

## Legal Certainty Group - Report on Core Issues

### Part 3 - CORPORATE ACTIONS AND VOTING RIGHTS<sup>1</sup>

#### Summary of recommendations

To remove the uncertainty, the following issues require addressing by the law:

- **Determination of the date relevant for the identification of the investor's entitlement** to vote, to information or to a specific corporate action;
- **Duties of the account providers** to:
  - **to maintain at the account provider account the number of securities matching the status of investor accounts.**
  - **pass downstream** in the chain of account providers all the information and rights necessary for the effective exercise of the right vested in securities
  - **pass upstream** in the chain of account providers the information and instructions of the accountholder
- **Determination that issuer should fulfill its obligations vis a vis to the upper-tier account provider and the account provider should be obliged to pass it down the chain of account providers to the final investor.**
- **Removal of any existing legal obstacles to cross-border electronic communication** between the investor or an entity authorized by the investor, directly or through account providers, with the issuer (This issue would require further examination.).

#### I. INTRODUCTION

This chapter focuses on the legal obstacles to effective exercise of corporate rights vested in securities by entitled persons. It relates to the function of the intermediated securities holding system which consists in securities administration activities performed for others (**asset servicing**), which can include the processing of corporate actions, including voting instructions and income and redemption payments. It is usually agreed in the contract between the investor and the account provider, to what extent this provider will provide for asset servicing. The existent legal obstacle in many cases prevent the account providers from undertaking certain asset servicing functions.

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<sup>1</sup> This chapter will require close coordination and cross-referencing with other chapters, in particular: 1. Scope, 2. Legal effects of a book entry, 4. Recognition of status of indirect holdings and 7. Moment of transfer.

According to a study released by the Group of Thirty (G30) in January 2003, “Corporate actions, across the market, are the major source of financial losses attributable to operational failure.” The Giovannini Report addressed the differences in national rules relating to corporate actions in Barrier 3.<sup>2</sup> This pertains in particular to corporate actions in case of cross-border holdings of securities. For the improvement and the reduction of costs related to the legal risk related to voting, requiring information and corporate actions, the EU needs a transparent harmonized framework for indirect holdings of securities. Such framework is particularly important in view of the significant cross-border securities holding structures existing in Europe and the differences between the country systems.

In this chapter, the Legal Certainty Group (hereinafter - LCG) identifies the legal obstacles to the effective exercise of rights vested in securities held through account providers on a cross-border basis. The purpose of this chapter is thus, to provide the answer to the following questions: 1) is there legal uncertainty which is obstacle to effective of corporate actions etc. processing and what are they, and 2) whether and in what way any such legal uncertainty should be removed at the EU-level.

It should be noted that many differences between the country systems derive from the company law of the member state (differences in types of securities held through account providers, prescribed notification periods, etc.). These differences impact the content of rights vested in securities issued under the law of a particular Member State. However, while they differentiate the assets traded, they do not as such amount to obstacles to cross-border securities holding through account providers. This report deals only with the obstacles in this area.

## **II. MINIMUM LEGAL FRAMEWORK FOR THE ENJOYMENT OF RIGHTS VESTED IN SECURITIES HELD THOROUGH ACCOUNT PROVIDERS**

### **1. The primary assumption: the investor’s entitlement.**

Pursuant to Article 4 Section 1(a) of the preliminary draft of the UNIDROIT Convention on Harmonised Substantive Rules Regarding Intermediated Securities, the credit of securities to a securities account confers on the account holder (except the accountholder acting in the capacity of an account provider) the right to receive and exercise the rights attached to the securities, including in particular dividends, other distributions and voting rights. This approach is also endorsed by the EU in the draft SVRD. There also seems to be an agreement on this issue among the EU countries (however not expressed in a legal form)<sup>3</sup>. The following analysis will, thus, also adopt this assumption.

### **2. The modified relations between the issuer and investor in securities held through account providers**

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<sup>2</sup> Giovannini Report 2003.

<sup>3</sup> Reference to the discussion of the Securities Entitlement in this report.

In case of the systems where securities are held through account provider, the simple issuer – investor relationship is substituted by a set of more complex relationships: the relationships between the issuer and account providers, and between the account providers and the investor. Because of this “separation” of the investor from the issuer, legal uncertainty exists, which is a barrier to an effective exercise of voting rights, information and corporate actions to which the investors are entitled. The longer the chain of account providers, the longer the processing and thus the more time pressure on the investor. The cross-border character of the investment adds particular uncertainty. Although legal uncertainty with respect to the exercise of rights vested in securities exists even at the domestic level (within the legal system of one country), it is particularly visible in case of cross-border security holdings, i.e., when the investor, through an account provider in Member State A, holds securities issued by an issuer in Member State B.

The obstacles relate to:

1. the timely notification of the investor of a corporate action affecting his rights or requiring his action;
2. making available to the investor all benefits from or enabling the investor to full enjoyment the rights vested in the securities he is entitled to;
3. the exercise of the rights vested in securities by the account provider to the benefit of the investor, with the use of means of distance (electronic) communication;
4. protecting the issuer from the multiplication of his obligations vis-a-vis investors in excess of the actual volume of the securities issue.

The events related to the exercise and enjoyment of rights vested in securities can be broken down into events not requiring an investor action and events not requiring such action:

- a) Corporate Actions which do not require investor action (e.g. **dividend distributions, information processing**). The following issues matter here:
  - Security of the investor that his entitlement to securities registered at his account is valid
  - Record date – identification of the investor entitled to participate in the particular corporate action
  - Timely provision of rights and notifications to the investor
  - Timely provision of the action is important
- b) Corporate Actions which require ind. investor action: actions requiring consent or a more complex investor decision (e.g. **optional corporate actions, exercise of preemptive rights to securities, tender offers with consent solicitations; voting, requesting information**); in addition to the issues mentioned above, here the investor’s right to give instructions or directly act vis a vis the issuer will be important.

### 3. Removing legal uncertainty in the investor-account provider relation

In the following, the relations between the investor and the account provider, as well as the relations between the issuer and the account provider, will be discussed.

Ad. 1.

The notification about an action of the corporation which affects the investor rights is generally the duty of the issuer. Depending on a legal system and on a type of security (bearer or registered), the issuer may be required to make a public announcement of the action or it may be required to notify each investor individually. In the latter case, the holding of securities through intermediaries creates a problem, as the issuer in most cases cannot identify who the investors are.

The identification of the investor takes place at the account provider level. To secure the proper identification of the investor, both for the purpose of notification and for the purpose of attribution of certain rights from securities, the following minimum legal framework is necessary:

- To achieve legal certainty with respect to the date which will be relevant for identification of the investor's entitlement, the issuer or the law should determine such date (record date) for the particular class of securities;

Ad 2 and 4.

- **As a general precondition, legal certainty is needed with regard to the legal effects of book entry and the moment of transfer of securities.**<sup>4</sup> The investor must have the certainty that his entitlement to securities registered at his account is valid. In particular, the following issues have impact on the determination of the person entitled to enjoy the rights vested in particular securities: the treatment of shortfalls, conditions of good-faith acquisition, the treatment of investor's securities in case of insolvency of the account provider; pledging of securities.
- **The account provider should have the duty to maintain at the account provider account the number of securities matching the status of investor accounts.**

The imposition of such a duty prevents the multiplication of book entries which would not be covered by the particular securities issue. This protection is necessary regardless of whether the book entry has derivative or autonomous character. In case of the derivative entries, it would protect the investors and in case of the autonomous entries it would protect the issuers.

- **The account provider should have the duty to pass down the chain of account providers all information and any rights and benefits associated with the security,** so that the investor is effectively enabled to fully enjoy the rights vested in securities, the right to which is credited to his account. The character of entries with

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<sup>4</sup> Reference to the relevant determination in other chapters of this report.

different account providers varies. Yet, the purpose it to impose a duty on all account providers, whenever they do acquire any rights/information, to pass it downstream

Ad 3.

- **The account provider should have the duty to pass “upstream” in the chain of account providers any information and instructions given by the shareholder.**

#### **4. Removing legal uncertainty in the issuer-account provider relation**

Ad 2 and 4.

With regard to any action affecting investors, the state company laws make the issuer generally responsible for announcements and transfers of rights related to a particular action. In case of intermediated securities, where the investors are not known to the issuer, there is uncertainty for the issuer as to whom its pecuniary and non-pecuniary obligations are due. Identification of shareholders: in some intermediated systems, other than in case of direct holding of securities, the issuer may never know who its actual investor is and whether the person exercising voting rights and other shareholder rights is the actual shareholder or an account provider. The account providers are not even required to disclose whether they are acting on somebody else’s or their own behalf.

It is uncertain, at what moment the issuer is free of its obligation vis a vis the investors - by the time of delivery to the upper tier account provider or by the time of the providing the information to the investor or crediting of the investor’s account?

Moreover, additional uncertainty for the issuer is related to the lack of determination by law of some countries of the consequences of errors in credit of securities on investor accounts in the amount exceeding the amount of issue.

- **This uncertainty for the issuer could be eliminated by determining that issuer should make sure to fulfill its obligations vis a vis to the upper-tier account provider and the account provider should be obliged to pass it down the chain of account providers to the final investor.**

### **III. THE CURRENT SITUATION IN THE EU**

#### **1. Overview of the country systems**

**The country legal framework for securities holding through account providers varies.**<sup>5</sup> Many legal systems attempt to create legal framework for intermediated securities by means of a direct analogy to the concept of direct holding of certificated securities, and thus assume the investor has the property right over the securities (the form of those property rights varies, they can be defined as co-ownership rights over the pool of securities held by the account provider of the investor at the upper-tier account). In those systems, the investor is considered the legal securities owner and thus has the right to enforce his/her rights against the issuer. In other systems, it is the account

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<sup>5</sup> More detailed analysis basing on the LCG Questionnaire should be included here.

provider who is the legal owner of the securities and the investor is the beneficial owner. In those systems, the investor cannot act directly vis a vis the issuer and the terms and conditions of the exercise of the rights from securities is conferred in the account provider, however, subject to instructions of the investor-beneficial owner. In case of a shortfall, most country systems do not regulate or do not provide for the investor's right of set off against the issuer.

**Regardless of whether an investor in securities held through account providers is granted the right to act directly vis a vis the issuer under the particular country system, the exercise of the rights by the investor always requires a certain action by on the part of account provider.** However, because of the nature of the holding of securities through account provider (including the fact that the investor typically has no legal relationship with the upper-tier account provider), the investor requires an action by the account provider in order to be able to enforce his/her rights, either through providing certification vis a vis the issuer that the investor actually is the owner of securities or through contractual authorizes the account provider to act vis a vis the issuer on behalf of the shareholder.

There are significant differences in national legal provisions affecting corporate action processing. The existing discrepancies between the Member States' laws relate to the **determination of the date relevant for identification of the person entitled to a security**<sup>6</sup> for the purposes of the exercise of particular rights vested in the security, e.g., for the exercise of voting rights or receipt of dividends. Some of the national systems do not recognize the concept of the record date as such. Where the concept of the record date is known, national laws vary in their determination of the records date providing that date is the trade date, the intended settlement date or the actual settlement date.

The **duty of account provider to pass all benefits related to securities** is not explicitly spelled out in some country legal systems. The answers to the questionnaire, however, indicate that this is the intention and approach taken by the Member States.

In a number of countries the **omnibus accounts** are not permitted, and in a number of countries there is uncertainty or lack of legal rules which would allow vote splitting in case of the exercise of the voting rights by an account provider where different votes are represented by the securities of the same class registered with an omnibus account of the account provider.

## **2. The initiatives of the EU on removal of the barriers related to enjoyment of corporate rights**

The LCG deals with the legal uncertainty related to cross-border securities holding through account providers in the European Union. Two other initiatives of the European Union aim to facilitate the enjoyment of securities held through account providers. Part of the framework necessary for the cross-border exercise of voting rights is covered by the

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<sup>6</sup> This date is not the date of security transfer; it is determined uniformly by the issuer for a particular class of securities.

proposed EC Directive on the Exercise of Voting Rights by Shareholders. In another EU initiative, the CESAME Group of the EU Commission has focused on the determination of the costs associated with the problems in processing of corporate actions and the means of approaching them.

### **3. Voting rights and information related to shareholder meetings**

#### **A. What the SVRD achieves for legal certainty and what remains to be addressed**

The proposed Shareholder Voting Rights Directive (hereinafter - SVRD)<sup>7</sup> is an important future EU-wide instrument closely linked to legal issues of the system of indirect holding of securities. It primarily covers the mechanisms which can secure effective exercise of voting rights by shareholders of European publicly held companies. For the purposes of the analysis in this report it is assumed that the SVRD will be implemented as the EU law.

Most of the shareholder rights set forth by the SVRD cannot be considered without the issue of modern legal and operational methods of securities holdings, which reaches beyond the exercise of voting rights. The proposed Shareholder Rights Directive refrained from providing solutions in this regard only for shareholder-voting. This decision bases on the assumption that the issues of legal certainty shall be addressed uniformly for all securities.

The proposed SVRD covers only rights related to shares of publicly held companies, whether or not held through account providers. In contrast, the Legal Certainty project deals with all types of securities and some other financial instruments, irrespective of the type of issuer, provided they are held through accounts with account providers.<sup>8</sup> However, the issues related to legal certainty which are valid for the exercise of shareholder rights, will also be valid for other corporate actions.

#### ***1. Imposition of certain obligations related to the timely provision of information on issuers***

Article 5 imposes on the issuer the obligation to send out to the addressee the meeting notice announcing that the meeting will take place and containing the basic information relating to the meeting. The explanatory notes to the SRD indicate that under the mechanisms currently in use, in the case of bearer shares, the addressee would normally be the CSD, and in the case of registered shares, the registered shareholder.

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<sup>7</sup> The Proposal for a Directive of the European Parliament and of the Council on the exercise of voting rights by shareholders of companies having their registered office in a Member State and whose shares are admitted to trading on a regulated market and amending Directive 2004/109/EC (published in January 2006).

<sup>8</sup> Cf. Chapter 1 of this Report discussing the Scope.

- The issue relevant for legal certainty is that the SVRD does not address the **duties related to timely transmission of information** by the CSD or the entity acting in the capacity of an account provider to the investor.

## ***2. Admission to the general meeting***

***2.1. Removal of blocking requirements and the record date.*** Article 7 of the SVRD provides for removal of the share blocking requirement and instead allows the Member States to rely on the condition that a natural person or legal entity qualifies as shareholder of the relevant issuer on a certain date prior to the relevant general meeting (**record date**).

The SVRD requires the **determination of the record date** at the country level for shareholder voting purposes. It does not attempt to introduce a uniform record date at EU level, due to considerable differences in processes for preparing general meetings and the ensuing needs in terms of timing differ considerably from one Member State to another. The minimum standard set forth by the SVRD is that the national laws determine such date, within a maximum period of 30 calendar days preceding the general meeting, and also that details of the procedure are laid down. To increase the EU-wide transparency, Member State shall communicate the date so fixed to the Commission which shall publish these dates in the *Official Journal of the European Union*.

- The key issue from the point of view of the legal certainty which was left open by the SVRD is the **determination of the existence of the entitlement on the part of the particular investor**. This issue has been dealt with extensively in this report<sup>9</sup>

***2.2. Proving the qualification as shareholder vis a vis the issuer.*** In order to avoid certain shareholders being prevented in practice from participating and voting, the SVRD also requires that the proof of the qualification (as set forth in the national law or in the articles of association) as shareholder be made subject only to such requirements as are necessary to ensure the identification of shareholders and to the extent that they are proportionate to ensure the identification.

- The SVRD does not determine the specifics of the mechanism of proving the investors entitlement. In the legal framework of intermediated securities, the role of the account provider is key to providing such proof. Thus, **an account provider should have the duty to provide the investor with such proof without undue delay or without undue obstacles** (e.g. in some countries the account provider require that the investor shows up in person at the office of the account provider to claim the certificate of his rights in securities which he then will be able to show to the issuer).

## ***3. Participation in the general meeting by electronic means***

Article 8 requires the removal by the Member States of all obstacles to the shareholder participation in the general meeting by electronic means (except insofar as they are

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<sup>9</sup> Reference to other chapters.

necessary to ensure the identification of shareholders and the security of the electronic communication and are proportionate to ensure the identification).

#### ***4. Proxy Voting***

The SVRD provides for proxy voting mechanism. Should the account provider be authorized to act on behalf of the investor:

- The outstanding issue relevant from the point of view of legal certainty is whether and to what extent the account provider acting as proxy should have the duty to vote upon the investor's instructions, if such are provided by the investor.

#### ***5. Operations of omnibus accounts***

SVRD abolishes the re-registration requirement (interim segregation of investors in omnibus accounts vis a vis CSDs)- instead the account provider can split votes. Removal of this obstacle corresponds with the duty of an authorized account provider duties to exercise voting rights on behalf of the investor and with the duty to follow investor's instructions.

### **B. Legal certainty and the voting rights in intermediated securities**

The analysis above shows that there is a certain overlap between the scope of the SVRD and the legal certainty in securities holdings through intermediaries. The following issues are part of the legal certainty framework exercise of **voting rights** in case of securities held through account provider:

#### **1) Convening the meeting by the issuer**

**The key issue here is the identification of the investor entitled to exercise these rights.** Of help can be the legal certainty issues identified during the preparatory works preceding the proposal of the Shareholder Rights Directive, which precondition the effective exercise of shareholder rights by shareholders who hold shares through account providers. In case of securities held through accounts with account providers, the exercise of voting rights depends on the allocation of rights and obligations between the investor, the account provider (account provider) and the issuer. Certainty on this matter can be achieved only if the precise **date** is determined which will be decisive for this identification of the entitled investor.

**The company law of the particular Member State determines the method of providing the notification to the investors.** The policy issue for the EU would be whether the effective enjoyment of the investor's right in the cross-border context requires imposition on the issuers (acting through intermediaries) of the duty to notify investors individually, rather than just making a public announcement of the general meeting.

#### **2) Communication between the account providers and the investors**

The rights of the investor and the corresponding obligations of the account providers/account providers *vis a vis* the investor play a significant role in the indirect holding system (in particular, those related to the identification and authentication of the person entitled to the security). The following should take place:

- a. Timely passing on by account providers on higher tiers to the lower tiers of the information and of any rights which will enable the investor to exercise its voting rights
  - i. There should be certainty that there is coverage for the investor's securities entitlement up in the chain of intermediaries;
- b. If shareholder decides to exercise voting rights, account provider has a function in enabling the exercise of the voting rights:
  - i. Undertakes the necessary action to empower the investor to exercise the voting rights, e.g through issues a certificate or authorizes the shareholder to vote (if shh votes directly)
  - ii. If the investor uses the account provider as intermediary in the communication with the issuer, the account provider collects instructions and passes upstream in the chain of account providers
    1. The issue here is the permissibility of the omnibus accounts and whether vote-splitting from securities of multiple investors entered to omnibus account would be permissible.

## 5. Corporate Actions and Related Notifications

### A. Legal Certainty Issues Identified by the CESAME Group

In view of the CESAME Group, apart from the industry-level standardization initiatives, a public sector action will be required for the removal of barriers relating to corporate actions, to the extent that they are the result of diverging national rules, especially in the areas of taxation, legal framework and supervisory issues.

The works of CESAME have focused to a large extent on addressing inefficiencies in corporate action processing, identified in the Giovannini Report as Barrier 3.

The clarification of the ex-date and record date could be helpful in clearing up the uncertainties related to dividend payments and annual meeting participation in regard to sold but not yet settled shares.

The analysis of **distributions** has been in the center of the works of the CESAME Group. Distributions (including cash distributions, stock distributions, interest payments and redemption on maturity, optional distributions) amount to 80% of all corporate actions.<sup>10</sup>

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<sup>10</sup> CESAME Synthesis Report 10.2005.

In addition, most issues applicable to distributions will be valid also for other corporate actions.<sup>11</sup>

One of the studies on distributions (focusing on **cash dividends**<sup>12</sup>) conducted for the CESAME Group by EALIC<sup>13</sup>, identified a number of legal obstacles. These obstacles fall into two categories:

1. Legal obstacles relative to the determination of **key dates** for corporate actions processing:
  - 1.1. The issue of beneficial ownership;  
The uncertainty may arise in case of those country systems, which give shareholder direct claims vis a vis the issuer: should the investor have the right to select whether he will receive the distribution through the account provider, or whether he will assert his claim directly vis a vis the issuer?
  - 1.2. Record date is not a “legal” concept in all markets;  
Record date determines what date is decisive for the determination of the person entitled to the corporate action.
2. Legal obstacles relative to the organization of the **notification process**:
  - 2.1. Harmonised legal basis is needed to establish harmonized information and distribution process from issuers to account providers;  
Account providers’ duties
  - 2.2. Legal prescriptions are to be modified to allow electronic communication;
  - 2.3. Various levels of liability exist for issuers and CSDs.

The following conclusion has been formulated by the CESAME Group with regard to the work of the Legal Certainty group should be, basing on the analyses conducted so far. Of key concern for corporate actions is the **determination of the moment when the purchasing investor is considered to be the owner of the securities** (for the purpose of payment of dividends, exercising voting rights and the control of the voting rights for other purposes).<sup>14</sup> It has been also noted certain other legal issues (e.g. announcement of only the payment date) could possibly be overcome by a code of good practice.

## **B. Legal Certainty, Corporate Actions and Notifications**

The legal certainty issues related to **notifications and corporate actions** in case of securities held through account provider are analogous to the issue of the exercise of the voting rights. This includes the obligation to follow investor instructions. Although many corporate actions do not require investor’s action, the sometimes an action in form of

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<sup>11</sup> Other issues with which CESAME is dealing with include: reorganisations; shareholders’ rights; transaction management.

<sup>12</sup> [http://europa.eu.int/comm/internal\\_market/financial-markets/docs/cesame/giovannini/ealic-corporate-actions\\_en.pdf](http://europa.eu.int/comm/internal_market/financial-markets/docs/cesame/giovannini/ealic-corporate-actions_en.pdf)

<sup>13</sup> European Association for Listed Companies.

<sup>14</sup> Basing on the estimates provided by the ESF members, the benefits of harmonisation and standardisation of ex- and record date alone with an aggregate annual amount of more than €10 million.

instructions to the account provider or a direct action of the investor vis a vis the issuer will take place.

### III. THE NEED FOR AN EU INSTRUMENT

In light of the above analysis, the following measures have been identified as means to remove legal uncertainty in cross-border securities holdings through intermediaries in the European Union. The SVRD addresses only certain aspects of legal certainty and only with respect to the exercise of shareholder voting rights. Apart from the issues of the legal effects of book entry and other determinants of certainty with regard to validity of an entry in a securities account<sup>15</sup>, a number of additional legal certainty issues remain outstanding and therefore, it is recommended that these matters are addressed by the EU law instrument:

- **As a general precondition, legal certainty is needed with regard to the legal effects of book entry and the moment of transfer of securities.**<sup>16</sup>
- **Determination of the date relevant for the identification of the investor's entitlement** to vote, to information or to a specific corporate action;
  - 1.2. The moment of determination of the security entitlement for the purposes of the enjoyment of rights vested in this security and corporate actions (record date) should be clearly identified.
  - 1.3. A related policy issue is **the issuer's right to identify the investors**; distinguishing between the account holdings on behalf of investors and *pro se* - Distinguishing between the investor and the account provider. E.g., should there be the information in the company's register that the entity indicated in the register is holding the securities on behalf of another person).
- **Duties of the account providers to:**
  - **to maintain at the account provider account the number of securities matching the status of investor accounts.**
  - **pass downstream in the chain of account providers all the information and rights necessary for the effective enjoyment by the investor of the rights vested in securities**
    - Provide all necessary means and certification to the shareholder to enable him/her to exercise the rights (voting, requesting information.
    - A related policy issue is to determine remedies against and liability of account providers for provision of the necessary information/processing of corporate actions;
  - **pass upstream in the chain of account providers the information and instructions of the investor in exercise of his rights to securities**

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<sup>15</sup> Reference to recommendations of other chapters.

<sup>16</sup> Reference to the relevant determination in other chapters of this report.

- The account provider should be required to **follow investor's instructions** and be prohibited from acting against those instructions or take instructions from persons other than the investor (with certain obvious exceptions);
- In analogy to the SVRD, the **operation of omnibus accounts** for the exercise of split rights in case of all corporate actions (this is particularly important for all actions where the investor provides instructions to the account provider – e.g. optional corporate actions) should be determined;

- **Removal of any existing legal obstacles to cross-border electronic communication** between the investor or an entity authorized by the investor, directly or indirectly, with the issuer. (This issue would require further examination.)
- **This uncertainty for the issuer could be eliminated by determining that issuer should make sure to fulfill its obligations vis a vis to the upper-tier account provider and the account provider should be obliged to pass it down the chain of account providers to the final investor.**