is a complex matter. In addition, identification of the elements to be taken into account in performing a risk-reward analysis is more burdensome, while the need for such analysis is particularly high given the variety of parties who may be affected by rules that have an impact beyond the institution which is the company.

In addition, targeting market instruments applied to create disproportionality raises another important issue, i.e. investor responsibility. There is a case to be made that institutional investors have a duty of their own to exercise their rights attaching to shares in a responsible manner. This is particularly relevant in view of the general increase in the EU over recent years of both shareholder rights and shareholder activism. Institutional investors, the argument would go, should at least be accountable to some extent for the manner in which they exercise their rights attaching to shares. In this regard, disclosure on e.g. size and nature of shareholdings, securities lending, short and long positions and voting policy will contribute to enabling fiduciaries and market participants in general to monitor institutional investors' behaviour. Indeed, investor responsibility is an issue that merits further analysis parallel to analysing the effects of and possible remedies to management entrenchment and controlling shareholder entrenchment, to ensure proper governance on all sides.

Thus, a scale emerges on which it becomes relatively more difficult to develop adequate regulatory responses as we move from disproportionate mechanisms that fall within the inner ring to mechanisms that are part of the outer ring. From this perspective, it appears that addressing problems deriving from corporate institutional arrangements directly affecting voting rights would yield the most effective results. However, paradoxically, measures in that area may trigger a response from shareholders seeking to leverage control who could be given an incentive to replicate the disproportionate mechanisms subject to regulatory action through different means. Such shareholders could try to put in place alternative mechanisms falling within the adjacent or outer rings. For instance, a shareholder who holds control through dual class shares could in stead seek to leverage his control by way of a pyramid structure or even by acquiring 'empty votes'.

Although we have not made an elaborate analysis in this regard, it appears that it would be difficult to replicate corporate institutional mechanisms through market instruments on a stable basis. Nonetheless, the use of market instruments such as decomposition of shares in units of cash flow

rights and control rights may have distorting effects on the voting process, even if applied by non-controlling shareholders. This observation is supported by the anecdotal evidence from the US and the EU. In view of this, the risk that the parties concerned would respond to regulatory action by trying to replicate corporate institutional mechanisms through market instruments should be taken into account in determining whether a particular regulatory response is adequate and whether regulatory intervention is justified.

Indeed, the issue of decoupling of voting rights from the corresponding economic ownership or cash flow rights poses a concern. It calls into question the very rationale of voting rights of shareholders, i.e. that they as the owners of the ultimate risk are best suited to decide on the affairs of the company. There is a need for better understanding of existing practices. This will enable consideration of the extent to which regulations presently existing in Member States (pursuant to e.g. the EC Directive on Market Abuse or the Transparency Directive) offer adequate protection to investors, companies and the market at large and whether additional regulation would be desirable. Additional disclosure obligations, e.g. in respect of positions achieved through borrowing securities and of long and short positions, may provide a tool to obtain more insight into the nature and use of the various instruments applied in the market and assist the regulatory response. Given the complexity of this specific issue, the assessment of whether more structural regulatory response is warranted and determination of apt regulatory tools arguably require particular attention from the Commission in addition to the Commission's current efforts in the area of proportionality.

The concerns raised by empty voting are aggravated in the EU by the fact that the voting architecture in the EU in terms of regulation, systems and practices, is seriously underdeveloped. It is a serious concern from a corporate governance perspective that listed companies are unable to identify their shareholders, particularly across borders, and that shareholders are unable to exercise their voting rights efficiently across borders. The lack of consistent rules on the role and obligations of securities intermediaries in this respect, through whom shareholders hold their shares and on whom they depend for the exercise of their voting rights, is a crucial factor, which has not been fully addressed in the Shareholders Rights Directive. We believe this to be an urgent issue that needs to be addressed in the short term.

(ii) Proportionality of regulatory response

In its consultation for the future priorities of the Company Law Action Plan, the Commission indicated how it wished to apply principles of better regulation to the area of company law. In particular, it stated that “application of the better regulation strategy and principles involve (...) (2) strict compliance with the principles that (i) legislating at EU level is only justified when that is the best level at which to act and where legislation is the only way possible – where the market alone cannot efficiently address concerns - and (ii) due consideration will be given to those instruments that put the least burden on companies and leave them as much flexibility as possible.” The

Commission reiterated the importance of these principles in its strategic review of better regulation published in November 2006.

We fully support these principles. Any impact assessment of regulatory intervention at EU level will therefore have to explain why intervention at EU level is required in light of the relevant EU policy objectives and how the least intrusive mechanisms have been chosen to attain the objectives. This is particularly important where the EU is to take decisions on policy issues where competing policy objectives have to be weighed and the impact of the choices made can affect the capital markets in the EU in a fundamental way.

(iii) Global playing field

Some would argue that whether or not the EU should undertake any regulatory intervention in relation to disproportionate structures should also depend on the regulatory situation in jurisdictions outside the EU, as EU companies need to compete globally with companies from other jurisdictions. It is true that, as the final report of the Study indicates, other major jurisdictions, such as the United States, Japan and Australia, do not appear to mandate proportionality. In each of these jurisdictions deviations from the proportionality principle occur but possibly in less instances than in the EU (the final report mentions that in the US 20% of listed companies appear to have dual class shares, in Australia 4%, in Japan 2 out of 248 companies; however the report does not refer to any other disproportionate mechanisms that are applied). However, it is very difficult to draw any meaningful conclusions from either the absence of mandated proportionality outside the EU or the relatively low occurrence of certain disproportionate structures in other jurisdictions. The occurrence of deviations and their effects are influenced by many factors, such as differing ownership structures, legal systems and market practices, which may be very different from the circumstances in the EU. What works positively or negatively in jurisdictions outside the EU may have the opposite or at least a different effect within the EU. Whether or not jurisdictions outside the EU mandate proportionality should therefore not be a decisive factor in setting EU policy. As the High Level Group has argued in its report on takeover bids when it compared the situation in the US with the EU situation, EU policy in this respect should primarily be driven by the policy objectives for its own integrated capital markets, the analysis of merits and concerns that deviations from proportionality raise in the EU in light of these policy objectives and the availability of appropriate and proportionate regulatory tools to deal with any problems that require to be addressed.

7. Possible regulatory tools

If it were to follow from the analysis of the mechanisms which deviate from the proportionality principle that we have suggested in this paper:

- (i) that certain mechanisms are to be judged negatively on balance,

- (ii) that such mechanisms inhibit the achievement of EU policy objectives, and
- (iii) that regulatory intervention at EU level is desirable,

the question arises which measures would be appropriate. Possible regulatory tools could include the following, which are listed here in order of intrusiveness, starting with the least intrusive measures:

Disclosure

Consistent with the better regulation principle that intervention should leave companies as much flexibility as possible, we believe that the focus of any regulatory intervention should first be directed to disclosure. There is a strong case for improving the current disclosure obligations in this area. Imposing additional disclosure obligations would allow the market to make more accurate judgements and valuations of these mechanisms, which may result in a move away from the more detrimental ones. Increased and better disclosure would also help to give further insight into the application of the various deviating mechanisms and their positive or negative effects at a more granular level. Such disclosure obligations could be imposed in different forms and at different levels:

- Companies could, in addition to the disclosure obligations pursuant to article 10 of the EC Takeover Bids Directive and the disclosures under the Transparency Directive, be required to provide more detailed transparency on disproportionate mechanisms applied by them. Such disclosure obligations could in particular include the obligation to provide for a reasoned explanation of the objectives and effects of the mechanisms applied, and the suitability and proportionality of the mechanisms applied to achieve such objectives.
- Shareholders who derive a voting position from such mechanisms exceeding a certain threshold, say 10% of the total votes that can be cast in a meeting, or hold specific control rights, such as the right to make binding nominations for board positions, could also be required to provide insight into the size and nature of their shareholdings as well as their policy on the exercise of the powers attached to these holdings. While we acknowledge that policies may change, we would argue that disclosure may have the effect (albeit slight) of raising the bar for policy changes and make them subject to public and market criticism. Some explanations will be unacceptable in market and even legal terms. They may also be relevant where “public interest” policies are invoked (see below). Such additional disclosure by shareholders would also be relevant in the context of the parallel agenda on investor responsibility referred to in section 6 (i).
- Companies and shareholders could also be required to provide more transparency on the actual usage of disproportionate mechanisms. For instance, in addition to the existing obligations to disclose related party transactions in annual accounts pursuant to IFRS, ad-hoc disclosure obligations could be imposed in respect of specific related party transactions, e.g. any related party transaction not entered into on an arm’s length basis or any related party transaction in

excess of certain balance sheet or revenue criteria. Disclosure should also be required on the effect of deviations on the outcome of voting by shareholders in case of certain key resolutions. Ideally, one would also like to impose a requirement to disclose any non-monetary private benefit extracted by a controlling shareholder, but a meaningful disclosure of such benefits may be difficult to achieve.

- In addition to disclosure by companies and shareholders and building on such disclosures, the Commission could require Member States to provide the Commission annually with comparable information regarding application of disproportionate structures in their jurisdiction to the extent they have been disclosed. Such an obligation could build on the obligation of Member States to provide the Commission with information on takeover bids that have occurred and their results, see article 20 of the Takeover Bids Directive. Member States could also be asked to explain to what extent their company laws or securities laws contain any countervailing measures addressing the concerns caused by the use of disproportionate mechanisms generally, to make judgements on their effectiveness and to indicate what measures they are considering where they find that the measures in place are not sufficiently effective. Member States could specifically be asked what mechanisms are applied that offer the ability to create incontestable board entrenchment and what measures, if any, they intend to take in order to remove that ability.
- Public or semi-public agencies or private entities which as shareholders make use of disproportionate mechanisms in order to further public objectives, could be required to provide more transparency on the public objectives they seek to achieve with their holdings and the disproportionate mechanisms applied, including an explanation of the suitability and proportionality of the relevant mechanisms in view of their accountability to other shareholders and the market.
- Specific disclosure obligations could be considered in respect of the use of decoupling mechanisms such as securities lending, contracts for difference and call/put options, either generally whenever shareholders are invited to vote on resolutions, or specifically when certain corporate events occur, such as the announcement of a takeover offer. Shareholders holding in excess of a certain percentage of outstanding share capital, say 1 or 3%, could be required to disclose to what extent and by what means they have reduced or increased their economic risk resulting from the shareholding.

Specific rules to prevent or correct inappropriate use of control

The company laws and securities laws of Member States currently contain a number of different regulatory tools that seek to prevent or correct abuse of controlling positions by shareholders. Such tools include conflict of interest rules, related party transactions rules, minority protection rules, and oppression rights. Typically such tools are not directed exclusively to address concerns triggered by disproportionate mechanisms but at abuses of controlling positions generally. For

example, the UK Listing Rules require that shareholder approval be obtained prior to entering into qualifying related party transactions, the related party and its associates being excluded from participating in the vote. Based on further disclosures by Member States as referred to above, a further analysis should be made into the effectiveness of such regulatory tools to deal with such abuses and to what extent in doing so they help to address wider concerns caused by disproportionate mechanisms as referred to in this paper. Such analysis should seek to identify any possibilities for improvement in this area, including the merits and feasibility of setting minimum standards at EU level.

Incidental application of mandatory proportionality

Where further evidence and analysis shows that additional disclosure and improvement of existing countervailing company law and securities law regulatory measures are unable to address the concerns caused by the use of disproportionate structures, imposition of some form of mandatory proportionality in particular circumstances could be considered. The break-through rule in article 11 of the Takeover Bids Directive is an example of such an incidental application of mandatory proportionality when a corporate event occurs that is of crucial importance. However it is only directed at a small number of disproportionate mechanisms. Imposing proportionality in specific circumstances would automatically trigger questions of compensation for loss of rights. Article 11 (5) of the Takeover Bids Directive requires Member States to address compensation issues.

Periodic application of mandatory proportionality

An alternative to application of mandatory proportionality in specific circumstances could be to periodically allow shareholders to decide either to continue or to discontinue disproportionate mechanisms; this decision would need to be made on a proportionate basis. Such a facility would give shareholders an ability effectively to terminate an entrenched controlling shareholder position or an entrenched board position. It would still allow shareholders flexibility; it would be up to them to weigh the benefits and concerns of the application of disproportionate mechanisms. However, such periodic ability to discontinue disproportionate mechanisms could also create substantial uncertainty in the market as rights of shareholders would no longer be clear but continuously subject to possible change. At the time of periodic review, and even before that, this could cause market disruption and the system could put companies in play at regular intervals. The objectives and effects of such a periodic review of disproportionate structures by shareholders would need to be carefully analysed before such review was introduced. Compensation issues would arise under a scheme of periodic review of disproportionate mechanisms similar to those triggered by the break-through rule in a takeover context.

A less sweeping alternative would be to allow shareholders to express their views periodically by an advisory resolution on whether they wish to continue or to discontinue disproportionate mechanisms rather than empowering them to actually decide on such continuation or discontinuation. This would mitigate the complexities described above whilst still sending out a potentially powerful message to the controlling shareholder. Such message could, depending on the circumstances, function as a catalyst for capital restructuring.

Full mandatory proportionality

Only if it were to be established that none of the previous approaches would be able to address the concerns caused by the application of disproportionate mechanisms would a full and continuous mandatory application of the proportionality principle become an option to consider.

8. Recommendations

The preliminary analysis presented in this paper suggests that the regulatory agenda should have a short term focus and a longer term focus.

Short term: improvement of disclosure obligations and targeting of obvious problems

We believe there is a strong case for the Commission in the short term to initiate measures that would improve the transparency of mechanisms that deviate from the proportionality principle and their application. Improved disclosure requirements would facilitate markets in making better judgements and valuations of these deviations and would enhance our understanding of the mechanisms applied and their effects at a more granular level. In section 7 we have described six elements of an enhanced disclosure regime, relating to companies, shareholders and Member States, and including the use of decoupling techniques allowing for empty voting. We believe it is also important that disclosures in this area are accompanied by reasoned explanations of the objectives that are to be achieved by the mechanism applied and of the suitability and proportionality of these mechanisms in light of these objectives.

In addition to increased disclosure we believe four issues warrant a more substantial approach in the short term.

- (i) Instances where full board entrenchment is achieved. As we have said, such full board entrenchment is unacceptable from a corporate governance perspective. The Commission should communicate this view in a Recommendation to Member States, request specific reporting by Member States on the possibilities of achieving such full board entrenchment in the Member States and require Member States to indicate what measures are being taken to remove such possibilities (see section 7 above under

disclosure). The Commission should further indicate that it will review the situation in Member States based on their reporting and could consider further regulatory initiatives if no improvements are visible after, say five years after the adoption of the Recommendation.

- (ii) Instances where public, semi-public or private entities as shareholders use disproportionate control rights to further public objectives or, more generally, for purposes which are not aligned with shareholders' typical primary interests. As we have indicated above (section 5 (iii)) free movement of capital and, to the extent relevant, freedom of establishment, may offer a fruitful avenue to be explored in order to restrict within limits which are acceptable under the Treaty the use of disproportionate mechanisms in order to further public objectives. The Commission, in a fashion similar to its approach to golden shares that has led to the European Court of Justice case law, could develop its views in this respect in a Recommendation to Member States, indicating what it believes to be the conditions for the use of disproportionate mechanisms to further public objectives and that it will seek to bring cases to the European Court of Justice where such conditions are not met. Tailored disclosure requirements as suggested in section 7 could bring to the fore the cases where seeking the view of the European Court of Justice would be appropriate.
- (iii) Concerns raised by decoupling of voting rights through market instruments such as securities lending, contracts for difference and call/put options.
- (iv) In addition to further disclosure requirements, the EU should focus efforts on the technicalities surrounding the voting architecture, such as the role of securities intermediaries in the voting process on behalf of their clients. As we have noted in section 6 (i) above, the voting architecture in the EU in terms of regulation, systems and practices is seriously underdeveloped, as a result of which companies are unable to identify their shareholders, in particular when they are located in another Member State, and shareholders cannot efficiently exercise their voting rights across borders. Companies and their shareholders as a result are vulnerable to exercise of significant voting rights by just a few shareholders. The role of securities intermediaries is crucial in this respect as shareholders depend on them for the exercise of their voting rights. This role has only partially been addressed in the Shareholders' Rights Directive and requires further attention as a matter of urgency. A specific point that could be addressed is the records dates for dividends and for voting. There are indications that dividend payments are an important driver of the securities lending market. If the record dates for dividends and for voting would be sufficiently separated in time, securities lending for dividend purposes would no longer affect the distribution of voting rights.

Longer term: obtaining more data and further analysis

From our preliminary analysis it is clear that there are many elements that require further investigation and analysis before meaningful conclusions can be drawn on the objectives and positive and negative effects of the different mechanisms deviating from the proportionality principle and on the need for and effectiveness of any substantive regulatory intervention. While we appreciate that full certainty will never be achieved, we believe that our current information and understanding are simply insufficient to justify further or more general substantive regulatory intervention. The enhanced disclosure that could be imposed on the short term would help to get meaningful data as a basis for further analysis. Consistent with the Commission's monitoring of steps taken by Member States pursuant to the Commission's Recommendations and the Takeover Bids Directive, the Commission could consider assessing the information thus obtained after a predetermined period of time, e.g. five years. Such assessment and further data collection should be directed at determining:

- (i) whether and to what extent particular mechanisms which deviate from the proportionality principle should be judged negatively on balance, including corporate institutional mechanisms but also market instruments enabling 'empty voting' or mechanisms otherwise affecting the voting system,
- (ii) whether and to what extent these mechanisms inhibit the achievement of EU policy objectives,
- (iii) what existing regulatory tools address the concerns caused by the application of these mechanisms or what new regulatory tools should be introduced effectively to address these concerns, and
- (iv) whether further regulatory intervention at EU level is desirable and which form this intervention should take.

This longer term agenda should include a review of the competing policy objectives referred to in section 6 and the parallel responsible investor agenda referred to section 7.

Annex I

First ring: Corporate institutional arrangements affecting rights attaching to shares

1. Multiple voting rights

- In Nordic countries: two classes of shares, with one class of shares having higher voting rights than the other class typically in a ratio of 10 to 1, 100 to 1 or 1000 to 1. Both classes of shares may be listed
- In the Netherlands: two classes of shares, with one class of shares (preference shares) with limited cash flow rights (typically fixed % of nominal value but with voting rights linked to nominal value as with ordinary shares; result is shares with voting rights disproportionately high in relation to their financial value
- In the Netherlands: high vote/ low vote: two classes of shares, one with high nominal value, no premium, other with low nominal value, high premium; voting rights based on nominal value, cash flow based on sum paid up (nominal plus premium)
- In France: double voting rights accrue to the shareholder who holds shares for a certain period of time

2. Non voting shares

- In the UK: e.g. the Daily Mail class B shares
- In Italy: non voting savings shares

3. Non voting preference shares

- In Germany: additional, preferred dividend on top of ordinary dividend to compensate for lack of voting rights
- In the UK: limited preferred dividend (but no ordinary dividend), no voting rights, or such rights only in case of default
- In Belgium: similar to UK, but rarely used if ever

4. Participating bonds

- In Germany: these do not qualify as shares but bear full cash flow exposure (thus reducing the cash flow exposure of voting shares)

5. Voting rights ceilings

- Fixed ceilings, in Spain: e. g. 10% voting rights maximum for a single shareholder
- Scales, decreasing voting rights
- Time lapse voting

Second ring: Corporate institutional arrangements indirectly affecting voting rights

1. Priority shares

- In the Netherlands: nomination rights, exclusive proposal and veto rights. Originally family owned, also now as management entrenchments (foundation, board of which may consists of non- executive board members of company)
- In Germany: special shareholder nomination rights
- Golden shares, special rights of states

2. Supermajority requirements

- If imposed by law they constitute minority protection offered as a policy matter; if pursuant to a provision in the articles of association (more stringent than statutory minimum) it becomes an entrenchment device, depends on degree of dispersion
- Quorum requirements

3. Depository Receipts of Shares sponsored by company

- in the Netherlands: non-voting depository receipts of shares issued by foundation; board foundation required to be independent of company, holders of depository receipts of shares since 2004 entitled to power of attorney to vote unless threat of takeover
- in Belgium: similar but more limited use; no independence requirement but effect on definition of control

Third ring: Other corporate institutional entrenchment mechanisms

1. Ownership ceilings

2. Share transfer restrictions

- in Germany: in articles of association, Vinkulierte Namensaktien
- in insider shareholders agreement

3. Staggered board

4. Co-determination

5. Unchangeable provisions in articles of association

6. Other provisions in insider shareholder agreements

Fourth ring: non corporate institutional mechanisms

1. Depository receipts of shares not sponsored by the company

2. Pyramids

3. Cross-shareholdings

4. Outsider shareholder agreements

5. Decomposition techniques

- securities lending
- contracts for difference
- call/put options

6. Change of control clauses
