

## **The shareholders' rights directive and cross-border voting**

The proposal of the Commission for a directive on the exercise of voting rights by shareholders dated 5 January 2006 (COM 2005 685 final) provides for a number of sound proposals that will facilitate the exercise of voting rights by shareholders of listed companies in the EU. The context of the proposal explicitly refers to the difficulties with the exercise of voting rights in cross-border settings, where chains of intermediaries not only make the communication process between issuers and shareholders but also the voting process more difficult (see Explanatory Memorandum par. 1.1)

Article 13 deals with the particular issues caused by the system of shareholdings through chains of intermediaries. Today, shares are typically held through securities accounts with intermediaries such as banks and brokers, who offer professional brokerage and custodial services. In cross-border situations: when an investor in Member State A holds shares in a company with registered office in Member State C, there usually is a chain of intermediaries in different Member States between the investor and the company. The investor holds his shares in an account with an intermediary in Member State A; that intermediary may hold an account with a large international depository bank in Member State B; the international depository bank holds an account with a local custodian in Member State C; the local custodian is registered in the share register of the company.

**Investor A → Intermediary A → Depository Bank B → Custodian C → Company C**

This is a relatively straightforward example. In reality the shareholding chains between investors and the companies in which they invest are often much longer, more complicated and involving even more jurisdictions. Typically, the intermediaries in the chain do not keep separate accounts with other intermediaries to register the shares held for each individual client. They combine their holdings on behalf of all of their clients into one or more so called omnibus accounts in their name with another intermediary. As result, it is impossible to track individual chains of securities accounts through which the shares of a specific investor are being held.

Such a cross-border chain of intermediaries does not only create communication problems and practical difficulties (e.g. time delays) but also legal uncertainty as to who actually is

entitled to determine how the votes on the shares are cast. Each of the custodian in Member State C, the international depository bank in Member State B, the intermediary in Member State A and the investor in Member State A have an account with either the company or with an intermediary confirming his entitlement to the shares. Under the national rules applying in each Member State to the relation of the intermediary and his client, the client usually will have an entitlement to exercise the rights attached to the shares administered in the account with the intermediary. In chains of intermediaries this adds up to multiple clients with multiple rights to exercise the rights attached to the shares in the various accounts in the chain. Few will deny that in the end, the investor who has paid for the shares and runs the economic risk of the shares should be able to determine how the shares held on his behalf will be voted. The key question is how to ensure that this really is effected throughout the chain of intermediaries. This basically requires that all of the intermediaries in the chain between that investor and the company provide voting services. In our example intermediary A in Member State A must accept the voting instructions received from his client, investor A, and must forward the voting instructions to Depository Bank B in Member State B. Depository Bank B must forward the voting instructions to Custodian C in Member State C. Custodian C must vote the shares it holds on behalf of, ultimately, investor A, according to the instructions provided to it by Depository Bank B (who has received these instructions from Intermediary A, who has received them from Investor A). Each of Intermediary A, Depository Bank B and Custodian C must do this for all their clients, their clients' clients and so on.

**Investor A → voting instructions → Intermediary A → voting instructions Investor A → Depository Bank B → voting instructions Investor A → Custodian C → votes in accordance with voting instructions Investor A → Company C**

An alternative method of ensuring that Investor A practically votes on the shares held on his behalf is that he receives a power of attorney to vote ("proxy") from the intermediary who is formally entitled to vote. In our example this would be Custodian C who is registered in the share register of the Company. The request for a proxy must be forwarded to Custodian C from Investor A. Custodian C therefore must provide a proxy to Investor A directly or to Depository Bank B, with the right to grant a further proxy to its client, Intermediary A, who in its turn should provide a proxy to Investor A.

**Investor A → request for proxy → Intermediary A → request for proxy to Investor A → Depository Bank B → request for proxy to Investor A → Custodian C → proxy to Investor A (or to Depository Bank B with right to issue subproxy to Investor A) →**

**Investor A (or Depository Bank B who can then issue subproxy to Investor A or to Intermediary A who has the right to issue subproxy to Investor A) → exercise voting rights on basis of proxy → Company C**

Article 13 of the proposal removes some of the obstacles to voting by the investor in a cross-border setting. Member State law may not forbid or frustrate the holding of omnibus accounts by professional intermediaries (par 1). Member States may not require temporarily registration of shares into individual accounts in order to be able to exercise voting rights (par 2). Intermediaries on behalf of others must be allowed to exercise voting rights, provided they have received instructions of their clients (par 3). The holder of omnibus accounts must be allowed to split the votes he casts on behalf of his clients according to their instructions (par 4). The holder of an omnibus account must be allowed to provide a proxy to vote to every client on whose behalf he holds shares or to a third party designated by such client (par 5).

All of these rules are sensible and necessary to solve the problems of cross-border voting. However, they are not sufficient to allow all investors holding shares through securities accounts with intermediaries to efficiently determine how the votes are cast on shares on their behalf. The proposed rules do not in and by themselves ensure that all intermediaries in the chain will indeed accept, forward and execute voting instructions received from the investor or that they will all facilitate that the investor can vote on the basis of a proxy. Paragraph 3 of article 13 provides that an intermediary may only cast votes if so instructed by its accountholder, but it does not impose a requirement to cast votes if the accountholder instructs the intermediary to do so in accordance with his instructions. In addition, the provision only deals with casting votes on the instruction of clients. However, in cases of chains of intermediaries all except one intermediary in the chain (in our example the exception is Custodian C) will not be able to exercise voting rights themselves because they are not a registered shareholder in the share register of the company (or, in case of bearer or dematerialised shares, the accountholder in the securities trading system of the Member State of the company). All but one of the intermediaries merely hold an account with the next intermediary in the chain. Their obligation is not to cast votes, but to forward voting instructions to the next intermediary, until the intermediary who is formally entitled to vote receives the instructions.

In our example: according to par. 3 of article 13 Intermediary A may not cast votes on the shares it holds on behalf of Investor A, but it is not required to cast votes if so instructed by Investor A. In addition, Intermediary A cannot vote itself on the shares, but can only forward

A's voting instructions to the next level. Par. 3 of article 13 does not require Intermediary A to do so. The same applies to Depository Bank B: it may not cast votes unless it has received voting instructions from Intermediary A. But it is not required to cast votes upon the voting instructions received from Intermediary A or to forward such instructions to the next level. The same applies to Custodian C: it may not vote unless it has received voting instructions from Depository Bank B, but it is not required to vote upon instructions received from Depository Bank B.

Similar gaps in the structure exist when the route of proxies is followed. Article 13 par 5 allows for an intermediary that holds shares in an omnibus account to issue a proxy to every person on whose behalf it holds shares in such account. But the intermediary is not required to issue such proxy if its client requests a proxy to vote himself. In addition, an intermediary who has no direct relation to the investor requesting a proxy is not required to issue a proxy to such investor, or to pass on a request for a proxy to the intermediary who is formally entitled to vote or to pass on a proxy to an intermediary with the right to designate the investor requesting the proxy. Also, the intermediary who has a direct relation to the investor but does not have the right to vote itself, does not have an obligation to request the next intermediary or the intermediary with the formal right to vote, to issue a proxy to it or to the investor.

Some would argue that it is not necessary to fill these gaps in the Directive as investors can sort this out with their intermediaries by contractual arrangements. This at best is true for some investors, dealing with some intermediaries. Institutional investors may be able to negotiate this type of voting services with the intermediaries through which they directly hold shares in companies in which they invest. In our example Investor A may be able to conclude a contract to this effect with Intermediary A. However, many investors, in particular private investors, would probably not be able to negotiate such a service with their intermediary. In addition, in order for the voting process to become effective, every other intermediary in the chain will also have to do the right thing (pass on voting instructions to the next intermediary, vote on instructions received from the chain, pass on proxies and requests for proxies etc) and the investor has no relationship with these other intermediaries in the chain. Even worse, it does not know who are the intermediaries down the particular chain through which its shares are held, because it is virtually impossible to determine through what precise chain the shares are being held for a particular investor. It is inconceivable that institutional investors, let alone private investors, could ever negotiate contracts with all the intermediaries they do not know but who are involved or may become involved in chains through which shares are held ultimately on behalf these investors. And if one intermediary in

the chain is not providing the service required, the whole chain dysfunctions and the votes of the investor effectively will not be cast.

Article 13 should address these problems by ensuring all intermediaries in the chain have obligations to facilitate the exercise of voting rights by or on behalf of investors. They should do this either by passing on voting instructions and voting in accordance with these instructions or by passing on requests for voting proxies and ensuring the proxies are received by investors who want to vote themselves. There is no need to define the investor on whose behalf intermediaries must do this. Investors are simply those accountholders who are not intermediaries themselves and who do not have the obligations of intermediaries.

To achieve this, the text of article 13 could be amended as set out below. The text underlined indicates changes to the current text of the proposal. I have included the term professional intermediary (as a person or entity allowed to hold securities in the course of a business for the account of another person or entity). This avoids recurring references in the text to "such person as referred to paragraph 1".

1. Member States shall ensure that any natural person or legal entity that under their laws as a professional intermediary is allowed to hold securities [in the course of a business] for the account of another natural person or legal entity may hold such securities in either individual or omnibus accounts.
2. Where the shares are held in omnibus accounts, it shall not be permitted to require that they be temporarily registered in individual accounts, in order to be able to exercise voting rights attaching to these shares at a general meeting.
3. Professional intermediaries shall be required to facilitate the exercise of voting rights attached to the securities held by such professional intermediary by or on behalf of the natural person or legal entity for the account of whom the securities are held by either of the two methods set out in paragraph 4. and 5.
4. At the request of a natural person or legal entity on behalf of whom a professional intermediary holds securities, such professional intermediary shall be required to (i) exercise the voting rights attached to these securities in accordance with the instructions received from such natural person or legal entity, or to (ii) instruct another professional intermediary with whom securities are held by the first professional intermediary on behalf of such natural person or legal entity to exercise the voting rights attached to these securities in accordance with the instructions received from such natural person or legal entity. Professional intermediaries shall not be prevented from exercising voting rights attaching to the shares which they hold for the account

of another natural person or legal entity, provided they have been instructed to do so by such other person or entity. Professional intermediaries shall keep a record of the instructions for a minimum period of one year.

5. At the request of a natural person or legal entity on behalf of whom a professional intermediary holds securities, such professional intermediary shall be required to (i) issue a proxy to such natural person or legal entity to exercise voting rights attached to these securities or to any third party designated by that person or entity, or (ii) request another professional intermediary with whom securities are held by the first professional intermediary on behalf of such natural person or legal entity to issue a proxy to such natural person or legal entity or to any third party designated by that person or entity. By derogation from Article 10(1), third subparagraph, a professional intermediary that holds securities in an omnibus account shall have the right to issue a proxy to every natural person or legal entity on whose behalf it holds shares in such account or to any third party designated by that natural person or legal entity.
6. Where a professional intermediary holds securities of the same issuer in an omnibus account, it shall be permitted to exercise voting rights attaching to some of the securities differently from voting rights attaching to the other securities.

Jaap Winter, June 2006