



## EUROPEAN COMMISSION

Internal Market and Services DG

FREE MOVEMENT OF CAPITAL, COMPANY LAW AND CORPORATE GOVERNANCE  
**Company law, corporate governance and financial crime**

Brussels, 25 July 2007

### EUROPEAN CORPORATE GOVERNANCE FORUM

#### Minutes of the meeting of 19 June 2007

#### 1. APPROVAL OF THE AGENDA

The agenda was approved without discussion.

#### 2. PROPORTIONALITY BETWEEN CAPITAL AND CONTROL

##### 2.1. Study prepared by ISS, the ECGI and Shearman&Sterling

In his introductory remarks, the Chairman recalled that the study on proportionality between capital and control was published on DG MARKT's website on 4 June 2007. He informed the members, furthermore, that the contractor was to give a first presentation on the study at the Corporate Governance Conference organised by the German Industry Association (BDI) on 28 June in Berlin. Referring to the remark of a number of members at the last meeting that such a conference would not be able to replace a proper public consultation, he confirmed that Commissioner McCreevy at this stage did not envisage launching a public consultation. However, the final decision on the further procedure would obviously depend on the outcome of the impact assessment which should be finalised in the autumn. Commissioner McCreevy would be open-minded as far as the outcome of the impact assessment and any possible follow-up measure are concerned.

It was agreed to structure the discussion as follows: (1) to provide comments on the ISS Study to complement those made at the last meeting, (2) to discuss the recommendations contained in the paper prepared by the Forum working group; and (3) to decide on the status of that paper, namely, whether it should remain a working group paper or become a paper of the Forum.

Concerning the **study**, Forum members agreed that its quality had significantly improved since the interim version. Two members, however, regretted that some factual inaccuracies were still contained in the paper. It was outlined that CEMs have different objectives and effects, that the study does not provide sufficient information for assessing the impact of CEMs and that certain of the study's conclusions therefore do not seem justified. It was, furthermore, criticised that the study does not give a clear idea on the control situation (e.g. legal control or control through devices). The study should therefore be seen as only providing as a first picture. Another member stressed that this is the first time that one has tried to show what the reactions of investors to CEMs are and which mechanisms are perceived by them as most toxic for the market. He highlighted

that it is interesting to see that investors favour more transparency. Another member, however, considered that the weakest part of the study is the investor survey, which essentially consists of (relatively few) replies from UK and US investors. Only about 400 of the over 7000 investors contacted would have replied to the survey. Therefore, the survey would be biased even if the study as a whole would be of good quality.

## 2.2. Finalisation of the Forum's position

One of the members introduced the **working group paper**. He outlined that the crucial part is formed by the recommendations, focusing on enhanced transparency. The key point of the six disclosure elements listed in the recommendations of the paper is trying to understand how CEMs are used by requesting the management to provide explanations on the objectives and justifications for these mechanisms. Apart from the transparency elements, he pointed out to three issues which would need to be addressed in the short term: (i) the Commission would need to make clear that full board entrenchment through the use of CEMs is not acceptable and ask MS to explain what they do in this regard; (ii) the use of CEMs to pursue public objectives (not shareholders' objectives), which in his view should be addressed by the Commission in a similar manner as golden shares; (iii) the question of empty voting (which might partially be addressed by the forthcoming Commission recommendation on shareholders' rights).

One of the members disagreed with the starting point of the exercise. It would result from the study that there is no principle of proportionality, but that the principle is rather freedom of contract. That member accepted that there are situations in which the freedom of contract needs to be limited. This would, however, not justify regarding proportionality as a principle of Corporate Governance. It would therefore not be for companies to explain why they use certain CEMs. If at all, all companies should be obliged to explain why they use a certain financial structure. This member, therefore, introduced a reservation with a view to a possible statement of the Forum on this issue.

Two other members, however, took the view that one share, one vote is the general rule, even if there are exceptions: "capital + say".

A fourth member agreed that freedom of contract should be the starting point. However, the key point would be that more transparency is needed in order to make financial markets work. Both market contestability and accountability of directors are needed.

Another member stressed that the issue behind the paper is whether the Forum's approach to corporate governance can work. It is about shareholders to be able to influence and to make the market forces work. He indicated that, as the study shows, CEMs are prevalent, and that there is therefore a need to focus on whether the freedom of contract should be limited. As regards the recommendations, he took the view that the Forum should be more tentative on some of them.

Another member explained that the Forum should come up with a serious paper and serious recommendations. The paper should not be too prescriptive but highlight the most problematic issues. The idea would not be to create additional red tape but the Forum should contribute to educating the public opinion on this. This member suggested focusing on the extreme cases of entrenchment situations in order to ensure that the market is contestable. Many CEMs would be innocuous or could even have a useful function. There would therefore be no need to address these. It was recalled that the objectives of corporate governance are to generate corporate performance and at the same time to protect shareholders (effectiveness and fairness). The public policy

dimension would be the second important point as it would often lead to protectionism. Empty voting, however, would be a different problem and should therefore better be dealt with in the context of the shareholders' rights initiative. Another member, finally, remarked that, contrary to the view expressed in the paper, corporate governance would not be about freedom of capital but about having successful companies.

It was agreed to focus in the discussion on the recommendations and not on the paper as a whole. The Forum should issue a separate paper containing operational recommendations which would be based on the working group paper but refrain from taking a position on the philosophical background discussed in the paper. Throughout the recommendations, the word "CEMs" should be used in order to avoid the term "deviations". One member suggested inserting a review clause given that in a few years' time more information might be available in this area. The working group paper will be published separately from the recommendations on the Forum's website. The recommendations will refer to the paper of the working group as source of inspiration but without endorsing its content.

#### *General disclosure by companies (draft recommendation 1)*

The member introducing the paper took the view that, in view of the potential negative effects of CEMs, MS but also companies should provide explanations on their use and any added value provided by them. It would then be a matter for the market to decide whether the justification is acceptable or whether there is a need for action. Another member added that explanations from companies, even if blunt, will be useful: providing explanations will require the board to be prepared. He suggested that there should be a vote, in regular intervals, in the general meeting on the explanations in order to provide the management with a feedback.

One member stressed that disclosure of CEMs related to the behaviour of shareholders would be more difficult for the company than disclosure duties concerning CEMs related to the company's behaviour. There would, therefore, be a need to distinguish in the recommendations.

Concerning shareholders' agreements, another member recalled that in some jurisdictions this kind of agreements must be made public to be enforceable before courts. This rule would be a powerful tool.

#### *Disclosure of voting positions of shareholders using disproportionate CEMs (draft recommendation 2)*

One member underlined the practical difficulties related to such disclosures, in particular as pyramids are concerned. Also another member warned that this recommendation would imply a lot of detail and wondered if this was a desirable objective. A third member stressed that the case of pyramids could be mentioned specifically. In this case, the obligation to give explanations lies with the ultimate shareholder.

#### *Disclosure of related parties' transactions (draft recommendation 3)*

The member introducing the paper took the view that today transparency as regards related parties' transactions is very limited. From his experience, a real audit by the external auditors does not take place.

Another member recalled that, in the UK, a provision in the listing agreements allows shareholders to vote individually on certain related parties' transactions without the shareholder related to the third party being allowed to participate in the vote. He clarified, furthermore, that it is difficult for auditors to assess the fairness of the price of trading transactions with related parties, noting that as annual accounts generally involve a great deal of aggregation, and in respect of other transactions the given that auditors in this respect normally have to rely on information provided by the company's advisers. In his view, the recommendations on this issue should be fairly high level. Another member supported this view. The recommendation should be limited to stressing that companies need to pay attention to third party transactions. If one wanted to go into details, also pricing issues, the situation in groups etc would have to be addressed.

A fourth member indicated that if one controls a company through a low percentage of capital, the incentive to deviate profits through related parties' transactions is high. While transparency can be a useful tool, it is not appropriate in all circumstances, with a view in particular to the commercial interest of the company. The audit committee (or another independent internal body) would be the appropriate body to examine such transactions and to give its green light. This proposal was supported by three other members that stressed that disclosure to the shareholders is the relevant point, not to the public.

It was concluded that the recommendation should not go into details on this point but be limited to the request to have a committee inside the company reviewing related party transactions and to ensure that a majority of the committee's members is not related to the third party.

#### *Disclosure duties in case of use of CEMs in order to pursue public objectives (draft recommendation 5)*

Three members questioned the need to recommend specific disclosure requirements on this point. This situation would already be covered by the general disclosure duties (draft recommendation 1).

Another member indicated that the main problem in this context concerns the protectionist behaviour of some national regulators which became obvious in the context of some recent corporate transactions in Europe. One other member took the view that it would only need to be clarified that any such instrument would have to be used by the state in the interest of all shareholders.

Members agreed that there should be no specific recommendation on this point but that it should be addressed in the context of the first recommendation.

One of the members argued that the reference to trade unions in that part of the paper should be explained, and also the reference to co-determination as an element leading to board entrenchment.

#### *Recommendations of the Forum*

Two of the members were charged with the preparation of the Forum's recommendations.

One of them stressed that there would be a need to look into the issue of empty voting with urgency. Most activist shareholders would work with a holding of clearly below the 5% threshold contained in the Transparency Directive. They would therefore not be known to the company. As a consequence, a number of Member States, when

transposing the Transparency Directive, would have chosen a considerably lower threshold. Another member agreed that there was an urgent need to address the question, referring to the findings of the paper of Prof. Hu and Black of 2006. A third member stressed the link with the consultation on shareholders' rights. The question of empty voting would, however, be broader than the stock lending issue mentioned in the consultation. Also derivatives would play an important role. The Forum should consider whether to enlarge its work on shareholders' rights on that point or to discuss the whole issue separately. Dealing with it exhaustively in the proportionality recommendations would not be possible. One other member took the view that the discussion on the disclosure of investors' identities should go beyond questions related to voting; also for the permanent dialogue between company and shareholder this would be important. Another member, however, drew the attention of the others to the fact that investors try to disguise themselves for tax reasons. If additional disclosure requirements were introduced this would only lead to more complicated circumvention mechanisms. He agreed that it is important to mention empty voting in the context of CEMs but stressed that the point deserves further study.

On the further time table, the Commission explained that it is currently working on the impact assessment, to be finished by the end of September.

### **3. FORTHCOMING RECOMMENDATION ON SHAREHOLDERS' RIGHTS**

The Chairman referred to the public consultation that was launched on 2 May and the questionnaire that was distributed to European associations of issuers, intermediaries and investors. He raised the question whether the Forum would want to provide its input on the subject, taking into account that it had issued a recommendation concerning shareholders' rights last year.

One member criticised the consultation paper. The section on "Disclosure of investors' identities" would not take account of the fact that disclosure is the starting point if one wants to facilitate voting. Relying on the chain of intermediaries would make the system not only complicated but also costly. It would therefore not be premature, but high time to look at this question. Any recommendation on the chain of intermediaries would, furthermore, have to take account of the Hague Convention. If, under the convention, the law of a third state was chosen this might have an impact on the intermediaries' right to exercise the voting rights. Finally, attention should be paid to a recent study of the SEC on the voting system in the US. If the findings of that study were correct one should make sure that Europe does not develop into a similar direction.

Another member reported on the findings of a UK working group according to which even at national level 5% of the votes get lost in the voting process. Because of the higher number of layers the results would be much worse in a cross-border context. This would be why the UK rule according to which the identity of the person behind a nominee can be inquired is so important.

A third member stressed that voting cannot function without the involvement of intermediaries. Even if there was a way to pass on voting instructions directly from the shareholder to the issuer the chain of intermediaries would always be needed in order to identify the shareholder. One should also be aware that the question of disclosure of investors' identities would be broader than the aspects related to voting. The discussion should pay attention to two issues:

- Doubts about the legal entitlement would need to be avoided. The chain of intermediaries would have to provide the name of the legal shareholder and the number of shares the person holds on the record date;
- This identification would need to have two effects: that the identification (even by a foreign bank) has to be accepted by the issuer but also that the issuer, at the same time, can rely on the identification.

Two members took the view that the Commission needs to coordinate the work of the financial institutions in order to make sure that identification by a foreign bank is accepted. An initiative should be undertaken in the area of clearing and settlement.

Two other members stressed that the identification of shareholders would not only serve the purpose of voting but also enable a dialogue between the issuer and the shareholders. A dialogue would not only provide shareholders with additional information but also give the company an insight into the shareholders' thinking. Another member took, however, the view that any such dialogue outside the general meeting would not be desirable as it tends to work to the advantage of large shareholders.

Another member referred to the section of the consultation paper on stock lending. The tendency in there to discourage stock lending for the purpose of voting would seem to go into the wrong direction.

It was agreed that the Forum would not reply in detail to the consultation but limit itself to stressing that the question of the role of intermediaries has to be dealt with urgently. One member pointed out that, given the resistance of the banks to take the initiative, pressure would be needed in order to make progress. At the proposal of another member, the Commission agreed to try to organise a meeting between one of the relevant expert groups (probably the Legal Certainty Group) and members of the Forum in order to discuss the issue.

#### **4. UPDATES ON ONGOING COMMISSION INITIATIVES**

##### **4.1. Simplification of the Company law *acquis***

The Commission announced the intention to have a draft communication on the subject adopted at the beginning of July. The communication will propose to limit EU legislation in company law to cross-border situations. As an alternative to the repeal of certain legal acts in the field of company law, it will envisage a number of modifications to these directives in order to simplify the current rules. In addition, the communication will contain proposals aimed at reducing administrative burdens for SMEs.

One member raised the question whether Member States would follow any such initiative and repeal the rules also at national level. Another member took the view that the Netherlands would at least take measures concerning the capital rules for public limited companies.

##### **4.2. Proposal for a directive on the transfer of the registered office**

The Commission explained that a proposal for a directive on this subject would have to be supported by strong economic arguments. It would not be easy to

establish the potential benefit for a company of moving its registered office instead of incorporating in another Member State. Two members remarked that the balance sheet, after the transfer, would have to be established under the law of the Member State where the newly registered office is located so that tax advantages that are based on the balance sheet could result from the transfer.

#### **4.3. Impact assessment for the Statute of a European Private Company**

The Commission announced that a public consultation on the content of a possible proposal for a statute of a European Private Company will be launched shortly.