

COMPANY LAW AND SECURITIES CLEARING AND SETTLEMENT: THE POSSIBLE IMPACT OF A SHAREHOLDER RIGHTS DIRECTIVE ON THE LEGAL CERTAINTY PROJECT

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In this note I discuss the over-crossing of the company law and the issues of legal certainty of securities accounts, focusing on the implications of a possible Shareholder Rights Directive or other legislative action on the works of the Legal Certainty Group. In part I, I provide a brief overview of the EU Commission's work on the Shareholder Rights initiative. In Part II, I discuss the possible impact of the planned Shareholder's Rights EU legislation on the works of the Legal Certainty Group. Finally, Part III briefly discusses other areas of company law, which are currently not within the scope of the Shareholder Rights initiative, but can be of relevance for the works of the Legal Certainty Group.

I. Overview of EU Commission's works on Shareholder's Rights

Following a report on Cross-Border Shareholder Voting prepared by the expert group chaired by Jaap Winter in 2002,¹ the EU Commission's (hereinafter – the Commission) May 2003 Action Plan to modernise company law and enhance corporate governance² contains a set of initiatives aimed at strengthening shareholders' rights, reinforcing protection for employees and creditors, increasing the efficiency and competitiveness of European business and boosting confidence on capital markets. In April 2004, the Commission published results of a public consultation on facilitating the exercise of basic shareholders' rights in company general meetings and solving problems in the cross-border exercise of such rights, particularly voting rights.³ In May 2005, the Commission issued the Second consultation on Fostering an Appropriate Regime for Shareholders' Rights (hereinafter – The Second Consultation) – the responses to the consultation are due by 15 July 2005.⁴

The goal of the Shareholder Rights Project is to specify standards securing the effective exercise of shareholder rights in particular in cross-border constellations, as means of adjustment to the requirements of the modern capital markets which reach beyond borders of one country. The following means of addressing those issues are suggested by the Shareholder Rights Project:

- **Determination of specific shareholder rights related to the general meeting of shareholders (hereinafter – GM):**

¹ [Http://www.minjust.nl:8080/b_organ/wodc/publications/ond02_6.pdf](http://www.minjust.nl:8080/b_organ/wodc/publications/ond02_6.pdf).

² [Http://europa.eu.int/comm/internal_market/en/company/company/modern/index.htm](http://europa.eu.int/comm/internal_market/en/company/company/modern/index.htm).

³ [Http://europa.eu.int/comm/internal_market/company/docs/shareholders/consultation-synthesis_en.pdf](http://europa.eu.int/comm/internal_market/company/docs/shareholders/consultation-synthesis_en.pdf).

⁴ [Http://www.europa.eu.int/comm/internal_market/company/docs/shareholders/consultation2_en.pdf](http://www.europa.eu.int/comm/internal_market/company/docs/shareholders/consultation2_en.pdf).

- Establishing notification duties before and after the general meeting to provide the shareholder with information and documents necessary to vote and to otherwise actively participate in the GM,
 - Setting minimum standards for the rights to ask questions and table resolutions,
 - Enabling shareholders throughout Europe to vote by post, electronically, or by proxy.
- **Determination of the person controlling the voting rights (“ultimate investor” or “ultimate account holder”).** It is currently suggested that the previously proposed concept to create a definition of the person that should be ultimately entitled to control the voting rights, should be abandoned. Instead the project should focusing merely on enabling the shareholder voting through other means: specifying the duties of account providers *vis a vis* investors, providing for transparency of stock lending agreements, and the uniform attribution of the voting rights to the person holding a depositary receipt.
 - **Admission to the GM.** The abolition of share-blocking in favor of share registration requirement is recommended.

II. The cross-overs and the possible impact of the Shareholder Rights Directive on the Legal Certainty Project.

The scope cross-over. The Shareholder Rights project covers only rights related to shares of publicly held companies, whether or not held through intermediaries. In contrast, the Legal Certainty project deals at this stage 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.

The subject matter cross-over. Whereas the work of the Shareholder Rights Group primarily consists in the determination of the mechanisms which can secure effective exercise of voting rights by shareholders of European publicly held companies, most of the planned mechanisms cannot be considered without tackling the issue of modern legal and operational methods of securities holdings. Thus, the link to the Legal Certainty Group (hereinafter - LCG) works is established.

The **possible impact of the Shareholders Rights Project on the works of the LCG** can be significant. The Shareholder Rights Project may reach beyond mere setting of standards facilitating execution of voting rights, and address certain aspects of the system of indirect holding of securities. 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 (intermediary) and the issuer. The legal certainty of the identification of the entity controlling the rights vested in securities (including the shareholder right to vote) is of key importance here. Also the rights and obligations of the account providers/intermediaries and the issuer *vis a vis* the shareholder 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), and thus are also

of significance for the work of the LCG. In the following I will discuss the specific subject matter areas, where the Shareholder Rights Project may influence the working framework of the LCG can occur.

1. The determination of the person entitled to control the voting right. Following the assumption that the legal position of holder of securities held through accounts with account providers should be no worse than the position of a holder of physical and directly held securities, the view of the Winter Group has been that the “ultimate accountholder” should be conferred with all the rights from the share, including the right to vote, with all its implications. There is also a tendency towards establishing a direct communication channel between the company/issuer and the shareholder regarding the notification requirements on the part of the company, the shareholder right to inquire etc.

Of direct relevance for the work of the Legal Certainty Group is **the definition of the person in control of the voting rights** as the “ultimate accountholder”, suggested by the Commission (i.e., *the last natural or legal person holding a securities account in the “chain” of intermediaries and who is not a securities intermediary within the European securities holding systems, nor a custodian*). As a result of critique of the definition raised in responses to the first consultation, in the Second Consultation the Commission recommends abandoning it in the short term. It is suggested that the definition of the person entitled to control the voting rights should be a long-term goal, reaching beyond the immediate scope of the works of the Shareholder Rights project, and could probably be addressed by the Legal Certainty Group. Alternatively, the Commission recommends considering the adoption of the definition of the person entitled to control the voting rights proposed by the UNIDROIT (note, however, that the definition is subject to changes in the UNIDROIT process since the original proposal was made).⁵

2. The intermediary definition. The Second Consultation proposes the following definition of the intermediary for the Shareholders Rights project: *a legal and natural person who, as part of a regular activity, maintains securities accounts of other legal or natural persons shall be considered as an intermediary*. This definition is taken from the original draft of the UNIDROIT Convention.

3. The duties and rights of the intermediary/account provider and issuer *vis a vis* the shareholder. Apart from the general duty (subject to any contractual and regulatory arrangements governing the account relationship) to maintain the securities accounts in accordance with the interests of securities holders and to avoid shortfalls, this means also determination of the duties of account providers/intermediaries towards the shareholders, with respect to enabling the exercise of shareholders’ rights. Those are, e.g., the duty of intermediary, where relevant, to grant the shareholder the power of attorney to attend the GM and vote, or the duty to follow voting instructions received from the shareholder (which is reflected by the right of the intermediary to hold shares on behalf of their clients on individual or pooled accounts and, in case of pooled accounts, to cast split

⁵ I.e. “the legal or natural person that holds a securities account for its own account shall have the right to determine how votes attached to shares credited to its securities account are to be cast”

votes – if the intermediary is entitled to vote); issuance of depositary receipts, where required for registration of shareholders' direct rights against the issuer.

4. The duties and rights of the issuer *vis a vis* shareholder as regards the registration and acknowledgement as a shareholder, i.e. allowing for direct rights of shareholder against the issuer and direct communication of the company with the shareholder.

5. Registration as nominees. Another focus point of the Second Consultation are the efficient means of registration (e.g. in case of nominee shareholder registration systems, the Commission suggest the determination in the company's register that the entity indicated in the register is holding the securities on behalf of another person).

Other issues considered by the Shareholder Rights project related to certainty of determination of the control over the voting rights, which are of relevance for the LCG:

6. Securities Lending. The practice related to securities lending presents an issue for the determination of the lender or the borrower should have control over the voting rights and other rights of a shareholder. In particular, the Shareholder Rights Project notes the need of transparency of such agreements and advocates for imposing a duty of disclosure on intermediaries entering such agreements.

7. Depositary receipts. The Commission recommends the rule that voting right should be attached to the holder of depositary receipts.

8. Settlement Times. In its previous works, the Winter Group noted the problem of the possible impact of differences in settlement times on the ability of shareholders to exercise their voting rights where shares are transferred in cross-border transactions. These differences may result in the situation that will be two investors in different countries who at the same time are regarded as the persons with an entitlement to the same securities. Alternatively, in another setting, there might be a period of a few days in which no one is regarded as having entitlement to the securities.⁶

This is linked to an issue identified as a legal barrier in the second Commission's Communication on clearing and settlement, i.e. differences in national legal provisions affecting corporate action processing, such as discrepancies in Member States' laws as to the determination of the exact moment when a purchaser is considered to be the owner of a security, e.g., for the payment of dividends. The Communication states that national laws may provide that such moment is the trade date, the intended settlement date or the actual settlement date. As noted in the two Giovannini reports, such discrepancies may inhibit the centralisation of securities settlement and,

⁶ Note that some sources indicate (e.g. the majority of responses to the preliminary consultation of the Winter Group) that in practice differences in settlement times may not cause problems with respect to the voting rights. It remains to assess whether these are mere incidents or indicate a wider problem with cross-border transactions. Note also that some sources (e.g. International Corporate Governance Network – ICGN, http://www.icgn.org/organisation/documents/cbv/cbv_letter_van_ginkel_may2002.php) note that there may be a way of using law to solve the problem of not harmonized settlement systems by precisely determining, for the purpose of exercise of the rights, the moment of transfer for the cases of cross-border transactions involving different standards of settlement time. The viability of creation of such a rule, as well as the potential issues related to its enforcement, remains to be further examined.

for this reason, constitute a barrier to further integration. As a consequence, there might be a need for harmonisation of the relevant rules.

III. Other areas of company law relevant for the works of the Legal Certainty Group.

It should be noted that a number of issues and areas of over-crossing of the corporate law and securities accounts law are currently not covered by the Shareholders' Rights project, but may be relevant for the Legal Certainty Project. To those belong:

- notifications other than those related to the exercise of voting rights (e.g. about mergers),
- dividend payment,
- interest payment and bonds redemption,
- conversion of convertible bonds into shares of a new issue,
- exercise of pre-emptive rights to shares in a new issue,
- exercise of warrants,
- redemption of investment certificates,
- exchange of securities,
- conversion of securities,
- exchange of securities following mergers or divisions of public companies.

Apart from the Shareholder Rights Project, other ongoing EU-Commission activities on company law harmonization can be potentially related to the works of the Legal Certainty Group. An example is the Commission's recent project on obstacles to cross-border mergers and acquisitions in the financial sector in Europe, which may to some extent be related to the LCG works.⁷

⁷ [Http://www.europa.eu.int/comm/internal_market/finances/cross-sector/index_en.htm#obstacles](http://www.europa.eu.int/comm/internal_market/finances/cross-sector/index_en.htm#obstacles).