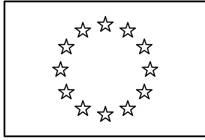

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Impact Assessment on the Proportionality between Capital and Control in Listed Companies

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EXECUTIVE SUMMARY

There is a general consensus in the academic, financial, and multilateral regulatory community that the development of financial markets is one of the key preconditions for economic growth, and that internal financing and bank financing should be complemented by strong securities markets. In turn, the functioning of the latter critically depends on protecting shareholders against extraction of private benefits by insiders.

Shareholders who control a proportion of total voting rights much larger than their ownership (and therefore dividend) rights have an incentive to extract value from the company at the expense of non-controlling shareholders. Such an incentive acts as a multiplier with respect to the general fact that parties in control of a corporation are in a position to enjoy private benefits of control that do not accrue to non-controlling shareholders

In its Action Plan for Modernising Company Law and enhancing Corporate Governance in the European Union of 2003, the Commission observed that any initiative at EU level concerning the principle of proportionality between capital and control would be preceded by an external study which would be undertaken in the short to medium term. The study has been undertaken by a consortium led by ISS Europe (see ISS et al. 2007) and its final report was published on 4 June 2007.

The study conducted by ISS et al (2007) shows how various instruments that allow for the separation of ownership from control, the so called control-enhancing mechanisms, or CEMs are used in listed companies. The study shows that corporate CEMs are relatively common across the EU. Of all the 464 European companies considered, 44% have one or more corporate CEMs (or other alternative mechanism). The countries with the highest proportion of companies featuring at least one of these mechanisms are, in decreasing order, France, Sweden, Spain, Hungary and Belgium, which all have a majority of companies with corporate CEMs or alternative mechanisms. The occurrence of those mechanisms varies from one country to another, but varies also between large companies and recently listed companies. A majority of large caps (52% of the companies analysed) have corporate CEMs or alternative mechanisms while one quarter of recently listed companies (26% of the companies analysed) have corporate CEMs or alternative mechanisms. Overall, the mechanisms mostly used are pyramid structures, multiple voting rights shares, and shareholders agreements.

According to the economic theory referred to in this document, the separation of ownership and control is often so high among EU listed companies as to constitute an important incentive for management and controlling shareholders to extract private benefits at the expense of non-controlling shareholders, particularly retail investors and investment and pension funds. However, the empirical studies on this issue do not provide sufficient evidence on the existence and extent of private benefit extraction resulting from lack of proportionality, except in a few cases of corporate scandals. Even if such company scandals are relatively rare, they might have systemic consequences. Moreover, a majority of the investors surveyed by the ISS study perceive all CEMs negatively, though some are perceived as more negative than others. CEMs that investors perceive most negatively are priority shares, golden shares, voting right ceilings, pyramid structures, multiple voting rights shares, ownership ceilings, non-voting shares and to a lesser extent cross-shareholdings and depositary certificates. Finally, some of the investors that replied to the ISS study survey made additional comments calling for more transparency on CEMs in order to improve the information they have on the existence and impact of any CEM.

Existing Community legislation in the field of securities markets already directly or indirectly addresses CEMs with a view to countering information asymmetry. This relates *inter alia* to rules on the exercise of control rights, on the prevention of conflict on interest and on market transparency, including financial disclosure. While this should allow for spontaneous market pressure to reduce the incentives for private benefit extraction, there is no conclusive evidence that market forces alone will allow in the near future to significantly reduce the presence and relevance of CEMs across EU listed companies. It also remains to be proved that non-controlling shareholders and in particular institutional investors will make the most of their voting rights so as to protect themselves against extraction of private benefits by controlling shareholders.

To reduce the incentives for extraction of private benefits at the expense of non-controlling shareholder, this document considers some policy options: The first specific option would be the prohibition of CEMs created by companies. The second specific option would be to enhance the transparency regarding CEMs and their use. Both options need to be examined against the possibility of doing nothing: in other terms, relying on the ability of the existing regulatory framework to deal with the problem identified.

Concerning the first option, the preliminary nature of the quantitative studies on the actual extent of extraction of private benefits and on whether such danger constitutes a measurable drag on the EU economy makes it inadvisable even to recommend prohibiting those corporate control-enhancing mechanisms (CEMs) that make separation between ownership and control possible. In any case, the prohibition of CEMs could be easily circumvented through the use of alternative mechanisms based on shareholder behaviour (pyramids, shareholders' agreements) which are beyond companies' control. Moreover, prohibiting corporate CEMs could have undesirable effects in terms of, inter alia, hindering long term policy of companies, hindering companies' (in particular family companies) access to the capital markets or increasing the monitoring cost for shareholders (the agency problem).

The second option could be to increase transparency on and around CEMs. The European Corporate Governance Forum, asked by Commissioner McCreevy to provide advice on the subject, has advanced three specific suggestions in this regard. In particular, the Forum suggests that, first, listed companies should provide for a reasoned explanation of the objectives and effects of the CEMs applied, together with their suitability and proportionality to achieve such objectives; second, that in certain cases shareholders should be required to provide insight into the size and nature of their shareholdings as well as the policy they have on the exercise of powers attached to their holdings; third, that companies and shareholders should be required to provide more transparency on the actual recourse to non-proportional mechanisms. There are, however, other arguments that could be advanced against these proposals, such as the risk that companies provide formalistic explanations with little interest and the cost for investors in making further disclosures to those already foreseen in the legislation.

In any case neither of these two options is devoid of costs while the benefits do not appear to be undisputable.

The option of doing nothing would imply reliance on the existing legal framework to address the identified risks. Existing EU legislation already contain several provisions on transparency which directly or indirectly address the risks posed by CEMs. This legislation is essentially composed of: the Transparency directive, the Takeover Bids directive, the 2006 amendments of the Accounting Directives, the new Auditing Directive, and the recently adopted

Shareholders' Rights Directive. These measures, by increasing the transparency around CEMs and by empowering shareholders appear to contribute directly or indirectly to reducing the risk of private benefit extraction by insiders.

Stock lending, directives and related techniques are reported to be increasingly used in order to gain control of voting rights without bearing the economic risk of the underlying shares. The result is also a separation of ownership from control. The corporate governance effects of those techniques have not been sufficiently studied yet and existing research does not provide conclusive results. This subject was recently addressed by the third consultation on shareholder rights organized by the European Commission, and is being considered in that context.

If one of the two specific options above were to be pursued, the most suitable type of legal instrument would need to be selected, in essence: a directive, a regulation or a recommendation. In view of the complexity of many of the issues at stake and the specificities of EU company law systems, if action were to be taken the instrument of the Recommendation would be preferable as it leaves member States the freedom to evaluate which of the transparency options suit best the respective specificities of each legal and industrial systems.

If action were to be taken, the main impact would be on the controlling shareholders, who could entail a reduction in their return as far as they would be limited in their possibility to obtain private benefits of control. The main beneficiaries of any action would presumably be minority shareholders, whether institutional or retail investors, while other stakeholders do not seem to be significantly affected. If, on the contrary, the no-action policy option is retained, the impact of the existing Community and national legislative and non legislative measures would apply in a similar manner to the categories of stakeholders described above. Without further measures, the diminution of the risk of private benefit extraction would be less significant. Nonetheless, existing transparency measures should to result in higher level of investments and lower cost of capital. On the cost side, however, the impact of not undertaking further action is less burdensome for issuers and investors

In terms of the proportionality test, it is not clear, in the light of the above, that adopting a Directive or a Recommendation would represent the least onerous way to reduce the risk of private benefit extraction by insiders across the EU Member States compared to the combined action of spontaneous market pressure, Member State regulatory initiatives and the existing Community legal framework. In the absence of empirical evidence on the existence and extent of shareholder expropriation, adopting further measures could entail a risk of imposing significant costs to issuers and controlling shareholders without a proportional benefit.

1. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

1. In January 2002, the High Level Group of Company Law Experts, appointed by the Commission in 2001, presented its report on Issues Related to Takeover Bids[1]. In the High Level Group 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*". For the group, the holder of the majority of risk-bearing capital should be able to exercise control.

2. In its subsequent Action Plan for Modernising Company Law and enhancing Corporate Governance in the European Union[2], the Commission observed that any initiative to give effect to the principle of proportionality between capital and control advocated by the High Level Group would require prior study. The Commission announced that such a study would be undertaken in the short to medium term.

3. Respondents to a public consultation in 2003[3] that followed this Action Plan expressed very diverging views on the issue. As expressed in the synthesis of the responses, "*a small majority of respondents on the subject supported the generalisation of the 'one share – one vote' principle and urged the Commission to launch its study as a matter of urgency. A significant minority, however, expressed serious concerns about the idea and contested the view expressed in the Action Plan that shareholder democracy should be interpreted as 'one share – one vote*'". Respondents also highlighted that any study should be sufficiently broad, also addressing the issues regarding pyramidal groups, cross shareholdings, golden shares etc.

4. The Commission services undertook a further consultation process in early 2006 on the priorities set up by the 2003 Action Plan, which was closed with a public hearing in May 2006[4]. In the replies, there was clear support for a fact-finding study at EU level but respondents' views were again split on any possible EU intervention: investors being in favour and issuers rather opposed to such an intervention. In any

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[1] Report of the High Level Group of Company Law Experts on Issues related to takeover bids, Brussels, 10 January 2002, available at: http://ec.europa.eu/internal_market/company/takeoverbids/index_en.htm

[2] Communication from the Commission to the Council and the European Parliament - Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward; COM(2003)284, of 21.5.2003. Available at: http://ec.europa.eu/internal_market/company/modern/index_en.htm

[3] Synthesis of the responses to the Communication of the Commission to the Council and the European Parliament "Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward" – COM (2003) 284 final of 21 May 2003. A Working Document of DG Internal Market, 15 November 2003. Available at: http://ec.europa.eu/internal_market/company/modern/index_en.htm

[4] The consultation document, the summary report of the replies and the hearing's records are available at: http://ec.europa.eu/internal_market/company/consultation/index_en.htm

event, concerning the form of any potential EU regulatory intervention, opinions were split between a potential directive and a potential recommendation.

Both the consultations in 2003 and 2006 respected the minimum standards for consultations of interested parties by the Commission[5].

5. In this context, the European Parliament adopted an own-initiative report on company law in 2006[6]. In this report, the EP, while waiting for the results of the study commissioned by the Commission, indicated that the Commission should not propose any legislative proposal regarding the issue of proportionality and control before evaluating the application of the Take-over Bids Directive[7].

6. An external study was commissioned in 2006 from a consortium led by ISS Europe. Its final report was made available to the public in May 2007 (see Annex 1)[8]. The objective of the study was to identify existing deviations from the proportionate allocation of capital and control across EU listed companies (including the review of such mechanisms as multiple-voting rights, voting caps and non-voting preferential shares, as well as of tools such as shareholders' agreements, cross-shareholdings and company pyramids), and to evaluate their economic significance and whether such deviations have an impact on EU financial markets. The study scrutinizes the regulatory framework in 19 jurisdictions (including 3 from outside the European Union) and examines the situation of 464 listed European companies. The study also consists of a review of the available academic literature and empirical evidence on the proportionality principle as well as a survey of institutional investors whose objective is to assess what role the proportionality principle plays in their investment decision.

7. Member States, notably within the Corporate Law Expert Group, have devoted time to the question of proportionality between capital and control. This issue has also been addressed in two high level conferences organised by two consecutive European presidencies: the Finnish Presidency in October 2006[9] and the German Presidency in June 2007. The ISS study was presented and discussed at the June 2007 German Presidency conference[10]. The study was welcome as a balanced presentation of the existing situation.

8. The review of the ISS study was completed at a conference organised by the European Corporate Governance Institute and the Copenhagen Business School in Copenhagen in September 2007 on control enhancing mechanisms in corporate governance. This conference focused on the review of the findings of the academic

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5 Communication from the Commission of 11 December 2002, Towards a reinforced culture of consultation and dialogue – General principles and minimum standards for consultation of interested parties by the Commission, COM (2002)704final.

6 Report on recent developments and prospects in relation to company law, JURI (and ECON) Committee, EP. Rapporteur: A.J. Szejna; Draftsman: K.-H. Lehne. Document A6-0229/2006.

7 Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on Takeover bids. See in particular Article 20. OJ L142, 30.4.2004, p.12.

8 The consortium was composed of ISS Europe, Shearman & Sterling and the European Corporate Governance Institute. The final report of the study is available at: http://ec.europa.eu/internal_market/company/shareholders/indexb_en.htm

9 www.om.fi/Etusivu/Ajankohtaista/BetterRegulationinEUCompanyLawProcessandSubstance?lang=en

10 www.bdi.eu/en/8674.htm

surveys of the ISS study[11]. There was a general consensus at the conference on the usefulness of the ISS study which has provided the first systematic overview of the presence of control-enhancing mechanisms across a large sample of EU listed companies.

9. Outside the consultation periods in 2003 and 2006, many interested parties, including relevant European associations, have forwarded position papers to the Commission services on the question of proportionality of capital and control. Positions in those papers are split, depending on the party involved. In general, industry representatives, chambers of commerce, some public authorities and some research/policy think tanks have expressed preference for maintaining the status quo and not introducing any further measure in this field. On the contrary, investors' representatives and representatives of businesses providing services to investors in the corporate governance field are generally in favour of a regulatory intervention at EU level, at least to provide further transparency in relation to the use of control enhancing mechanisms. Meetings with some of those interested parties have taken place where possible. In addition, the Commission services have taken part in several conferences, seminars and roundtables addressing this issue as well as in discussions with non-governmental experts in corporate governance and company law.

10. Finally, the Commission also asked the European Corporate Governance Forum (composed of high level experts from the public and private sectors and which assists the Commission in this field) to provide input on this subject and in particular to analyse the results of the ISS study. Following discussions in several meetings in 2006 and 2007, the Forum adopted a statement in June 2007 providing its position on this issue. The statement was published on the Commission's website on 12 September 2007[12]. It is attached as Annex 2. Its conclusions are that it is unadvisable to mandate or even recommend the prohibition of control-enhancing mechanisms and that initiatives aimed at ensuring more transparence could be considered. The contents of such statements will be examined in detail in Section 5.2.2 below.

11. This impact assessment has been prepared by the Commission staff. A steering group with representatives of the Secretary General, DG Employment and DG Enterprise has assisted during 2007 DG Internal Market and Services in the preparation of this text. A draft impact assessment was submitted to the Commission's Impact Assessment Board, which provided its opinion in early November 2007[13]. The recommendations of the board led to changes into the impact assessment draft, in particular regarding the presentation of the problems arising from the separation of ownership and control (section 2.2) and the development of a clearer baseline scenario (section 2.3). The presentation of the policy objectives was also improved (section 3).

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11 www.cbs.dk/cem

12 http://ec.europa.eu/internal_market/company/ecgforum/index_en.htm

13 This opinion is available at: http://ec.europa.eu/governance/impact/iab_en.htm

2. PROBLEM DEFINITION

2.1. The current situation: Control-Enhancing-Mechanisms (CEMs) and their use

2.1.1. Identification of CEMs

12. Control-Enhancing-Mechanisms (CEMs) should be primarily understood as the institutional arrangements (e.g. taken by the listed company itself) creating a discrepancy in the relation between financial ownership and voting power with the result that a shareholder can increase his control without holding a proportional stake of equity.

There is a wide variety of Corporate CEMs, which may be used in isolation or cumulatively in the same company according to national legal specificities and company practices. For instance (for further details see Annex 3; see also ISS et al. (2007) and ECGF (2007), available in Annexes 1 and 2):

- Corporate institutional arrangements directly affecting voting rights attached to shares, such as: shares with multiple voting rights, shares with loyalty schemes that may increase their voting rights, non voting shares (without preference), non voting preference shares, participating bonds or voting rights ceilings;
- Corporate institutional arrangements indirectly affecting voting rights by creating specific rights or by reducing or inhibiting the ability to exercise voting rights proportionally, such as: priority shares, golden shares[14], depository certificates of shares sponsored by the company or supermajority requirements;
- Other corporate institutional mechanisms that reduce or inhibit the exercise of control through the exercise of voting rights, such as ownership ceilings, share transfer restrictions, staggered board provisions and other arrangements.

13. As alternatives to corporate CEMs, other mechanisms are used across the EU to reinforce controlling shareholders' power, in particular company pyramids and shareholder agreements.

14. These mechanisms are the focus of this document insofar as they are an incentive to extract private benefits of control. However, it should also be taken into account that they may also have other different objectives and effects.

15. From ISS et al (2007) it is clear that no jurisdiction within the sample has opted for an all-proportionality or all-freedom of contract legal system. On the contrary, most jurisdictions tend to hold a middle-ground position: they all have between five and eleven corporate CEMs (or alternative mechanisms) available. Even countries which have, to some extent, formally adopted the proportionality principle authorise the use of a number of corporate CEMs (and alternative mechanisms). As a result, they are widely available in all of the countries reviewed: all CEMs (or alternative

[14] Golden shares are a variety of priority shares in which the beneficiary is a public authority. In many cases, golden shares are the result of legislation rather than created by the company itself. In this paper, legislation regarding golden shares will not be addressed.

mechanisms) but one are available in more than 40% of the jurisdictions and six of them are available in more than 80%.

2.1.2. *Scope: listed vs. unlisted companies*

16. The scope of this assessment applies to CEMs in listed companies understood as companies formed under the laws of a Member State and whose securities are admitted to trading on a regulated market in one or more Member States within the meaning of Council Directive 2004/39/EC. As a matter of principle, for listed companies a certain level of uniform, compulsory, substantive rules may be required to protect sufficiently both (non-controlling) shareholders (investors) and creditors. Indeed, there is a public interest in the governance of companies whose shares are offered to the public[15].

17. For private companies, generally speaking, there is a wider scope for the parties to determine autonomously the structure of the company and the rights, responsibilities and obligations of those participating in it. Moreover, though figures are not available, unlisted companies are likely to have a very reduced cross-border ownership. In 2006, out of a total number of approximately 4,806,896 companies across the EU, only around 9,500 are listed ones.

2.1.3. *Measurements of separation of ownership and control in the EU: the use of CEMs*

18. Although no systematic data are available on the degree of separation of ownership from control across the entire EU, there are signs that such a phenomenon can reach important levels. As shown by Enriques and Volpin (2007), thanks to company pyramids, separation of ownership from control can go as far as giving the controlling shareholder of the French Louis Vuitton Moet Hennessy (LVMH) 47% of the voting rights in LVMH with a direct and indirect ownership of 34% of the cash flow rights. In the case of Telecom Italia, one of the world's largest telecom companies with a market capitalization of about $40 billion, in 2001 a single shareholder controlled 18% of the votes (and was by far its largest shareholder) by making recourse to a pyramid group, although he held only 0.7% of the cash flow rights. Because of the combined effect of the dual classes of shares and the pyramidal structure, one German family controls 25.1% of the votes in Volkswagen AG but owns only 9.44% of its cash flow rights.

19. Family control can even go beyond specific listed companies: Agnblad, Berglöf, Högfeldt and Svancar (2001) show that in Sweden a single family shareholder controlled about 50% of the Stockholm stock exchange mainly through recourse to company pyramids and multiple-voting rights. According to Faccio and Lang (2002) a single Italian family controlled about 10% of the Borsa Italiana total market capitalization. More generally, according to the findings reviewed in Morck et al. (2005), the large corporate sectors, excluding state-owned enterprises, of several EU countries are predominantly controlled by a small number of very wealthy families through pyramids and such other means as dual-class shares, cross shareholdings and differential voting shares.

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[15] Additionally, it is conceivable to extend such protective measures to all companies with publicly raised capital, *i.e.*, not only those whose shares are admitted on a regulated market, since such companies may also have, in certain Member States, dispersed ownership structures.

20. More generally, systematic measurements of the separation of ownership from control are available only for Italy. Bianchi et al. (2005) show that the Italian listed companies are characterised by a high incidence of pyramidal structures, shareholder agreements and shareholder coalitions.

21. The study conducted by ISS et al. (2007) quantifies the recourse to the various instruments that allow for the separation of ownership from control. The study shows that corporate CEMs are relatively common across the EU. Of all the 464 European companies considered, 44% have one or more corporate CEMs (or other alternative mechanism). The countries with the highest proportion of companies featuring at least one these mechanisms are, in decreasing order, France, Sweden, Spain, Hungary and Belgium, which all have a majority of companies with corporate CEMs or alternative mechanisms (see Table 2). The occurrence of those mechanisms varies from one country to another, but varies also between large companies and recently listed companies. A majority of large caps (52% of the companies analysed) have corporate CEMs or alternative mechanisms while one quarter of recently listed companies (26% of the companies analysed) have corporate CEMs or alternative mechanisms. Overall, the mechanisms mostly used are pyramid structures[16], multiple voting rights shares, and shareholders agreements[17] (see Table 3). It is also interesting to note that recently-listed companies in Europe which were included in the ISS sample feature a smaller number and a smaller variety of those mechanisms than large companies. As in large companies, pyramid structures, shareholders agreements and multiple voting rights shares are the most common mechanisms in recently listed companies. Finally, some of these companies combine different mechanisms, thereby enhancing their impact.

22. Although the study by ISS et al (2007) did not collect data systematically for countries outside the EU, the existing data reported in the study point out to the existence of a variety of CEMs and of multiple CEMs in non-EU countries as well (on the same subject see also OECD 2007). In the United States, companies usually issue one type of share. However, 20% of companies do have dual class shares. Indeed, 896 US-listed companies out of a 4,399 companies sample have dual-class shares. In addition, 0.2% of companies (nine companies in the US sample) grant shareholders loyalty votes. In general, this consists in granting common shares five or ten votes per share if held for four years. In addition, 24 out of 4,399 companies of the US sample have voting right ceilings. This ceiling is generally set at 10% of outstanding shares. US companies also issue non-voting shares, although we do not have consistent data to illustrate their occurrence. Interestingly, pyramids seem not to be used in the US because of tax reasons. In Australia, 4% of companies (ten companies out of 248) have multiple classes of shares. These shares consist mainly in preference voting shares. In Japan, multiple voting shares are very rare. Two companies have two types of shares out of a 248.

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[16] It is important to note that the definition of pyramids in the ISS study is subject to interpretation. In some of the situations described as pyramids, the controlling company is a family-owned company or it is fully owned by an individual legal person. The figures would be lower if only controlling companies with minority shareholders were taken into account.

[17] It is important to note that some of the agreements identified in the ISS Study are not significant in terms of control. They would not reach or cross the lowest threshold triggering the notification obligation in the Transparency Directive.

2.1.4. *Listed companies in the EU: ownership structure*

23. According to the indicators of ownership concentration reported by Enriques and Volpin (2007), widely-held companies are relatively rare even among the largest listed companies in Italy while they are very common in the UK and the US, with Germany and France in between. Second, with the exception of the UK (where it is absent), family control is quite widespread even among the largest corporations. Third, pyramids are frequent in continental Europe and totally absent in the Anglo-Saxon countries. Moreover, looking at the median of votes owned by the largest shareholder across all listed companies, ownership appears very concentrated in Germany and Italy, and diffused in the Anglo-Saxon countries, with France falling in between. Finally, in continental Europe ownership is largely concentrated in the hands of a small number of wealthy families (see Table 1).

24. Bianchi et al. (2005) provide data on ownership concentration of listed companies across 16 European countries (including 14 EU Member States) with reference to the percentage of total share capital owned by small shareholders (the so called free float). They show that while the general average free float across all the countries considered is about 90%, there are significant differences: in Italy the average free float is less than 60% against about 90% in the UK and Ireland, more than 70% in the Scandinavian countries and about 66% in Germany (see Table 8).

Institutional and retail investors as non-controlling shareholders

25. It is important to notice that in today's corporate Europe non-controlling shareholders are to a very significant extent made up of pension funds, mutual funds and direct retail investment from households.

Data provided by FESE (2007) on share ownership in the EU show that institutional investors and households represent the first category of non-controlling share ownership in companies listed in the EU. From Table 6 it is possible to see that in 2005 private financial enterprises (pension funds and mutual funds) owned 24% of total market capitalisation, and that individual investors and households owned 15%. Moreover, we should also take into account that part of the 33% of total market capitalisation owned by foreign investors belongs to European investors[18].

26. Table 4 gives another measure of the importance of institutional investors in EU-listed companies. With reference to a large sample of the companies making the Eurostoxx 50 Index, in 2005 foreign and resident institutional investors together made almost 60% of total share capital, in constant increase with respect to 2003 and 2004. This increase corresponds to a decrease in the percentage held by private and core shareholders in the three-year period considered.

27. There is also evidence that EU institutional investors are increasingly diversifying their equity portfolios. According to ECB (2007a), the share of investment funds' total holdings of all shares and other equity (excluding investment fund shares/units),

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[18] Of course there are also differences in the investing pattern across EU Member States, the main being that the participation of private financial companies is particularly high in the UK while in Germany shareholdings by private non-financial companies are particularly high (FESE 2007).

issued by residents of the Euro area outside the Member States in which the investment fund is located, went up from about 16% in 1998 to about 24% in 2006.

2.2. The economic case

2.2.1. The question of the extraction of private benefits

The theoretical case

28. The debate on proportionality between capital and control and on the opportunity to limit control-enhancing mechanisms (CEMs) centres on preventing the abusive extraction of private benefits by executive directors and controlling shareholders. Shareholders who control a proportion of total voting rights much larger than their ownership (and dividend) rights have an incentive to extract value from the company at the expense of non-controlling shareholders. Such an incentive acts as a multiplier with respect to the general fact that parties in control of a corporation are in a position to enjoy private benefits of control that do not accrue to non-controlling shareholders. Private benefits can be of a psychological nature (for instance the pleasure managers experience from being at the top of a large organization) but can also take the form of wealth extraction at the expense of non-controlling shareholders. In turn, wealth extraction can take several forms, from outright theft, to transfer pricing or diverting assets from the company at below market prices in favour of insiders, to managerial entrenchment (Shleifer and Vishny 1997). In this sense managerial or controlling shareholder entrenchment can be seen as specific forms of wealth extraction.

29. There is a general consensus in the literature on corporate finance and corporate governance that a critical component of financial development, that is the willingness of investors to provide funds to companies, might be hampered in the absence of guarantees against wealth expropriation of outside investors[19]. In particular, according to Black (2001) a key precondition for the existence of strong securities markets is that non-controlling shareholders receive good information about the value of a company's business and have confidence that managers and controlling shareholders will not expropriate them of all or part of the value of their investment.

30. Already Adam Smith (1776), and then Berle and Means (1932) and Jensen and Meckling (1976), address the agency problem between managers and shareholders caused by dispersed ownership structure. The problem is that small shareholders lack the economic incentives to spend resources to control management. As noted by Shleifer and Vishny (1997), large shareholders do have economic incentives to gather information and monitor management. By exercising their voting control, large shareholders do put pressure on management to act in shareholder interest. However, as showed by Demsetz (1983), Fama and Jensen (1985), and Grossman and Hart (1988), a concentrated share ownership structure also brings an incentive for controlling shareholders to expropriate non-controlling shareholders. There is a danger that controlling shareholders use their influence to transfer corporate assets to themselves at below-market prices.

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[19] See Black (2001) for a list of reasons why securities markets should be intended as complementary to inside financing and bank financing.

31. Inquiry into the dynamics of private benefits of control is the focus of Grossman and Hart (1988) and Bebchuk (1999): Grossman and Hart (1988) observe that the allocation of voting rights influences whether control will stay in the hands of a high private benefit party or a high security benefit party; Bebchuk (1999) observes that private benefits of control are an incentive for controlling shareholders to maintain a lock on control and to prevent the formation of dispersed ownership.

Indeed, the risk of board entrenchment and incontestability of control is high in those cases in which CEMs are used (see ECGF(2007) on this).

32. More generally, the consequence is seen as having a direct impact on company economic performance, since in both cases the company is not run in the interest of (all) its suppliers of finance. Even when a company manager pursues a profit-maximizing behaviour, he may have an incentive not to return the money to investors: for instance, instead of distributing dividends he may embark the company on costly investment projects.

33. According to the literature, incentives for controlling shareholders to expropriate non-controlling shareholders are directly proportional to their separation of ownership from control. For instance, La Porta, Lopez-de-Silanes and Shleifer (1999), Claessens, Djankov and Lang (2000), and Faccio and Lang (2002) show that in many cases European companies are characterised by individual or family control over the majority of the votes via pyramids and other such instruments as multiple voting shares, cross-holdings, shareholder agreements and so on. As observed by Mork et al (2005), "*entrusting the governance of huge slices of a country's corporate sector to a tiny elite can bias capital allocation, retard capital market development, obstruct entry by outsider entrepreneurs, and retard growth*."

The empirical evidence

34. If the theoretical side of the debate on shareholder expropriation is well established, the empirical studies on the existence and extent of private benefits of control are still at a relatively early stage, since they are based on methodologies which are still under discussion and a small number of observations for each country (see ISS et al 2007, p. 56-62).

35. The extraction of private benefits of control is at the origin of some of the recent company scandals in Europe in recent years. In particular, this is the case of the Cirio and Parmalat scandals which took place in 2003. Ferrarini and Giudici (2005) illustrate the details of the Parmalat scandal and of the abusive behaviour of its controlling shareholder: "*Basically, all Parmalat's financial statements had been false for a long time, even though it is not yet clear from exactly when. Both the bad performance of the core business and the exceptional cash amount siphoned-off by the Tanzi family during the years, also in connection with the terrible results of the tourism business and the other activities of the Tanzi family (e.g. the football business), had created a mountain of debt that went out of control…As far as the technical means used to conceive the fraud, they were extremely basic. Parmalat hid losses, overstated assets or recorded non-existent assets, understated its debt, and*

diverted company cash to Tanzi family members.[20] As for the Cirio scandal, according to Onado (2003), this scandal took place through, among other things, manipulations of intra-group cash flows and the recourse to shell companies to extract assets out of the company at the expense of non-controlling shareholders.

European scandals took place in Europe after a wave of scandals in the United States in 2001-2002, among which the most important were Enron and WorldCom (see Coffee 2005).

36. If company scandals are relatively rare, they might have systemic consequences. As observed by OECD (2007), company scandals caused by shareholder expropriations may have unforeseeable effects and may be accompanied by considerable externalities which take place "*via the pricing of financial assets, involving steep, if mostly short-lived, increases in the cost of external finance, which may hit totally unrelated companies that happen to be in the same country – or considered by financial investors as being in the same risk class. Examples of corporate upsets leading to such 'contagion' include the Parmalat scandal, which had as one of its outcomes a temporary virtual cessation of short-term credits to Italian corporations*".

37. Finally, it should be recalled in this context that the extraction of private benefits to the prejudice of non-controlling shareholders could result, depending on the specific circumstances, in either market manipulation or asset misappropriation or both.

2.2.2. The role of institutional investors as minority shareholders

38. According to Maes (2007), a crucial structural development in recent years has been the growth of institutional investors, such as pension funds and insurance companies. Against a background of ageing populations and rising longevity, a larger proportion of household savings is now being placed in private-funded pension schemes and life insurance policies investing directly in equity and corporate bonds. Moreover, in the last years the enhanced role of institutional investors, like pension and mutual funds and insurance companies, and other new actors, such as hedge funds, has been crucial for the rise of financial markets.

39. From our consultation process it has emerged that institutional investors are increasingly aware of the importance of preventing controlling shareholders' conflicts of interest. The main instrument chosen seems to be making more frequent use of the voting rights attached to their shares even when they own small shareholdings in each company for reasons of portfolio diversification.

40. In this respect, it is interesting to note that the new OECD Principles of Corporate Governance of 2004 recommend that "*Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with*

[20] For a description of Parmalat scandal see Ferrarini and Giudici (2005), Enriques and Volpin (2007) and Melis (2005a and 2055b).

investments, including the procedures that they have in place for deciding on the use of their voting rights"[21].

41. Finally, shareholder activism has also recently been encouraged by the rising number of institutional investors (among which a few very important European pension funds) that have a focused portfolio of company holdings for which they invest sizable sums in every company. As shown by Becht et al. (2006), in such cases investor activism is also motivated by economies of scale.

42. It is true that in such cases investors seem to be able to anticipate the risk of expropriation by paying less for shares issued by companies characterised by CEMs. As observed by OECD (2007), *"investors are mostly sophisticated enough to assess the risks and expected losses that may arise from unconventional securities-voting structures, or rather from the combination of such structures and weak protection of non-controlling shareholders. [...]"*. On the other hand, an adequate pricing of the presence of CEMs results in sub-optimal allocation of resources, which should translate in lower efficiency at industry level and lower aggregate economic growth. However, as shown in section 5.1.1, there are no empirical studies available that try to address this last point.

43. Costs caused by the obstacles to investment in cross-border listed companies are likely to become even more serious as financial integration in the EU continues. As we have seen above, cross-border share ownership in the EU has already reached a significant level and it is still rising.

The point of view of institutional investors on Control-Enhancing Mechanisms

44. ISS et al (2007) conducted a survey addressing institutional investors. The purpose of the survey was to determine whether and to what extent investment decisions are influenced by the ways companies do or do not follow the proportionality principle. The survey was distributed to 7,792 investors, corresponding to all the institutional investors identified worldwide. In total, 445 institutional investors worldwide replied to the questionnaire. They represent collectively more than 13% of assets under management in Europe, which is more than 4.9 trillion euros. Such figures are underestimated as 59 respondents (13% of the total) chose not to disclose their assets under management. Most of the respondents to the survey, by number, have an asset manager profile (60%). The second largest group of respondents has a hedge fund profile (11%), closely followed by pension funds (10%).

45. A majority of the investors surveyed perceive all CEMs negatively. However, some CEMs are perceived as more negative than others. CEMs that investors perceive most negatively are priority shares, golden shares, voting right ceilings, pyramid structures, multiple voting rights shares, ownership ceilings, non-voting shares and to a lesser extent cross-shareholdings and depositary certificates (see Table 5).

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[21] OECD (2004), Principle II.F.1. Moreover, the annotations to II.F.1 also specify that "*…the right to vote can be considered part of the value of the investment being undertaken on behalf of [] clients. Failure to exercise the ownership rights could result in a loss to the investor who should therefore be made aware of the policy to be followed by the institutional investor.*"

46. Depending on the type of CEM, between 58% and 92% of investors say they take the presence of CEMs into account in their investment decisions. Multiple voting right shares impact most on investors' decisions. In addition, 80% of investors would expect a discount on the share price of companies with CEMs. This discount ranges from 10% to 30% of the share price for the majority of investors who attempted to quantify it. This discount is seen in the first place as compensation for the absence of a bid premium. It is also seen as the price of a vote, as a compensation for a lower valuation, or as the remuneration of the extra risk taken by non-controlling shareholders in a company that may not defend their interests.

47. Finally, some of the investors that replied to the ISS study survey made additional comments calling for more transparency on CEMs in order to improve the information they have on the existence and impact of any CEM.

2.3. 'No policy change' scenario

2.3.1. The existing legal framework

48. Shareholder protection from expropriation does not come only from reducing the incentives to put in place conflict of interest transactions thanks to separation of ownership and control. As observed by Enriques and Volpin (2007), the law traditionally protects shareholders by enhancing their rights to sell, vote and sue and by guaranteeing a high level of transparency on the decisions taken by the board and by controlling shareholders. According to Black (2001), countries with strong securities markets have developed a number of institutions to counter information asymmetry including, among other things, effective regulators, prosecutors and courts, extensive financial disclosure, reliable and well-regulated intermediaries (accountants, investment banking, lawyers, stock exchanges), company and insider liability, market transparency, and so on.

As part of the Action Plan on Corporate Governance of 2005 and the Financial Services Action Plan, the EU has adopted several initiatives over the last few years aimed at addressing such issues from an EU point of view (see Annex 4 for further detail). The company laws and securities laws of Member States, in some cases pursuant to Community law obligations[22], currently contain a developed number of different regulatory tools based on well-grounded principles of corporate law that seek to prevent or correct abuse of controlling positions by shareholders and to enhance the protection of minorities. Although not always directly addressed to CEMs, these measures address some of the problems caused by CEMs. In addition, these laws foresee a number of provision on the exercise of voting rights and some transparency measures on and around CEMs. Further to the legislative obligations, specific practices or disclosures are made on the basis the national corporate governance codes which are voluntarily applied by companies or imposed by the listing rules of stock exchanges.

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[22] In addition, the EC Treaty prohibits Member States from restricting the free movement of capital in the EU. Enforcing this provision on free movement of capital through administrative or judicial proceedings is possible when a clear violation of such Treaty rules can be demonstrated. This is the case of the legislation imposing CEMs, such as the golden shares. The Commission has been attacking this kind of legislation imposing golden shares before the Court of Justice in the past years, with successful results.

The exercise of control rights: empowering shareholders

49. First, there are requirements which are mainly addressing the exercise of control rights. These requirements are therefore addressing (*inter alia*) the questions of board entrenchment and accountability as well as the contestability of corporate control. The main objective of this kind of requirements is to empower shareholders (as represented by the general meeting) to exercise their control rights in the company. They essentially relate to: (i) the rules governing the general meetings (including rules to facilitate the vote, the question of enhanced voting majorities in order to protect minorities, the right to put questions etc); (ii) the rules governing the election and dismissal of directors as well as the rules on directors accountability; and (iii) the rules to facilitate the exercise of voting rights by (future) shareholders in the context of takeover bids.

50. At EU level, the exercise of voting rights in listed companies by non-resident shareholders should be facilitated by a new Directive on shareholders rights[23] adopted in 2007. This facilitation is done by introducing minimum standards ensuring timely access to complete information on general meetings, facilitating the access to the general meeting and putting at the disposal of shareholders simple and effective means to exercise their voting rights, such as the vote by proxy or by using electronic means. It also contains rules on the functioning of the general meeting regarding the right to ask questions, to put items on the agenda or to table resolutions.

51. The exercise of voting rights in the case of takeover bids is addressed by the 2004 Directive on Takeover Bids[24], though the amendments voted by the Parliament and the Council largely denaturalized the Commission's proposal. One of the aims of this Directive (see also below on transparency) is to facilitate the market for corporate control by, among other things, the application of the so-called breakthrough rule and passivity rule. The breakthrough rule (Article 11 of the Directive) neutralises pre-bid defences during a takeover. Additionally, the so-called reciprocity exception (Article 12(3) allows Member States to permit companies applying this rule to disapply it, and thus to "retaliate" against a bidder who is not subject to the same rules. The passivity or board neutrality rule (Article 9) also has an impact on the possible exercise of voting rights. This rule provides that during the bid period the board of the target company must obtain prior authorisation from the general meeting of shareholders before taking any action which may result in the frustration of the bid. This rule may facilitate takeover activity by limiting the board's power to raise obstacles to hostile takeovers to the detriment of shareholders' interests. As yet, since not all Member States have adopted the Directive, it is not clear what the impact of the breakthrough rule across the EU will be. This Directive foresees that the Commission should conduct an examination of its operation in 2011[25].

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[23] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJ L 184, 14.7.2007, p.17.

[24] Directive 2004/24/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids. See also Commission Staff Working Document of 21.12.2007, Report on the implementation of the Directive on Takeover Bids, SEC(2007)268. Available at http://ec.europa.eu/internal_market/company/takeoverbids/index_en.htm

[25] Article 20 of the Directive on takeover bids: "*Five years after the date laid down in Article 21(1), the Commission shall examine this Directive in the light of the experience acquired in applying it and, if*

The prevention of conflicts of interest

52. Secondly, there are requirements which aim at preventing conflicts of interest. These requirements are directly addressing the question of private benefits extraction. They essentially relate to: (i) rules on related party transactions; (ii) rules on off-balance sheet arrangements; (iii) rules on groups; (iv) rules on the involvement of independent/non-executive directors; (v) minority protection rules in the context of take-over bids; rules on statutory audit; and (vii) rules in relation to the prevention of market abuse.

53. The recent modification of the accounting Directives and the introduction of the International Financial Reporting Standards (IFRS) have resulted in an improvement of the disclosures which aim at the prevention of conflicts of interest, notably regarding disclosure of related-party transactions and of off-balance sheet arrangements. Rules on related party transactions at EU level are governed by the recently modified Fourth Company Law Directive (see Article 43(1)(7b)) for single company accounts. For consolidated accounts, the International Accounting Standards Regulation (Regulation 1606/2002) and the Seventh Company Law Directive for consolidated accounts (see Article 34(1)(7b)) apply. The recent (2006) changes to these two directives extend disclosure on related party transactions (previously only covering the transactions between a company and the company's affiliated undertakings) to cover other types of related parties provided they are material and not carried out at arm's length. The IAS 24 definitions should apply. Transposition into national law of the modifications to the accounting directives need to be done by September 2008.

Off-balance-sheet arrangements[26] may expose a company to risks and benefits which are material for an assessment of the financial position of the company and, when the company belongs to a group, the financial position of the group as a whole. The Fourth and Seventh Company Law Directives were modified in 2006 to ensure that appropriate disclosure of the material risks and benefits of such arrangements that are not included in the balance sheet are set out in the notes to the accounts or the consolidated accounts.

The accounting rules also address the question of intra-group financial information.

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necessary, propose its revision. That examination shall include a survey of the control structures and barriers to takeover bids that are not covered by this Directive.
To that end, Member States shall provide the Commission annually with information on the takeover bids which have been launched against companies the securities of which are admitted to trading on their regulated markets. That information shall include the nationalities of the companies involved, the results of the offers and any other information relevant to the understanding of how takeover bids operate in practice."

[26] Such off-balance-sheet arrangements could be any transactions or agreements which companies may have with entities, even unincorporated ones, that are not included in the balance sheet. Such off-balance-sheet arrangements may be associated with the creation or use of one or more Special Purpose Entities (SPEs) and offshore activities designed to address, inter alia, economic, legal, tax or accounting objectives. Examples of such off-balance-sheet arrangements include risk and benefit-sharing arrangements or obligations arising from a contract such as debt factoring, combined sale and repurchase agreements, consignment stock arrangements, take or pay arrangements, securitisation arranged through separate companies and unincorporated entities, pledged assets, operating leasing arrangements, outsourcing and the like.

54. The Commission adopted in 2005 a recommendation on the involvement of independent/non-executive directors. This recommendation is only followed to a certain extent and in some Member States the control over the company's accounts by independent/non-executive may be insufficient and therefore the risk of abuse remains high[27] (although this may change in the future as a result of the new Directive on Statutory Audit, see below).

55. The Takeover bids Directive also protects minority shareholders from possible conflicts of interest, notably through the mandatory bid rule (which grants minority shareholders the right to sell their shares in the event of a change of control as well as the benefit of the premium paid for the controlling stake – at least when the classes of shares are equal), the sell-out right (which allows minority shareholders to force the majority shareholder to buy their shares at a fair price) and the board neutrality rule (see above).

56. The new Eighth Company Law Directive on Statutory Audit[28] aims at reinforcing and harmonising the statutory audit function throughout the EU. Its objectives are to restore credibility of financial reporting and to enhance the EU's protection against the types of scandals that occurred in the past in companies such as Parmalat and Ahold. The Commission is actively involved in facilitating the timely implementation of this Directive by the Member States which is due by 29 June 2009. In this regard, in January 2007 the Commission launched two public consultations on the treatment of third country auditors and on the reform of liability regimes in the EU[29]. Replies were due by 15 March 2007. This consultation is based on the study carried out for the Commission by the consultant London Economics which was published in early October 2006.

57. A 2003 EC Directive on Market Abuse[30] (a short name for insider trading and securities fraud) contains disclosure provisions aimed at preventing it (Ferrarini, 2004). First, the Directive extends the definition of inside price-sensitive information that requires immediate disclosure. Second, it requires disclosure of trading activity on a company’s shares by its directors and persons closely connected with them.

Transparency Obligations

58. Thirdly, there are disclosure requirements which aim at providing transparency on the use of CEMs and on practices related to the exercise of voting rights. Disclosure obligations are subject to supervision by securities markets regulators and penalties can be imposed for failure to comply. In addition, normal procedures before courts are also possible. The transparency rules on and around CEMs relate to: (i) disclosure obligations for listed companies which apply at different moments (e.g.

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27 Commission staff working document of 13.7.2007 (SEC(2007)1021), Report on the application by the Members States of the EU of the Commission Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, pp. 4 and 8.

28 Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, OJ L 157, 9.6.2006, p. 87.

29 The replies and the summaries of both consultations have been published in the Commission's website: http://ec.europa.eu/internal_market/auditing/index_en.htm

30 Directive 2003/06/EC of 28 January 2003 on insider dealing and market manipulation (market abuse), OJ L 96, 12.4.2003, p. 16.

when creating the company – or modifying the articles of association, when listing the company or periodically afterwards); (ii) disclosure obligations for voting rights holders; and (iii) disclosure obligations for holders of financial instruments.

59. Further to the information to be disclosed at the moment of listing the company, additional disclosure derives from the Takeover Directive. Although, as observed by Ferrarini (2006), this Directive admits deviations from the proportionality principle which may substantially limit the contestability of corporate control, the Directive nevertheless introduces, in case of takeover, mandatory disclosure of all deviations from the proportionality principle. Art 10 of the Directive includes extensive disclosure requirements on, inter alia, ownership control devices. According to article 10, detailed information has to be provided by listed companies in particular regarding: 1) significant direct and indirect shareholdings (including indirect shareholdings through pyramid structures and cross-shareholdings); 2) the holders of any securities with special control rights and a description of those rights;_3) any agreements between shareholders which may result in restrictions on the transfer of securities and/or voting rights.

60. The corporate governance disclosures by the company have been completed by Directive 2006/46/EC[31], which requests listed companies to provide information on their corporate governance practices, in particular by reference to the compliance with the corporate governance codes where they are applicable. This new obligation will have to be transposed into national law by September 2008[32].

61. The Transparency Directive[33] maintained and in some cases introduced a series of mandatory disclosure items in relation to voting rights which are directly related to CEMs and also alternative mechanisms. Part of these requirements only became enforceable in January 2007. This Directive establishes specific transparency obligations for voting rights holders of listed companies (irrespective of whether they hold the underlying shares or not) when certain thresholds are reached or crossed (cf. Article 9 and 10). The lowest threshold is set at 5%, although some Member States have lowered it to 3% (Germany, Spain, United Kingdom) or even 2% (Italy). This Directive also requires, in particular, the notification of voting rights held through shareholders' agreements if the relevant thresholds are crossed (cf. Article 10 a)). It

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[31] Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings, OJ L 224, 16.8.2006, p. 1.

[32] ECGF (2007) questions the effectiveness of the "comply or explain" mechanism where a shareholder controls the board and the shareholders meeting through the use of CEMs. Such a controlling shareholder sets the corporate governance policy, and in fact basically explains to itself what compliance with or deviations from the governance code are acceptable. Notwithstanding that the market may criticise the policy adopted, outside shareholders cannot effectively change the policy adopted by the controlling shareholder. This results in a reduced incentive to strive for good corporate governance practices. It is true that this effect also occurs where a controlling shareholder derives proportionate control from his holdings of say 51% of the company´s share capital. However, use of CEMs 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 smaller shareholding.

[33] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2005, http://ec.europa.eu/internal_market/securities/transparency/index_en.htm. See also ISS et al. (2007) for a summary of provisions from the Transparency Directive which apply to CEMs.

also requires the notification of major holdings to identify the chain of controlled undertakings through which voting rights are effectively held, when applicable (cf. Article 12(1)(b)). Therefore, the Directive provides for some transparency as regards the notification of pyramids[34]. The transparency obligations on disclosure of holdings also extend to holders of financial instruments that result in an entitlement to acquire, on such holder's own initiative alone, under a formal agreement, shares to which voting rights are attached, already issued, of an issuer whose shares are admitted to trading on a regulated market. This covers call/put options.

2.3.2. Future developments that could affect the current situation

Spontaneous convergence towards the proportionality principle?

62. According to a few authors there may be a convergence across the EU towards common corporate governance standards, including the proportionality principle. Ferrarini (2006), quoting Goergen et al. (2005), observes a convergence towards the abolition of voting caps, the declining use of multiple-voting shares at European level, and increasing restrictions to non-voting shares. Moreover, the authors observe a convergence of European takeover regulation towards the UK regime. This convergence would need to be assessed in the light of the implementation by EU Member States of the Takeover Directive. Finally, Deminor (2005) observes a few signs that lead towards a wider acceptance of the proportionality principle, such as in the UK, the renunciation by the state of most of its golden shares; the reduction in Sweden of the ratios of multiple voting shares as well as legal voting right ceilings; and in the Netherlands, the reduction in the recourse to multiple voting rights.

63. It is possible that market pressure will lead in the future to a spontaneous reduction in the recourse to CEMs. As we have seen above, the UK is characterised both by a

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[34] Disclosure duties in the case of joint control over an intermediary company in a pyramid are, however, unclear. According to some views, the control test applied by the directive (cf. Article 2)(1)(f)) would require to hold 51% of the voting rights in the controlled undertaking. In the cases of joint control of an intermediary undertaking, the disclosure obligation would not be triggered for the controlling shareholders of that undertaking. As a result, the transparency over the ultimately investor diminishes. For other views, the directive also foresees that a controlled undertaking is one over which a natural person or legal entity has the power to exercise, or actually exercises, dominant influence or control. In a joint control situation, this (secondary) test is likely to be satisfied in most cases.
It is also argued that transparency of voting rights notifications is also limited when the ultimate voting right holder is a foundation which may, at least in certain countries, not be subject to any transparency measure itself. Therefore, foundations holding a significant umber of voting rights in listed companies should be requested to disclose (in a manner similar to the obligations arising from the 1st Company Law Directive for companies) the governing rules of the foundation, the powers of the governing board, the members of the board etc.
However, a recent report prepared for the Commission shows that in the vast majority of Member States there are legal provisions requiring the registration of foundations, the deposit of the statutes, the identification of the person(s) who control or direct the foundation and the regular update of this information. Only Greece and Sweden are identified as countries where registration of foundations is not provided for. Most Member States also require independent auditing of annual reports. Although the report perspective is different (it focuses of the risk of foundations for terrorist financing and money laundering purposes), interestingly the report does not recommend further transparency measures for foundations, except with regard to the independent auditing of annual reports. Cf. Savona et al. (2007), Cost Benefit Analysis of Transparency Requirements in the Company/Corporate Field and Banking Sector relevant for the Fight against Money Laundering and other Financial Crime, section 16. This report is not yet public.

high share of total market capitalisation held by private financial companies and by a very low recourse by companies to the wide range of CEMs allowed by local legislation. We have also seen that institutional investors are increasingly diversifying their portfolios across listed companies in the EU. Moreover, ISS et al. (2007) report a downward trend in the recourse to CEMs by newly listed companies.

64. However, we are far from having conclusive evidence that market forces alone will bring about a significant reduction in the presence and relevance of CEMs across EU listed companies in the near future. As we have seen above, the study by ISS et al. (2007) shows that listed companies in many Member States are still characterised by a wide recourse to control-enhancing mechanisms. The responses to the Commission consultations regarding the Action Plan (referred to in section 1) indicate that initiatives at Member State level do not seem to lead towards a prompt removal of existing cross-border investing obstacles.

65. We have also seen evidence that companies may dismiss certain CEMs by adopting others to the same effect: Bianchi and Bianco (2006) observe that although certain shareholder practices such as pyramids in Italy may be discouraged by market aversion, the structure of the Italian listed companies has not changed in the last decade due to controlling shareholder recourse to informal alliances.

66. Moreover, the use of less transparent financial instruments to acquire control of voting rights appears to increase: stock lending, directives and related techniques are reported to be increasingly used in order to gain control of voting rights without bearing the economic risk of the underlying shares. The result is also a separation of ownership from control. The concern is growing because of the reported increase of the use of those techniques during the season of general shareholders' meetings. This may lead to the so-called 'empty voting' phenomenon and to the use of those techniques for short-term market manipulation purposes. There is already market pressure to render those operations more transparent[35]. However, the corporate governance effects of those techniques have not yet been sufficiently studied and existing research does not provide conclusive results[36]. This subject was therefore recently addressed by the third consultation on shareholder rights organized by the European Commission and is being considered in this context[37].

67. Concerning the developments of takeovers in the EU, it is difficult to predict. Anecdotal evidence from recent events suggests that cross-border hostile takeovers remain difficult and that significant barriers remain at national level, as the takeover bids Directive only has a limited impact so far[38].

More shareholders' activism?

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35 Cf. Guidelines from the ICGN.

36 See OECD (2007), The implications of alternative investment vehicles for corporate governance – A Synthesis of research about private equity firms and "activist hedge funds", notably §§72-74

37 See http://ec.europa.eu/internal_market/company/shareholders/indexa_en.htm

38 See Commission Staff Working Document of 21.12.2006, Report on the implementation of the Directive on Takeover Bids, SEC(2007)268. Available at http://ec.europa.eu/internal_market/company/takeoverbids/index_en.htm

68. Another possibility is that in the near future non-controlling shareholders and in particular institutional investors will make the most of their voting rights so as to protect themselves against expropriation by controlling shareholders.

69. Although systematic data of shareholder voting rates across the EU are not available, the large sample of listed companies analysed by PIRC (2007) shows average voting levels in France, Germany, Spain and Italy (Table 7) with average voting ratios from 36% in the Netherlands and about 50% (Germany and Italy) to about 60% in the UK and Spain with France in between. If we take into account that, apart from the UK, in general controlling blockholders represent a high, and in some cases very high percentage of total votes cast, we see that there is a large space for increased investor activism.

70. As we have seen above (section 2.2.2) institutional investors appear to be more likely to be present at shareholder meetings, also encouraged by supranational institutions and by the availability of intermediaries specialized in voting advice. In this respect, the recent Shareholder Rights Directive (see section 2.3.1) should allow for the reduction of the costs of direct and proxy voting thereby enabling non-controlling shareholders to increase their voting record. The Directive also introduces minimum standards on the right to ask questions, to put items on the agenda of the general meeting and to table resolutions, thereby also facilitating shareholder activism.

More transparency on CEMs and their use?

71. EU corporate governance legislation (see section 2.3.1) has changed in recent years. While those changes should contribute to reducing information asymmetries between company insiders and non-controlling shareholders, they have not yet developed their full potential. Further to the Takeover bids directive (cf. § 67) and the directive on shareholders rights (cf. § 70), the Transparency Directive is only fully applicable since January 2007, while the directive 2006/46/EC which imposes disclosures of corporate government practices and integrates changes to the accounting directives is to be transposed by Member States only by September 2008. Transposition of the Statutory Audit directive is to be done by June 2009.

72. However, the effectiveness of the application to CEMs of the existing corporate governance legislation and practices is already subject to debate. Typically the tools described above are not directed exclusively to address concerns triggered by disproportionate mechanisms but at abuses of controlling positions generally (i.e. irrespective of whether obtained by using CEMs or not). Thus, the specificities of CEMs are not always directly addressed by legislation.

73. As suggested by ECGF (2007) – see Annex 2, there is room for improving the effectiveness of the legal framework as regards CEMs by ensuring that this legal framework specifically addresses CEMs. This could relate to:

- enhanced transparency on and around CEMs, notably on the actual use by companies/voting right holders of CEMs, their reasons for using them and the effects of their use; and

- enhanced disclosure requirements regarding related-party transactions involving persons benefiting from CEMs

2.4. Subsidiarity test: does the Commission have the right to act?

74. From the definition of the problem it emerges that there is a case for considering the subject of shareholder expropriation at EU level, according to the subsidiarity principle. As we have seen above, control-enhancing mechanisms are relatively common across EU listed companies, although the occurrence of those mechanisms varies from one country to another, as well as between large companies and recently-listed companies.

We have also seen that institutional investors are already the main group of non-controlling shareholders in EU-listed companies and that they are increasingly diversifying their equity portfolios across the EU. A significant sample of those institutional investors active in the EU disagree with the use of such mechanisms and apply a discount as high as 30% on companies applying such instruments. Such a discount increases the costs of capital for the companies concerned. Moreover, although there are signals that a convergence towards the proportionality principle across the EU is spontaneously under way as a result of market pressure and Member State regulatory initiatives, the study by ISS et al. (2007) nevertheless indicates that such a spontaneous trend might not lead to a reduction in the perverse incentives to expropriate non-controlling national and cross-border shareholders (sufficiency criterion). Furthermore, in relation to the contestability of control through takeover bids, anecdotal evidence from recent events suggests that cross-border hostile takeovers remain difficult and that significant barriers remain at national level, as the Takeover Bids Directive has had only a limited impact so far. Finally, we have also seen that the Community legal framework needs to be completed at national level, while at the same time there is scope for its improvement by addressing issues specific to CEMs.

75. Should a decision to act be taken, the EC Treaty provides sufficient legal basis. Binding measures in this area could be adopted on the basis of Articles 95 (Internal Market harmonisation) and 44 (freedom of establishment), as has been the case recently for Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies. Non-binding measures could in any event be adopted on the basis of Article 211 of the EC Treaty, which allows the Commission to address recommendations to Member States.

3. OBJECTIVES

76. The general overall objective is to enhance investor confidence in capital markets. Dynamic securities markets are vital to Europe's future. This requires giving investors the opportunity to be more active across the different EU capital markets and to have confidence that the companies they invest in have sound and equivalent corporate governance frameworks[39].

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[39] See generally the Communication from the Commission to the Council and the European Parliament - Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward; COM(2003)284, of 21.5.2003, p. 7. Available at: http://ec.europa.eu/internal_market/company/modern/index_en.htm
See also the Consultation document of DG Internal Market and Services on future priorities for the Action Plan, p. 5. Document available at:

77. To achieve this general objective, the following specific objective is defined in line to what has been shown in section 2: reducing the risk of private benefit extraction by insiders (management and controlling shareholders) to the detriment non-controlling shareholders.

Preventing non-controlling shareholder expropriation at the hands of managers and controlling shareholders is a key prerequisite for the development of stock markets and facilitating financial market integration in the EU. This is all the more so since, as widely recognised in financial literature, stock markets in EU countries still play a lesser role in corporate finance compared to the US.

This specific objective results in more precise complementary operational objectives: reducing the incentives for management and controlling shareholders to expropriate (non-controlling) shareholders and strengthening shareholders' rights to allow them to play their full role in the decision-making process of the company.

78. Such a specific objective should be pursued through measures which would ensure higher benefits compared to costs and in general the lowest possible costs on issuers and controlling shareholders. The present assessment consists of verifying whether and to what extent it is appropriate to adopt legislative or non-legislative measures to this end.

79. The general and specific objectives are consistent with the more general objectives set out by the Lisbon Strategy, the agenda for reform launched by the European Council in March 2000 to improve the competitiveness of the European businesses and economy. In its communication of 2 February 2005 the Commission launched “A Renewed Lisbon Action Programme” which identifies new actions at European and national level which will help to see our Lisbon vision achieved. In this context, among the focused set of key reforms identified to complete the single market, financial markets figure prominently.

4. POLICY OPTIONS

80. The section on the problem definition showed that CEMs increase the risk of private benefit extraction by insiders to the detriment of non-controlling shareholders. To reduce the incentives of insiders to expropriate non-controlling shareholders and to enhance the rights of non-controlling shareholders, specific policy options could be taken:

- (1) The first specific option would be the prohibition of CEMs, as a radical measure to reduce the incentives to expropriation and to enhance shareholders' (voting) rights. This would involve applying the principle of proportionality and control to all listed companies[40];

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http://ec.europa.eu/internal_market/company/consultation/index_en.htm

40 Cf. The 2002 report of the High Level Group of Company Law Experts for the Commission: "*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*

- (2) The second specific option would be to enhance the transparency regarding CEMs and their use, as a deterrent to the extraction of private benefits and as a tool to reduce the asymmetry of information between insiders and non-controlling shareholders.

Both options need to be examined against the possibility of doing nothing, in other terms, relying on the ability of the existing regulatory framework to deal with the problem identified (see also section 2.3).

81. In the case that one of the two specific options above would be pursued, the most suitable type of legal instrument needs to be selected, in essence: a directive, a regulation or a recommendation.

- Directive: a directive would be a legally binding instrument for Member Sates. However, it would give Member States some flexibility to adapt their rules to national specificities.

- Regulation: a regulation would introduce uniform rules, directly applicable in the Members States, irrespective of the national specificities. It provides no flexibility to Member States.

- Recommendation: a recommendation is a non-binding instrument which guarantees maximum flexibility to Member States as they would have discretion on whether and to what extent to implement it into their national legal regime.

82. The following sections will analyse the impacts of those policies.

5. ANALYSIS OF IMPACTS

83. In this chapter we examine the costs and benefits of two of the possible specific policy options which in principle are available, and we assess their adequacy to fulfil the objective of preventing shareholder expropriation across EU listed companies. We then examine the costs and benefits of pursuing the two specific options through each of the possible instruments available (Directive, Regulation and Recommendation) compared to the option of doing nothing.

5.1. No action

84. The first possibility from a policy point of view would be to leave the present situation as it is. A number of EU legislative initiatives have recently been adopted concerning corporate law, corporate governance, statutory audit and accounting. Although most of their provisions still need to be implemented by Member States, they should contribute to reducing information asymmetries between company insiders and non-controlling shareholders. The most relevant provisions were described in section 2.3 (see also Annex 4 for further detail).

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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". Report of the High Level Group of Company Law Experts on issues related to takeover bids, 10 January 2002, page 21. Report available at: http://ec.europa.eu/internal_market/company/takeoverbids/index_en.htm

85. However, as it will be shown in the following sections, this would mean leaving untouched the existing costs of capital in listed companies characterised by CEMs, which are in the first place connected to the following aspects: risks of expropriation at the hands of managers or controlling shareholders, management entrenchment and protection from (cross-border) takeovers. As we also have seen (section 2.2.2), such costs are evaluated by institutional investors as being between 10% and 30% of company share value.

5.2. Community action: the content of possible specific options

5.2.1. Prohibition of CEMs

86. The first specific option to remove or at least reduce the incentives for non-controlling shareholder expropriation would be the prohibition of CEMs. However, several arguments have emerged against such an option from the consultation process referred above in Section 2 and from the literature survey contained in the study by ISS et al. (2007).

Freedom of contract and different investor preferences

87. According to this argument, companies should be free to offer whatever voting arrangements they choose, and those arrangements that do not ensure good company governance would entail exit from the market. The freedom to apply different CEMs 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. Not all investors are interested in buying shares in pure one-share-one-vote companies; some may be more focused on return on capital and dividends than voting rights[41].

88. The consequence of such an argument is that issuers should adapt their offers of equity according to investor preferences. As we have seen above, the fact that a significant sample of institutional investors active within the EU havs expressed their disagreement with the recourse to a certain number of CEMs could perhaps indicate the presence of inefficiencies in the market for corporate securities. However, although restrictions to freedom of contract are usually justified on grounds of investor protection and ensuring the adequate functioning of capital markets, as observed by ECGF (2007), the necessity for such restrictions should be justified by quantifiable arguments, in the absence of which freedom of contract should prevail[42]. This brings us to the next argument.

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[41] A more restricted argument has been formulated strictly with reference to listed media companies: CEMs are necessary to ensure editorial independence from controlling shareholders. This is actually an adaptation of the previous general argument, in which private benefits from control take a positive form and are expressed in the form of editorial autonomy.

[42] The principle of freedom of contract is not an absolute one in the corporate and financial area. 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 or to ensure an adequate functioning of capital markets. For instance, in many countries, while multiple voting rights shares are authorised, the law also establishes that no shared may have more than X times the voting rights of any other share. In Sweden, for instance, the differential may not exceed 10 to 1.

Lack of empirical evidence

89. Due to the lack of systematic inquiries made according to generally accepted methodologies, it has not been empirically demonstrated that CEMs, taken as a whole, have negative or positive economic effects *per se*. In particular, there is no conclusive empirical evidence supporting the theory that the most common deviations from the proportionality principle systematically affect total firm value[43]. This is partly because firm value is the sum of the market value of outside equity and private benefits of control. While the former can be measured relatively easily, the latter cannot. In addition, the estimates of the effect of disproportional ownership on the market value of outside equity are often unreliable (ISS et al 2007).

90. Moreover, Black (2001) observes that the danger of shareholder expropriation may act as a perverse incentive on investors who do not know which insiders are honest and which will appropriate most of the company's value, so they discount all companies' share prices. The consequence of such an argument is that economic growth should be adversely affected in countries where shareholder expropriation is higher. Unfortunately, as underlined by ECGF (2007) and ISS et al. (2007), no systematic research has been conducted as yet to link the effects of deviations of the proportionality principle at firm level to the overall efficiency of the Member States' and wider EU capital markets.

Alternative (non corporate) mechanisms to enhance control

91. There are mechanisms which are not part of the company's constitution but which affect the effective exercise of proportionate voting rights in the company. These non-corporate mechanisms are the result of shareholder behaviour and are generally less transparent than corporate CEMs. Although it is not necessarily their main purpose, they may, like corporate CEMs, be used for enhancing control. For instance, the increased use of market techniques that allow for decoupling of voting rights from cash flow rights (securities lending, contracts for differences, call/put options and others), results in votes being exercisable without any economic equity investment (´empty voting´).

92. This argument in general involves the possibility that prohibitions of specific CEMs be evaded or circumvented. As observed by ECGF (2007), 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. In company law, contract innovation is a characterising factor and prohibiting certain contract features (non-voting shares,

[43] The ISS Study undertook a review of the empirical economic literature on this issue. The literature reviewed focuses on some CEMs (and alternative mechanisms) only: essentially multiple-voting rights shares (of the Nordic or Dutch types), non-voting shares (with or without preference), pyramid structures, cross-ownership and shareholders' agreements. However, no research papers could be identified estimating the impact on firm value of priority shares, depository certificates, voting right ceilings, share transfer restrictions, supermajority provisions and shares with loyalty schemes (such as in France). Therefore, there is an empty box in relation to those mechanisms. It should also be noted that some of them are identified by the theoretical survey as the most dangerous ones. Indeed, there seems to be a general perception that priority shares have little justification.

multiple-voting shares) would run the serious risk of being circumvented in a very short period.

93. According to Becht (1999), Berglof and Burkart (2003) and Katchaturian (2006), any attempt to mandate the proportionality principle in the EU may induce companies to either move to pyramidal structures, or to use complex derivative instruments to separate dividend rights from voting rights. One could reply that such a shift would be positive anyway, since it would then be possible to limit the extent of pyramids and provide adequate disclosure. However, the Italian experience is not encouraging in this respect. According to Bianchi and Bianco (2006) if it is true that Italian company pyramids have recently been reduced, it seems that controlling shareholders have merely shifted from formalised voting agreements to another mechanism, i.e. informal alliances.

Increasing the monitoring cost (the agency problem)

94. It is often argued that a controlling shareholder monitors the board of the company both for himself and also on behalf of non-controlling shareholders. This may reduce the agency costs of board control, 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.

95. Such an argument has a logical limit in the fact that, the higher the separation of ownership from control, the higher the possibility for the controlling shareholder to monitor the company's management, but the lower his incentive to do so, since his entitlement to the share of the dividends produced by his monitoring is lower.

Hindering the access to capital markets

96. It is often argued that the ability to strengthen a control position by mechanisms deviating from the proportionality principle may provide an incentive to (founder/family) 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. Or he would have to rely on (maybe more costly) alternatives to raise finance such as banking loans or private equity. Further to the loss of transparency, companies also risk giving up partial control in those cases. 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.

97. In this case, the counter-argument is that there is a trade-off between higher market liquidity and risks of shareholder expropriation. In the absence of market inefficiencies, such a trade-off should be dealt with directly by issuers and investors. This brings us back to the freedom of contract argument examined above.

Hindering the long term policy of companies

98. It is often argued that controlling shareholders, or entrenched boards, would focus more on long term development in a sustainable way. In doing so, controlling shareholders would compensate for 'market myopia', the alleged tendency of capital markets to be short-sighted as investors do not properly value the short-term and long-term value of their investments, thereby 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.

99. Such an argument seems to be contradicted by the fact that the majority of the investors who answered to the questionnaire by ISS et al. (2007) expressing disfavour towards several CEMs, are long-term investors.

National specificities

100. Some respondents to our open consultation also wrote that deviations satisfy national specificities, although they did not specify which ones. One possibility is that they wish to guarantee continuity to their national socio-economic model. From our open consultation it emerged that in some cases CEMs seem to represent a reassuring presence for shareholders who might prefer to reinforce the power of national controlling shareholders, as a guarantee for national employment or for maintaining head office functions and associated revenues.

101. However, as remarked by ECGF (2007), in the recent past the European Court of Justice has systematically denied the merits of justifying golden shares and special rights arrangements based on national economic policy grounds.

Ex-post safeguards

102. Member States provide reliance on ex-post measures such as court litigation (see ISS et al. 2007). However, exclusive reliance on litigation instruments might be too expensive and might not ensure an adequate level of (non-controlling) shareholder initiative. It would also be useful if conflicts among shareholders were solved, as much as possible, at the general meeting.

Transition factors

103. Introducing full proportionality would mean wealth redistribution in favour of non-controlling shareholders, who would pay less for shares which would then be worth more.

This is a standard argument to be considered when removing rents of any kind. In other cases compensation plans have been introduced when liberalizing access to regulated markets, such as in the case of taxis. In this case, the debate centres on whether to give reimbursements to those controlling shareholders who acquire controlling shares in a listed company by paying a premium over stock market share price.

Hindering the protection of stakeholder or societal interests

104. A final argument which has been advanced to justify the presence of CEMs is that the need to focus on the long term is often linked to the objective of furthering different stakeholder or societal interests. Applying CEMs, in this line of reasoning, would offer benefits to such stakeholders as employees, suppliers or clients. Such an argument seems to apply only as far as employees, suppliers or clients buy company equity accompanied by CEMs. Once again, we refer to the freedom of contract argument above[44].

5.2.2. *Transparency measures*

105. The transparency provided by listed companies pursuant to the existing legislation (see above section 2.3 and also Annex 4) has some limitations and, *prima facie*, there is room for enhancing the transparency on and around CEMs. ECGF (2007) suggests addressing a number of issues[45] as a matter of priority in this regard (see Annex 2).

Disclosure by listed companies

106. ECGF (2007) suggests that companies should, in addition to the disclosure obligations pursuant to article 10 of the EC Directive on Takeover Bids[46] and the disclosures under the EC Transparency Directive, be required to provide more detailed transparency on the non-proportional voting and control mechanisms applied by them. Such disclosure obligations should 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.

107. However, it is likely that companies would rely on the explanations given at the general meeting in which the CEM(s) were accepted. As a result, a requirement to provide an annual update would most likely lead to a bureaucratic repetition of arguments. Moreover, any reasoned explanation, whether right or wrong, whether valuable or not, would be sufficient to meet a possible legal obligation. As a result, it is possible that such a measure would not lead to enhanced transparency in all cases.

108. It should also be considered in this context that the new Directive on Shareholders' Rights provides partial remedy for this situation insofar as it makes it easier for shareholders to add items to the agenda. If non-controlling shareholders are

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44 For more critical views on this argument see also ECGF (2007).

45 ECGF (2007) also suggested that specific disclosure requirements should be introduced in respect of the use of mechanisms decoupling voting rights from economic ownership, 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. To the extent that the question of securities lending is included in the assessment under the possible recommendation on shareholders' rights, this issue will not be addressed here. Concerning the financial instruments that result in an entitlement to acquire shares to which voting rights are attached, specific disclosure obligations were included in Directive 2004/109/EC. Practical experience on the implementation of this provision is lacking given that the obligations of this Directive are only applied since January 2007. Therefore, this proposal will not be further considered in this impact assessment.

46 Article 10 of the Take-over bids Directive requires Member States to ensure that listed companies publish detailed descriptive information on a number of issues connected with the exercise of voting rights and the use of non-proportionate mechanism. This information shall be published in the company's annual report as provided for in Article 46 of Directive 78/660/EEC and Article 36 of Directive 83/349/EEC.

dissatisfied with the application of CEMs, they can request that the point be added to the agenda so that the management and controlling shareholders provide relevant explanations. It is also true, however, that relying exclusively on the Directive on Shareholders' Rights would not allow potential investors to obtain the same kind of enhanced transparency.

109. Concerning the costs of this proposal, the main cost would be the administrative cost of preparing the information in question. However, this cost is estimated to be marginal to the extent that companies already need to disclose the information referred to in Article 10 of the Take-over Bids Directive. It should not be higher than 2 or 3 man days per company plus the associated legal advice costs.

Disclosure by shareholders

110. ECGF (2007) suggests that shareholders who derive a voting position from such non-proportional mechanisms exceeding a certain threshold, say 10% of total votes that can be cast in a meeting, and shareholders who hold specific control rights, such as the right to make binding nominations for board positions, should be required to provide insight into the size and nature of their shareholdings as well as the policy they have on the exercise of powers attached to their holdings. This is also relevant for public, semi-public or private entities which, like shareholders, make use of non-proportional mechanisms in order to further public objectives.

111. The main benefit of this proposal would be: (i) the increase of transparency as regards the separation between cash flow rights and control, and (ii) the transparency on the policy of qualified shareholders in that situation regarding the exercise of powers attached to their holdings. This proposal should also encompass shareholders holding joint control over pyramid structures and shareholders participating in a controlling shareholder agreement or, in any case, in a shareholder agreement reuniting more than a certain percentage of total voting rights.

112. Transparency regarding the policy applied to the exercise of powers attached to voting rights should facilitate the understanding by non-controlling shareholders and potential investors of whoever has the right to implement a CEM, and in which circumstances and why he/she would do so, which is of critical importance for them.

113. Among the disadvantages of this proposal, one should mention that it would create a significant administrative burden for (qualified) shareholders in addition to the disclosure obligations foreseen by the Transparency Directive. This proposal also presents the risk, as regards the second element (the explanations on the voting policy) that the explanations provided by the (qualified) shareholders would potentially be bureaucratic and of little interest. As in the preceding paragraph, it would be difficult to enforce any requirement to provide additional explanations.

Transparency on the actual use of non-proportional mechanisms

114. ECGF (2007) suggests that companies and shareholders should be required to provide more transparency on the actual usage of non-proportional mechanisms. For instance, in addition to the existing obligations to disclose related party transactions in annual accounts pursuant to the existing accounting legislation, ad-hoc disclosure should be imposed in respect of related party transactions involving a shareholder

benefiting from such a mechanism. Disclosure should also be required on the outcome of voting by shareholders in the case of certain key resolutions.

115. Concerning further disclosures as regards related party transactions, this proposal is not without disadvantages. First, following the Parmalat and other scandals, new disclosure requirements in relation to related party transactions were introduced in EU legislation in 2006, which are still to be transposed by Member States. It is questionable in this regard whether further measures are needed in this area without first examining the impact of that national legislation. Moreover, the new Directive on Shareholders' Rights makes it easier for non-controlling shareholders to add items to the agenda of the general meetings if they fear that their interests are not respected. It should also be recalled that the Commission has already recommended that independent directors be appointed in listed companies and be given a particular role in relation to the audit committee of listed companies. It is unclear whether the proposal above would add more value than the implementation of the existing recommendation.

116. Concerning further disclosure on the effect on the outcome of voting by shareholders in case of certain key resolutions, such a proposal would be difficult to implement as it is likely to result in too casuistic an approach. It should be recalled that the new Directive on Shareholders' Rights makes it easier for non-controlling shareholders to add items to the agenda of the general meetings if they would like more disclosure to be made.

5.3. Type of regulatory instrument

5.3.1. First option: Directive

117. In principle, the instrument of the Directive allows national specificities to be respected while introducing basic common minimum standards. This flexibility, compared with a regulation, has often led the Commission to make recourse to this instrument in the field of corporate law and corporate governance.

118. However, a Directive appears not to be the appropriate means with respect to the proportionality issue since, as we have seen in section 5.2.1, the option of mandating the prohibition of CEMs to EU Member States would leave several objections unresolved, principally concerning the lack of empirical evidence which would justify overcoming the principle of freedom of contract, and the possibility that a prohibition of specific CEMs would be easily circumvented through financial innovation.

As regards mandating the transparency measures suggested by ECGF (2007) through a Directive, as we have seen in section 5.2.2, there is the concrete risk that the benefit would be largely inferior to the costs required.

5.3.2. Second option: Regulation

119. In view of the complexity of many of the issues at stake and the specificities of EU company law systems, the adoption of directly applicable rules through a Regulation is probably an even less desirable and efficient of way of achieving the objectives identified in section 3. A Regulation would introduce a uniform treatment

irrespective of national specificities. This path is normally undertaken by the Commission in the field of company law only in particular circumstances, such as the introduction ex novo of a new type of company model, for instance in the case of the European Company. Although adopting a Regulation would guarantee the introduction of a tight common framework for cross-border related issues, the costs of a Regulation would be very high, since it would not be possible to guarantee flexibility for national specificities, which are a very important factor for company law across the EU-27.

120. Such regulatory choices would be in contrast with national specificities deeply embedded within corporate law and corporate governance across Europe. In the first place, the specificities of industrial structure across the EU-27 Member States are such that it is not possible to identify a unique model for EU listed companies inasmuch as they differ significantly in size, relevant market and shareholder base. Moreover, there are significant differences that characterize legal traditions across EU Member States, so that the legal structure of listed companies across the EU inherits the specificities, among others, of the Napoleonic Code, the Common Law, the Germanic Law, the Scandinavian Law and the legal system adopted by the new EU Member States.

5.3.3. Third option: adopting a Recommendation

121. A Recommendation guarantees maximum flexibility on the part of Member States, who are free to implement it into their national systems to the extent they deem opportune. Moreover, Member States do not normally regulate such subjects with binding measures but with "soft law" measures such as non-mandatory corporate governance codes.

122. However, the logical argument remains that CEMs greatly increase the separation of ownership and control already present in the majority principle which governs listed companies in the EU (as well as the rest of the world). This, in a context in which, on the one hand, financial literature tells us that the threat of expropriation is the main factor which discourages small investors and where, on the other hand, institutional investors (pension funds and mutual funds) are rapidly acquiring a very large stake in EU listed companies.

123. As we have seen in the previous sections, the arguments put forward in the consultation process in defence of CEMs do not touch on the opportunity to guarantee full disclosure. Our consultation process has shown that even those respondents who were against prohibiting CEMs, were not against introducing measures aimed at ensuring full transparency in the voting rights attached to shares. On this the OECD Principles of Corporate Governance 2004, at principle II.D, state that "*capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.*" Principle V.A.3 goes on to say that "*disclosure should include, but not be limited to, material information on…major share ownership and voting rights.*"

124. Potential content for a Recommendation on more disclosure is provided by ECGF (2007). However, as we have seen in section 5.2.2, neither of the proposals are devoid of costs while the benefits do not appear to be undisputable. Moreover, as we have seen in section 2.3, there are several EU instruments already under way to

ensure more disclosure and to facilitate non-controlling investor activism and prevention of shareholder expropriation. Of course, the instrument of the Recommendation would leave Member States the freedom to evaluate which of the transparency options best suit the respective specificities of each legal and industrial system.

5.3.4. Synthetic recapitulation of specific options

125. The following table provides a synthetic examination of the costs and benefits of pursuing the two specific options through each of the possible instruments available (Directive, Regulation and Recommendation) compared to the option of doing nothing.

	Prohibition of CEMs	**Supplementary transparency measures**
Doing nothing	Benefits: complementary EU measures already under way; prohibition could be circumvented; lack of empirical evidence whether CEMs affect total firm value. Costs: incentives to expropriate minority shareholders; higher cost of capital.	Benefits: Other EU measures under way; danger of bureaucratic repetition of arguments. Costs: incentives to expropriate minority shareholders; higher cost of capital.
Directive	Benefits: lower incentives to expropriate minority shareholders; lower cost of capital.. Costs: complementary measures already under way; prohibition could be circumvented; lack of empirical evidence whether CEMs affect total firm value.	Benefits: lower incentives to expropriate minority shareholders. Costs: Other EU measures under way; danger of bureaucratic repetition of arguments.
Regulation	Benefits: lower incentives to expropriate minority shareholders; lower cost of capital.. Costs: complementary measures already under way; prohibition could be circumvented; lack of empirical evidence whether CEMs affect total firm value; no flexibility to adjust to national legal specificities.	Benefits: lower incentives to expropriate minority shareholders. Costs: Other EU measures under way; danger of bureaucratic repetition of arguments; no flexibility to adjust to national legal specificities.
Recommendation	Benefits: lower incentives to expropriate minority shareholders; lower cost of capital.. Costs: complementary measures already under way; prohibition could be circumvented; lack of empirical evidence whether CEMs affect total firm value; no guarantee of uniform adoption across the EU.	Benefits: lower incentives to expropriate minority shareholders. Costs: Other EU measures under way; danger of bureaucratic repetition of arguments; no guarantee of uniform adoption across the EU.

5.4. Proportionality

126. As for the Proportionality principle, from section 5.2 it emerges that mandating (through either a Regulation or a Directive) or even recommending the first specific option illustrated in section 5.2.1 would probably not represent the least onerous way of reducing the risk of shareholder expropriation across the EU Member States compared to the combined action of spontaneous market pressure, Member State regulatory initiatives and already running EU initiatives described in section 2.3. As for the second specific option illustrated in section 5.2.2, it is not clear that adopting such an option through a Directive or even through a Recommendation would represent the least onerous way to reduce the risk of shareholder expropriation across the EU Member States.

6. DISTRIBUTION OF IMPACTS ON VARIOUS STAKEHOLDERS

127. If EU legislative or non-legislative action along the lines described in the previous section were to be taken, such action would have different impacts on the various categories of relevant stakeholders. In the first place **issuers** would be the direct addressees of the measures contained in a legislative or non-legislative initiative. Issuers should benefit from a lower level of non-controlling shareholder expropriation by having their cost of capital lowered. On the cost side, an EU initiative could contain significant additional costs for issuers in terms of higher disclosure costs. However, should a Recommendation be adopted, Member States would be free to adopt those disclosure measures that they would deem to be the most cost-effective according to the specificities of their legal systems.

128. **EU Institutional investors** are presumed to be the main beneficiaries of a possible legislative or non-legislative EU initiative, since they would see their risks of expropriation lowered, would have a higher return on their present investment, and would possibly increase the share of their portfolios invested in risk capital.

129. As for **small individual investors**, reductions in the risk of being expropriated would translate into a higher level of investment in shares of EU listed companies. This would allow them to increase the diversification of their financial portfolios.

130. The impact of a possible EU initiative on **controlling shareholders** could entail a reduction in their return insofar as they would be limited in their possibility to obtain private benefits of control. However, from the response to our open consultation, many controlling shareholders stated that although they have the incentive to extract private benefits, in practice they do not do so. In such cases, they would not incur any extra costs.

131. As for **other remaining stakeholders**, such as issuers' employees, it is not possible to give an estimate of the effect of a possible EU proposal on reducing shareholder expropriation and cost of capital. This should lead to more efficient listed companies, something which in principle should have a positive effect on employment. However, the chain of causalities being very long, it is not possible to propose quantitative estimations, although it should be possible to say that a more efficient corporate Europe should have a positive effect on employment. Moreover, there is no environmental impact of the present proposal.

132. Finally, the impact of a possible EU proposal on **EU Member States** should be to reinforce the ability of shareholders to exercise their control function on listed companies' management. This market-friendly approach should allow national regulators to do without more prescriptive corporate governance measures which are always more costly in terms of negative side effects.

133. If, on the contrary, the no-action policy option is retained, the impact of the existing Community and national legislative and non legislative measures would apply in a similar manner to the categories of stakeholders described above. Without further measures, the diminution of the risk of private benefit extraction would be less significant. Nonetheless, existing measures on transparency and empowering shareholders should to result in higher level of investments and lower cost of capital. On the cost side, however, the impact of not undertaking further action is less burdensome for issuers and investors.

7. MONITORING

134. Should a proposal for a Recommendation be adopted, a specific indicator and mechanism could be introduced to help monitor the implementation and assess its future impacts:

- a yearly questionnaire distributed to EU Member States for three years after the adoption of the Recommendation to ask which of the suggested measures have been adopted. This would enable the impact of the Recommendation to be monitored so as to evaluate its impact and the need for further initiatives.

135. Should a legislative proposal (Directive or Regulation) be adopted, two mechanisms could be introduced to help monitor the implementation and assessment of its future impacts:

- yearly contacts with national authorities and FESE for three years after the coming into force of the initiative to monitor the evolution of cross-border share ownership in the EU;

- yearly contacts/questionnaires with the main intermediaries and with issuers for three years after the coming into force of the initiative to monitor the evolution of the cost of capital.

136. These instruments would help evaluate, for three years after the entry into force of the initiative, whether: (i) the cost of capital in listed companies had been significantly reduced; (ii) the present trend towards an increase of institutional investors and retail investors holding shares had continued or increased.

137. Should the possibility of doing nothing be retained, monitoring would be limited to provisions foreseen in the existing legal texts. In particular, the Transparency Directive foresees that the Commission reviews the operation that directive by June 2009 and the Takeover Bids Directive that the Commission examines the experience in the application of the Directive by 2011.

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TABLES

Table 1. Ownership concentration

	(1) Widely held	(2) Family control	(3) Pyramid control	(4) Median largest block	(5) Family wealth
France	60%	20%	15%	20%	29%
Germany	50%	10%	20%	57%	21%
Italy	20%	15%	20%	55%	20%
United Kingdom	100%	0%	0%	10%	6%
United States	80%	20%	0%	5% (NYSE) 9% (Nasdaq)	.

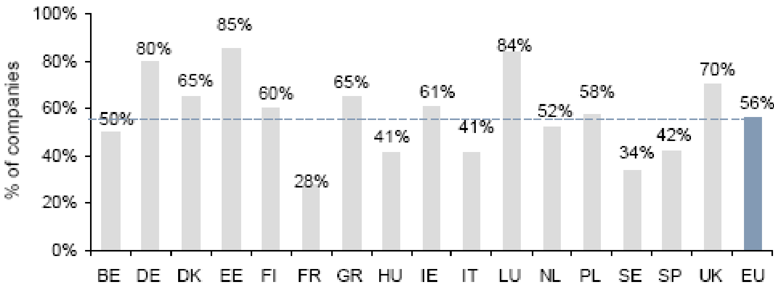
Source: Enriques and Volpin (2007).

Table 2. Presence of CEMs across the EU: countries

Proportion of companies in each Country included in the ISS et al (2007) study which have one or more CEMs.

Of all the European companies analysed, 56% feature no CEM. The countries with the highest proportion of companies featuring at least one CEM are France, Sweden, Hungary, Italy and Spain, which all have a majority of companies featuring CEMs.

Figure 4-2 Companies with no CEM in EU Member States

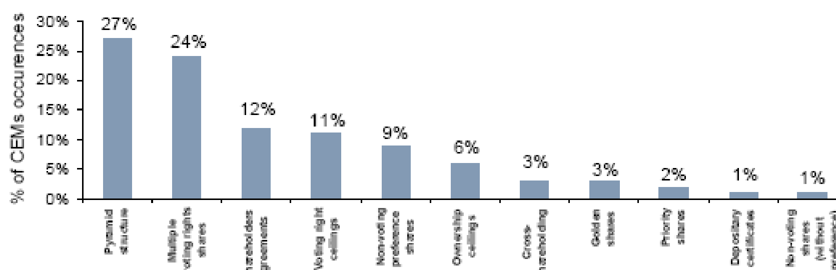


Source: ISS et al. (2007).

Table 3. Presence of CEMs across the EU: instrument

Presence of CEMs in the ISS et al (2007) sample, all countries considered.

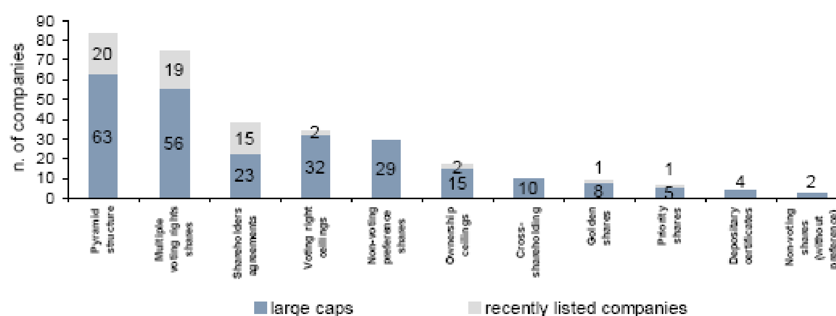
Figure 4-7 Overall frequency of each type of CEM



Large companies in the European Union feature a variety of CEMs, the most common of which are pyramid structures, multiple voting rights shares and shareholders agreements. Recently listed companies in Europe feature a smaller number and a smaller variety of CEMs than large companies, except for shareholders agreements. As in large companies, pyramid structures, shareholders agreements and multiple voting rights shares are the most common CEMs in recently listed companies.

Figure 4-8 Number of occurrences of each type of CEM in large and recently listed companies

In addition, all companies in the sample are subject to super-majority requirements in some circumstances as mandated by national law. No company in the sample was structured as a partnership limited by shares.



Source: ISS et al. (2007).

Table 4. EUROSTOXX50: ownership structure

Comparison 2005-2003

Shareholders	Shares held (percentage of share capital)					
			AVERAGE			
	2005	2004	2003			
Core shareholders	20	19.9	24.1			
Domestic Inst. Inv.	17.4	17.2	18.4			
Foreign Inst. Inv.	42.5	41.9	36			
Private Shareholders	18.8	19.6	19.8			
Treasury Shares	1.3	1.3	1.7			

Source: Georgeson 2006

Table 5. Investors' perception of CEMs

Figure 5.5: Investors' perception of CEMs

Total = 252 responses

	Very positive (+1)	Positive (+0.5)	Neutral (0)	Negative (-0.5)	Very Negative (-1)	Don't know /No opinion	Average weighted response (in investors)*	Average weighted response (AUM)**
Multiple voting rights shares	10	24	24	89	92	13	-0.48	-0.55
Non-voting shares	6	14	54	80	82	16	-0.46	-0.40
Non-voting preference shares	9	40	104	55	28	16	-0.11	0.00
Pyramid structures	5	10	48	87	90	12	-0.51	-0.57
Priority shares	5	15	28	81	110	13	-0.58	-0.66
Depositary certificates	4	19	72	81	52	24	-0.35	-0.47
Voting right ceilings	4	13	43	81	99	12	-0.54	-0.53
Ownership ceilings	6	14	54	81	86	11	-0.47	-0.50
Supermajority provisions	14	72	62	55	36	13	-0.06	-0.12
Golden shares	4	11	35	85	99	18	-0.56	-0.64
Partnerships limited by shares	16	35	81	60	34	26	-0.13	-0.05
Cross-shareholdings	5	7	84	94	47	15	-0.36	-0.23
Shareholders agreements	15	34	106	56	23	18	-0.08	-0.18

* Giving a value ranging from 1 for "very positive" and -1 for "very negative", this first "weighted average" is the average sensitivity of investor decisions to the CEMs concerned based on the number of investors sharing an opinion.

** Giving a value ranging from 1 for "very positive" and -1 for "very negative", this second "weighted average" is the average sensitivity of investor decisions to the CEMs concerned weighed by the assets under management assets of investors sharing an opinion.

Source: ISS et al (2007).

Table 6. Share ownership structure of European listed companies – end 2005

Foreign investors	33%
Private financial enterprises: collective investment (pension funds, mutual funds)	24%
Private non-financial companies	16%
Individual investors/households	15%
Private financial enterprises: banks and other	7%
Public sector	5%
Total	100%

Source: FESE (2007).

Table 7. Average voting turnout in 2006

UK (FTSE 350)	61%
Netherlands	36%
Italy	52%
France	57%
Germany (Dax30)	49%
Spain	65%

Source: PIRC (2007).

Table 8. Ownership concentration in listed companies: main European companies (2003)

	Number of companies considered	Weight	Average freefloat	Weighted average freefloat	Percentage of widely held companies
Austria	11	58,1	57,1	46,8	18,2
Denmark	24	82,9	74,2	61,2	50,0
Belgium, France, Netherlands, Portugal	197	86,4	66,4	74,7	37,6
Finland	26	85,7	79,0	89,3	53,8
Germany	87	76,3	67,0	72,9	37,9
Greece	28	65,1	57,9	58,6	21,4
Ireland	16	80,6	89,2	95,0	75,0
Italy	79	90,0	56,9	59,1	17,7
Norway	15	79,9	67,0	46,2	33,3
UK	317	92,9	91,4	96,1	83,3
Spain	49	61,4	59,1	70,3	26,5
Sweden	56	87,3	77,2	77,9	51,8
Switzerland	76	92,5	78,7	87,0	57,9

Source: Bianchi et al. (2005).

List of Annexes

– Annex 1 – ISS Study (2007)

– Annex 2 – European Corporate Governance Forum statement on proportionality (2007)

– Annex 2 – Definition of CEMs

– Annex 3 - The Broader context: Corporate Governance legislation and systems

ANNEX 1 – ISS STUDY (2007)

Available at: http://ec.europa.eu/internal_market/company/shareholders/indexb_en.htm

ANNEX 2 – EUROPEAN CORPORATE GOVERNANCE FORUM STATEMENT ON PROPORTIONALITY (2007)

The Forum has reviewed the Report on Proportionality in the European Union, dated 18 May 2007, prepared by ISS, Shearman & Sterling and ECGI and the Paper of the European Corporate Governance Forum Working Group on Proportionality, dated 12 June 2007. The Forum has taken notice of the intention of Commissioner McCreevy to have the issue of proportionality examined in an impact assessment in order to determine whether it is appropriate to adopt a Commission Recommendation on the subject.

Proportionality is usually described as in the words of the High Level Group of Company Law Experts of 2002: "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. 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."

Our current information on and understanding of the application of proportionality in EU Member States and the effects of non-proportionality on the stated EU policy objectives, as appear from the ISS Report and the Forum Working Group Paper, do not provide a basis for mandating proportionality rules across the EU, in the sense that all listed companies in the EU would need fully to adhere to such proportionality. However, non- proportional systems do raise concerns in relation to board entrenchment, extraction of private benefits by the controlling shareholder, incontestability of control and ineffectiveness of corporate governance codes based on the "comply or explain" approach. Further, the issue of proportionality is related to the issue of responsible investor behaviour, in particular where investors use techniques that allow for a decoupling of economic exposure and voting rights, allowing for empty voting. In light of these concerns, and considering competing policy objectives as set out in the Forum Working Group Paper, the Forum makes the following recommendations to the Commission.

1. Increased transparency

There is a strong case for the Commission in the short term to initiate measures that would improve the transparency of the application of non-proportional mechanisms. Improved disclosure requirements would facilitate markets in making better judgements and valuations, which may result into a move away from the more detrimental mechanisms and would enhance the understanding of the mechanisms applied and their effects. An enhanced disclosure regime should include the following elements:

- Companies should, in addition to the disclosure obligations pursuant to article 10 of the EC Directive on Takeover Bids and the disclosures under the EC Transparency Directive, be required to provide more detailed transparency on the non-proportional voting and control mechanisms applied by them. Such disclosure obligations should 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 non-proportional mechanisms exceeding a certain threshold, say 10% of total votes that can be cast in a meeting, and

shareholders who hold specific control rights, such as the right to make binding nominations for board positions, should be required to provide insight into the size and nature of their shareholdings as well as the policy they have on the exercise of powers attached to their holdings. This is also relevant for public, semi-public or private entities which as shareholders make use of non-proportional mechanisms in order to further public objectives. The disclosure should explain what objectives are being pursued by the relevant mechanisms and how they can be justified in view of the interest of the other shareholders.

- Companies and shareholders should be required to provide more transparency on the actual usage of non-proportional mechanisms. For instance, in addition to the existing obligations to disclose related party transactions in annual accounts pursuant to IFRS, ad-hoc disclosures should be imposed in respect of related party transactions involving a shareholder benefiting from such mechanism. Disclosure should also be required on the effect on the outcome of voting by shareholders in case of certain key resolutions.

- Specific disclosure requirements should be introduced in respect of the use of mechanisms decoupling voting rights from economic ownership, 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 for the company.
  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 their economic risk resulting from such shareholding.

2. Information gathering and follow-up

- 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 non-proportional mechanisms in their jurisdiction. Such an obligation for Member States should build on their obligation to provide the Commission with information on takeover bids that have occurred and their results as provided for in article 20 of the EC Takeover Bids Directive. Member States should 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 non-proportional mechanisms generally, to make judgements on their effectiveness and to indicate what measures they are considering if existing measures are not sufficiently effective. Member States should also specifically be asked what mechanisms are applied by public, semi-public or private entities as shareholders to further public objectives.

- Member States should specifically be asked what non proportional mechanisms are applied that offer the ability to create incontestable board entrenchment, which is in our opinion unacceptable from a corporate governance perspective. Boards should be accountable to shareholders and shareholders should be able to determine the composition of the board by a company law mechanism. Where Member States observe that incontestable board entrenchment can be created by use of non proportional mechanisms, they should be asked what measures, if any, they intend to take in order to remove that ability.

3. Developing EU voting architecture and the responsible investor

The concerns raised by market mechanisms used to decouple voting rights from economic exposure are aggravated in the EU by the fact that the voting architecture in the EU is seriously underdeveloped, as a result of which companies are unable to identify their shareholders and shareholders cannot exercise their voting rights efficiently, particularly across borders. Companies and their shareholders as a result are vulnerable to the exercise of significant voting rights by just a few shareholders. As the Forum has pointed out in its recommendations on the Commission proposal for a directive on the exercise of shareholders´ voting rights, 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. Institutional investors should be required to disclose their voting policies and practices, as suggested in the Company Law Action Plan, to enable fiduciaries and market participants in general to monitor institutional investor behaviour.

ANNEX 3 – DEFINITION OF CONTROL ENHANCING MECHANISMS

This annex presents the most common types of Control Enhancing Mechanism.

(A) CORPORATE CONTROL ENHANCING MECHANISMS

Control Enhancing Mechanisms (CEMs) should be primarily understood as the institutional arrangements (e.g. taken by the listed company itself) creating a discrepancy in the relation between financial ownership and voting power with the result that a shareholder can increase his control without holding a proportional stake of equity. They are included in the constitutional documents of the company (articles of association or statutes). These kinds of CEMs are referred to as **Corporate CEMs**.

There is a **wide variety of Corporate CEMs**, which may be used cumulatively in the same company and whose impact on control rights is divergent:

– (i) Corporate institutional arrangements directly affecting voting rights attached to shares;

– (ii) Corporate institutional arrangements indirectly affecting voting rights by creating specific rights or by reducing or inhibiting the ability to exercise voting rights proportionally;

– (iii) Other corporate institutional mechanisms that reduce or inhibit the exercise of control through the exercise of voting rights.

(i) Corporate institutional arrangements directly affecting voting rights attached to shares

CEMs may directly affect the voting rights attached to shares in a disproportionate way (e.g. shares with multiple voting rights, non voting shares, non voting preference shares, participating bonds and voting ceilings).

- Shares with multiple voting rights: shares issued by a company giving different voting rights based on an investment of equal value. These kinds of shares are traditionally used in the Nordic countries, typically giving 10 votes per share in the case of the A class and 1 vote per share of the B class (in some cases the ratio may be different). Both classes of shares may be listed but this is not always the case. In the Netherlands, there are two types of situation. In the first one, a class of shares (preference shares) has limited cash flow rights (typically fixed % of nominal value) but with voting rights linked to nominal value as with ordinary shares; this results in shares with voting rights disproportionately high in relation to their financial value. The second situation relates to two classes of shares, one with high nominal value and no premium, the other with low nominal value and high premium. The voting rights are based on nominal value while the cash flow rights are based on the sum paid up (nominal plus premium).

- Shares with loyalty schemes that may increase their voting rights. The shareholder who holds shares in the company for a certain minimum period of time obtains double voting rights. If the shares are sold, the double voting rights are not transferred. In this case the shares are of the same type.

- Non voting shares (without preference): shares with no voting rights and which carry no special cash-flow rights (such as a preferential dividend) to compensate for the absence of voting rights (found in Switzerland, the UK, France and other EU15 countries).

- Non voting preference shares: non-voting stock issued with special cash-flow rights (e.g. preferential – higher or guaranteed – dividend) (prevalent in Italy, Germany and the UK) to compensate for the absence of voting rights. They are used in Germany (with additional preferred dividend on top of ordinary dividend to compensate for the lack of voting rights), in the UK (limited preferred dividend, but no ordinary dividend), with the possibility of having voting rights only in case of default) and Italy. In Belgium, this kind of share is similar to the UK type, but rarely used.

- Participating bonds. In Germany participating bonds do not qualify as shares but bear full cash flow exposure. Thus, they reduce the cash flow exposure of voting shares.

- Voting rights ceilings: restriction prohibiting shareholders from voting above a certain threshold irrespective of the number of voting shares they hold. Voting right ceilings can be expressed as a percentage of all outstanding voting rights (for example, when no shareholder may vote for more than three percent of the company's registered share capital) or as a percentage of all votes cast at a general meeting (very common in many European countries, except Belgium where they are no longer imposed, and the Netherlands). There are other possibilities such as scales and decreasing voting rights or time lapse voting.

(ii) Corporate institutional arrangements indirectly affecting voting rights

CEMs may also indirectly affect the voting rights attached to shares by creating specific rights or by reducing or inhibiting the ability to exercise voting rights proportionally (e.g. priority shares such as shares conferring exclusive rights to nominate board members, supermajority provisions, or depository receipts sponsored by the company which reserve voting rights to depository institutions that may or may not be subject to board influence).

- Priority shares: these shares grant their holders specific powers of decision or veto rights in a company, irrespective of the proportion of their equity stake (found in the Netherlands, the UK and France). The rights attributed to the holders of priority shares vary from company to company and can range from the entitlement to propose specific candidates to the board of directors, to the right to directly appoint board members or to veto a decision taken at the general meeting. They are used in the Netherlands with nomination rights, exclusive proposal and veto rights. The latest development is to grant priority shares to the board of a foundation, which may consist of the non-executive board members of the company, with a view to entrenching management. They are also used in Germany (special shareholder nomination rights) and in France.

- Golden shares: these are a type of priority share. They are issued for the benefit of governmental authorities, frequently in the context of privatisation processes. Golden shares confer special rights used by national or local governments or government controlled vehicles to maintain control in privatised companies by granting them rights that go beyond those associated with normal shareholding. They enable governments i.a. to block takeovers, limit voting rights and/or veto management decisions.

- Depository certificates of shares sponsored by the company: financial instruments representing the underlying shares in a company which are held by a foundation that administers the voting rights. In this case the holder of the depository certificates does not hold voting rights but only the financial rights of the underlying share. The depository certificates are the financial instruments issued on the market and representing the shares held by the foundation, which executes the votes. The board of the foundation needs to be independent from the company. This instrument is used in particular in the Netherlands (since 2004, holders of depository receipts have been entitled to vote by using a power of attorney unless there is a takeover threat). Even though Belgian companies have recently been granted the legal possibility of issuing similar (but not identical) depository certificates to those in Dutch Law, none of the Belgian companies analysed has so far done so.

- Supermajority requirements: where company bylaws or national law require a majority of shareholders larger than 50% + 1 vote to approve certain important corporate changes. 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) they become an entrenchment device, depending on the degree of dispersion. Quorum requirements may also work as an entrenchment device.

(iii) Other corporate institutional mechanisms

Institutional arrangements may also consist of **other mechanisms** that reduce or inhibit the exercise of control through the exercise of voting rights, such as ownership ceilings, share transfer restrictions, staggered board provisions and other arrangements.

- Ownership ceilings: share transfer restrictions which prohibit potential investors from taking a participation in a company above a certain threshold (found especially in Italy, the UK and other EU15 countries).

- Share transfer restrictions: companies can limit the transferability of these shares by imposing ownership caps or a right of first refusal or approval right for the company or other holders of these shares. They may be included in the articles of associations (in Germany, *Vinkulierte Namensaktien*) or in the insider shareholders agreement.

- Staggered board.

- Unchangeable provisions in articles of association.

- Other provisions in insider shareholder agreements.

(B) ALTERNATIVE MECHANISMS (NON CORPORATE CEMS)

There are mechanisms which are not part of the company's constitution (e.g. non corporate/institutional mechanisms) but which affect the effective exercise of proportionate voting rights in the company. These non corporate mechanisms are the result of shareholders behaviour and are generally less transparent than corporate CEMs. Although it is not necessarily their main purpose, they may be used for enhancing control, similar to corporate CEMs. They are referred to as "**alternative mechanisms**".

- Depository receipts of shares not sponsored by the company: financial instruments representing the underlying shares in a company which are held by an institution that administers the voting rights.
- Pyramid structures: this situation occurs when an entity (such as a family or a company) controls a corporation that in turn holds a controlling stake in another corporation, the process of which can be repeated a number of times. This device is based on the idea that the separation of ownership and control can be obtained by chaining several companies. The higher the number of companies involved in the pyramid, the higher the degree of deviation from the proportionality between ownership and control.
- Cross-shareholdings: a situation where company X holds a stake in company Y which, in turn, holds a stake in company X. Circular holdings, e.g. where A has shares in B, B in C and C in A are a special case of cross-shareholdings.
- Shareholder agreements: formal and/or informal shareholders' alliances.
- Decomposition techniques: securities lending, contracts for difference, call/put options and similar financial instruments.
- Change of control clauses.

These alternative mechanisms are increasingly being used. The ISS Study found that pyramid structures and shareholder agreements are among the 3 mechanisms mostly used (out of the 11 mechanisms analysed) in the European companies subject to the survey. As regards decomposition techniques using market instruments, no conclusive figures are available. However, it is reported that the use of these mechanisms (notably securities lending) in the period ahead of general meetings, in order to obtain voting rights without a corresponding economic interest, is increasing. This may lead to the so-called "empty voting" problem. Hedge funds are suspected in particular of being recent users of this strategy.

ANNEX 4 – THE BROADER CONTEXT: CORPORATE GOVERNANCE LEGISLATION AND SYSTEMS

CEMs should be examined in conjunction with other factors in order to understand the broader context in which corporate CEMs and alternative mechanisms are implemented. Some of the negative effects of CEMs, (board entrenchment, ineffectiveness of the corporate governance codes based on comply or explain principle, incontestability of corporate control or the extraction of private benefits) could be offset by specific countervailing factors, notably existing legislation. Indeed, CEMs are already significantly regulated in order to prevent abuse.

These countervailing factors are:

– (A) the EC Treaty rules on free movement of capital in the EU;

– (B) the robustness of the corporate governance legislation and systems, including the rules on the protection of minorities, and the level of transparency on (and around) CEMs;

(A) ENFORCING THE EC TREATY PROVISIONS ON FREE MOVEMENT OF CAPITAL

The EC Treaty prohibits Member States from restricting the free movement of capital in the EU. Enforcing this provision on free movement of capital **through administrative or judicial proceedings** is possible when CEMs constitute a clear violation of such Treaty rules. This is clearly the case of golden shares. The Commission has been attacking those golden shares before the Court of Justice in the past years, with successful results.

(B) CORPORATE GOVERNANCE LEGISLATION AND SYSTEMS

The company laws and securities laws of Member States[47], in some cases pursuant to Community law obligations, currently contain a number of different regulatory tools based on well-grounded principles of corporate law that seek to prevent or correct abuse of controlling positions by shareholders and to enhance the protection of minorities. Two broad categories (although in some cases the requirements play in both categories) are presented:

- **(1)** the requirements which are mainly addressing the exercise of control rights (therefore addressing the questions of board entrenchment and accountability as well as the contestability of corporate control); and

- **(2)** the requirements which aim at preventing conflicts of interest (therefore addressing the question of private benefits extraction).

In addition, **(3)** these laws foresee a number of transparency measures on CEMs and in relation to voting rights.

[47] Notably regulations on admission to trading, on transparency obligations of listed companies, on takeover bids, on shareholders rights, on accounting standards etc.

Further to the legislative obligations, specific practices or disclosures are made on the basis the national corporate governance codes which are voluntarily applied by companies or imposed by the listing rules of stock exchanges.

(1) Requirements addressing the exercise of control rights.

The main objective of this kind of requirements is to empower shareholders (as represented by the general meeting) to exercise their control rights in the company. They essentially relate to:

- (i) the rules governing the general meetings, including rules to facilitate the vote, the question of enhanced voting majorities in order to protect minorities, the right to put questions etc;
- (ii) the rules governing the election and dismissal of directors;
- (iii) additionally, the rules to facilitate the exercise of voting rights by (future) shareholders in the context of takeover bids.

(i) Rules applicable to the shareholder meetings.

The Council and Parliament adopted on 11 July 2007 a Directive[48] aiming at facilitating non-resident shareholders the exercise of their voting rights in listed companies.

This facilitation is done by introducing minimum standards ensuring timely access to complete information on general meetings, facilitating the access to the general meeting and putting at the disposal of shareholders simple and effective means to exercise their voting rights, such as the vote by proxy or by using electronic means.

In particular, this Directive will ensure the following:

– Equal treatment for all shareholders who are in the same position with regard to the participation and exercise of voting rights in general meetings. A similar requirement was already included in Article 17 of Directive 2004/109/EC (Transparency Directive).

– A sufficiently long convocation period (21 days, which can be reduced to 14 days where shareholders can vote by electronic means and the general meeting agrees to the shortened convocation period) for general meetings that allow shareholders to prepare themselves for the general meeting;

– Internet publication of the convocation and of the documents to be submitted to the general meeting at least 21 days before the general meeting;

– A right to put items on the agenda and to table draft resolutions, providing some minimum standards are respected. Today, some countries make it relatively easy for shareholders to add items to the agenda of the next shareholders meeting[49] by requiring to hold 5% of less of the capital to made such addition to the agenda.

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[48] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJ L 184, 14.7.2007, p.17.

[49] ISS Study, p. 16.

- The abolition of share blocking and its replacement by a record date system (which may not be more than 30 days before the general meeting)

- The abolition of legal impediments in Member States' laws to the use of electronic means in the context of the general meeting (electronic voting, electronic designation of a proxy, participation in the general meeting via Internet etc.).

- A right to ask questions (and obligation for the company to answer them),

- A liberalized proxy voting system, although a five years' transition period (from the entry into force of the directive) has been granted with a view to existing national provisions that prevent members of the company's management from acting as proxy holders;

The deadline for implementing the obligations of this directive is August 2009.

(ii) Rules on election and dismissal of directors.

Unless the company's articles of association provides differently, election of directors is normally done by simple majority at the general meeting, with cooptation possibility (subject to ratification by the following shareholder meeting in some cases[50]. Representation of minority shareholders is not guaranteed, except to some extent in Italy and Spain.

Dismissal of directors follows similar rules, with specific provisions in some cases (notably Germany) regarding the role of the supervisory board. It should be noted that in Germany, France, Spain and Luxembourg, it is possible to dismiss a director at a shareholder meeting even if the dismissal was not foreseen in the agenda. This possibility explains to a certain extent the comparatively higher use of voting cap restrictions in Germany, France and Spain.

Most jurisdictions allow dismissal of directors without cause and without indemnity, while others (Germany, Ireland, Italy, UK) provide for indemnification[51]. Staggered boards are possible in some countries.

(iii) Rules to facilitate the exercise of voting rights by (future) shareholders in the context of takeover bids.

The breakthrough rule (Article 11 of the Takeover Bids Directive[52]) neutralises pre-bid defences during a takeover. This rule is considered to be a radical tool to facilitate takeovers as it makes certain restrictions (e.g. share transfer or voting restrictions) inoperable during the takeover period and allows a successful bidder (having acquired 75% of capital) to easily remove the incumbent board of the target company and modify its articles of association. Based on the principle of proportionality between capital and control, this rule overrides multiple voting rights at the general meeting authorising post-bid defensive measures as well as at the first general meeting following a successful takeover bid.

However, Article 12 of the Directive subjects the breakthrough rule to complex optional arrangements. Member States are allowed to choose between imposing these rules or not.

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[50] See generally the ISS study.

[51] ISS Study, p.16.

[52] Directive 2004/24/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids.

However, if a Member State decides not to make them mandatory, it cannot prevent companies from applying these rules on a voluntary basis. The decision on voluntary application of the rules in turn has to be adopted by the general meeting and can be reversed in the same way.

Additionally, the so-called reciprocity exception (Article 12(3) allows Member States to permit companies applying this rule to disapply it, and thus to "retaliate" against a bidder who is not subject to the same rules. The reciprocating power can be used only if it is authorised by both the Member State and the general meeting of the target company.

In terms of legal obligations, the way in which Member States have implemented this rule[53] is unlikely to significantly change the status quo, for the following reasons. The vast majority of Member States have not imposed (or are unlikely to impose) the breakthrough rule, but have made it optional for companies. Breakthrough is expected to be imposed only by the Baltic States and possibly Italy[54]. None of the other countries will oblige their companies to apply this provision in full. Therefore a mere 1% of listed companies in the EU will apply this rule on a mandatory basis.

However, some Member States have already eliminated multiple voting securities and/or other pre-bid defences, and the structure of the companies in these Member States is therefore more open to takeovers (Germany). Others lifted some of the barriers referred to in the breakthrough rule before transposition and this partial breakthrough rule continues to apply (France and Italy). Portugal imposes the rule on a limited number of companies[55].

Given that only a few Member States intend to impose the application of the rule, its takeover-facilitating effect will depend almost exclusively on whether or not companies will apply the rule on a voluntary basis. In this respect it is worth noting the following:

Voluntary application of the breakthrough rule is made conditional upon the approval of those benefiting from disproportionate or special rights or of a large proportion of shareholders in certain Member States. This makes the application of the rule on a voluntary basis more difficult[56].

The breakthrough rule does not neutralise all pre-bid defences. A company applying it may continue to use other robust defences to thwart hostile takeovers, such as: non-voting or

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53 See Commission Staff Working Document of 21.12.2007, Report on the implementation of the Directive on Takeover Bids, SEC(2007)268.

54 On 13th September 2007, the Italian Council of Ministers approved a new version of the draft Legislative Decree implementing the Takeover Bids Directive which contains a mandatory breakthrough rule, though reciprocity might be applied.

55 Portugal mandates the application of the rule to companies in which the approval of a supermajority (more than 75% of the votes) is required to change the articles of association.

56 Although companies are allowed to apply the breakthrough rule on a voluntary basis by adopting a resolution at the general meeting, such a resolution can be conditional upon the approval of a certain percentage of those affected by such a resolution (i.e. shareholders with multiple vote securities, where such multiple votes are neutralised during and after a successful bid). Austria requires approval of the person enjoying a right to appoint members of the supervisory board. Denmark and Slovakia make such a decision conditional on the approval of two-thirds of those affected by the resolution. In the UK, rights of shareholders in a particular class may not be overridden unless three-quarters of that class consent, etc. In some countries, no additional resolution is required (e.g. the Netherlands). Sweden made it particularly difficult for companies to adopt such a resolution by making its validity subject to the approval of not less than nine-tenths of all the shareholders in the company.

double vote shares, granting veto rights in respect of a change to the articles of association, granting special rights to an entity which is not a shareholder. Companies having acquisition plans may therefore choose to apply it so as to avoid reciprocity and continue to be protected against takeovers once they become targets. Furthermore, the fact that the breakthrough rule has a limited coverage may induce companies to switch to other available pre-bid defences not covered by it.

If a company decides to apply the breakthrough rule on a voluntary basis, such decision can immediately be reversed as soon as the bidder becomes a target. The reversibility of the company's decision may even create confusion on the market[57].

The **board neutrality rule** also has an impact on the possible exercise of voting rights. Additionally, it also protects the minority interests (see below).

(2) Requirements which aim at preventing conflicts of interest

The rules which aim at prevention conflicts of interest essentially relate to:

- (i) rules on related party transactions;
- (ii) rules on off-balance sheet arrangements;
- (iii) rules on groups;
- (iv) rules on the involvement of independent/non-executive directors;
- (v) minority protection rules in the context of take-over bids (e.g. mandatory bid rule, board neutrality rule, sell-out rights);
- (vi) rules on statutory audit; and
- (vii) rules in relation to the prevention of market abuse.

(i) Rules on related party transactions.

Rules on related party transactions at EU level are governed by the recently modified Fourth Company Law Directive (see Article 43(1)(7b)) for single company accounts. For consolidated accounts, the IAS Regulation (Regulation 1606/2002) and the 7th Company Law Directive for consolidated accounts (see Article 34(1)(7b)) apply. The recent (2006) changes to these two directives extend disclosure on related party transactions (previously only covering the transactions between a company and the company's affiliated undertakings) to cover other types of related parties provided they are material and not carried out at arm's length. The IAS 24 definitions should apply.

4th CLD Article 43 (Contents of the notes on the accounts)

57 To address these concerns, some Member States have imposed limitations on the reversibility of the decision (e.g. UK, Malta).

"1. In addition to the information required under other provisions of this Directive, the notes on the accounts must set out information in respect of the following matters at least:

(7b) transactions which have been entered into with related parties by the company, including the amount of such transactions, the nature of the related party relationship and other information about the transactions necessary for an understanding of the financial position of the company, if such transactions are material and have not been concluded under normal market conditions. Information about individual transactions may be aggregated according to their nature except where separate information is necessary for an understanding of the effects of related party transactions on the financial position of the company.

Member States may permit the companies referred to in Article 27 to omit the disclosures prescribed in this point unless those companies are of a type referred to in Article 1(1) of Directive 77/91/EEC, in which case Member States may limit disclosure to, as a minimum, transactions entered into directly or indirectly between:

(i) the company and its major shareholders,

and

(ii) the company and the members of the administrative, management and supervisory bodies.

Member States may exempt transactions entered into between two or more members of a group provided that subsidiaries which are party to the transaction are wholly owned by such a member.

'Related party' has the same meaning as in international accounting standards adopted in accordance with Regulation (EC) No 1606/2002;"

7th CLD

Article 34

"In addition to the information required under other provisions of this Directive, the notes on the accounts must set out information in respect of the following matters at least:

(7b) The transactions, save for intra-group transactions, entered into by the parent undertaking, or by other undertakings included in the consolidation, with related parties, including the amounts of such transactions, the nature of the related party relationship as well as other information about the transactions necessary for an understanding of the financial position of the undertakings included in the consolidation taken as a whole, if such transactions are material and have not been concluded under normal market conditions. Information about individual transactions may be aggregated according to their nature except where separate information is necessary for an understanding of the effects of the related party transactions on the financial position of the undertakings included in the consolidation taken as a whole."

Regulation 1606/2002

IAS 24 deals with related party disclosures

These transparency rules, however, do not address the question of shareholder approval of conflicted transactions. Many EU jurisdictions make the review by disinterested board directors of conflicted managerial/controlling shareholder transactions either mandatory or strongly advisable (see also below on independent directors). However, the effectiveness of such review may be impaired by the absence of independent directors or by their being however biased in favour of management or controlling shareholders[58]. This explains the

[58] See Kraakman et al. (2004).

interest of having in alternative or in addition to board review, shareholders approving such transactions.

France in 2001 extended its regime of self-interested transactions to include those involving the parent company or any shareholder holding more than 10 percent of the voting rights. The new regime requires that these transactions be approved by the board and ratified by the shareholder meeting. The interested party must abstain from voting both within the board and at the shareholders meeting. However this provision does not seem to have worked in practice, due to the fact that it is left to board members to appreciate whether specific transactions fall within the category of "current transaction entered into at normal conditions."

In the UK the same provision is in place with a quantitative limit instead of a qualitative one. Under FSA, Listing Rule 11 on related party transactions, transactions decided by the board with a related party (a director or a substantial shareholder) must be approved by the company shareholders with the abstention of the related party and the related party's associates. The provision does not apply in case of small transactions and in a series of specific cases specified by the listing rule in the absence of unusual features (loans to a related party on normal commercial terms, incentive schemes, and so on).

(ii) Rules on off-balance sheet arrangements.

Off-balance-sheet arrangements[59] may expose a company to risks and benefits which are material for an assessment of the financial position of the company and, when the company belongs to a group, the financial position of the group as a whole. The Fourth and Seven Company Law Directives have been modified in 2006 to ensure that appropriate disclosure of the material risks and benefits of such arrangements that are not included in the balance sheet are set out in the notes to the accounts or the consolidated accounts.

> 4th CLD
>
> Article 43 (Contents of the notes on the accounts)
>
> "1. In addition to the information required under other provisions of this Directive, the notes on the accounts must set out information in respect of the following matters at least:
>
> (7a) the nature and business purpose of the company's arrangements that are not included in the balance sheet and the financial impact on the company of those arrangements, provided that the risks or benefits arising from such arrangements are material and in so far as the disclosure of such risks or benefits is necessary for assessing the financial position of the company.
>
> Member States may permit the companies referred to in Article 27 to limit the information required to be disclosed by this point to the nature and business purpose of such arrangements; […].
>
> 7th CLD

[59] Such off-balance-sheet arrangements could be any transactions or agreements which companies may have with entities, even unincorporated ones, that are not included in the balance sheet. Such off-balance-sheet arrangements may be associated with the creation or use of one or more Special Purpose Entities (SPEs) and offshore activities designed to address, inter alia, economic, legal, tax or accounting objectives. Examples of such off-balance-sheet arrangements include risk and benefit-sharing arrangements or obligations arising from a contract such as debt factoring, combined sale and repurchase agreements, consignment stock arrangements, take or pay arrangements, securitisation arranged through separate companies and unincorporated entities, pledged assets, operating leasing arrangements, outsourcing and the like.

Article 34

"In addition to the information required under other provisions of this Directive, the notes on the accounts must set out information in respect of the following matters at least:

(7a) The nature and business purpose of any arrangements that are not included in the consolidated balance sheet, and the financial impact of those arrangements, provided that the risks or benefits arising from such arrangements are material and in so far as the disclosure of such risks or benefits is necessary for assessing the financial position of the undertakings included in the consolidation taken as a whole.

(iii) Rules on groups.

Groups of companies, which today are frequent in most, if not all, Member States, are a legitimate way of doing business, but at the same time they may present specific risks for shareholders and creditors in various ways. There is **no Community comprehensive legislation addressing group relations**[60] and previous assessments[61] have considered that the enactment of an autonomous body of law specifically dealing with groups does not appear necessary. However particular problems to be addressed through specific provisions in three areas were identified.

- Financial and non financial information. Complete information and disclosure with regard to the group's structure and intra-group relations are a crucial pre-requisite to ensure that the functioning of groups remains compatible with the interests of shareholders and creditors at the different levels. The need for better financial and non financial information about groups of companies has already addressed partly by a series of EU measures applying to listed companies, notably the application of IAS to consolidated accounts; the information to be provided under Article 10 of the takeover bids directive or the

[60] A draft "Ninth Company Law Directive on the Conduct of Groups containing a Public Limited Company as a Subsidiary" was circulated by the Commission in December 1984 for consultation. According to its Explanatory Memorandum, the Directive was intended to provide a framework in which groups can be managed on a sound basis whilst ensuring that interests affected by group operations are adequately protected. Such a legal framework, adapted to the special circumstances of groups, was considered to be lacking in the legal system of most Member States.
Apart from its provisions dealing with the notification and disclosure of shareholdings in PLCs, which covered all PLCs, the Directive otherwise applied only when a PLC was the subsidiary of another undertaking (which could itself be a PLC, but could also be a natural person or a legal person).
The main features of the proposal were : a) a definition of a "subsidiary undertaking" which would oblige Member States to provide for "control contracts", b) rules about the disclosure of shareholdings in PLCs, c) detailed rules (Section 4) as to the conduct of a "parent undertaking" towards a PLC subsidiary (including the liability of the parent undertaking for damage to the PLC subsidiary and for its debts), d) detailed rules applicable when the parent undertaking had entered into a "control contract" with a PLC (Section 5), or when it had made a "unilateral declaration instituting a vertical group" (Section 6), which would contain similar safeguards to those prescribed in Section 4 but with important additions (including a rights for the employee representatives on the subsidiary PLC's supervisory body to veto instructions from the parent undertaking).
The consultation on the draft Directive showed that there was very little support for such a comprehensive framework on group law: such an approach was largely unfamiliar to most Member States, and the business sector viewed it as too cumbersome and too inflexible. As a consequence, the decision was made not to issue an official proposal.

[61] See the 2002 report by the High Level Group of Company Law Experts, p. 96 and seq. See also the Commission Communication of 21.5.2003 (COM(2003)284), Modernising Company Law and Enhancing Corporate Governance in the European Union – a Plan to Move Forward, p.18.

information to be provided in the annual corporate governance statement (see below on transparency rules).

- Implementation of a group policy. The implementation of a co-ordinated group policy by groups of companies allows for improved business efficiency and competitiveness. However appropriate safeguards need to be applied to ensure that the interests of that company's creditors are effectively protected and that there is a fair balance of burdens and advantages over time for that company's shareholders. This is particularly important in the case of listed companies that may form part of a group of companies with unlisted companies and where control may be exercised through CEMs. Currently, there are no community rules concerning the implementation of a group policy by listed companies.

- Pyramids. Pyramidal groups that include listed companies raise particular concerns stemming from their lack of transparency, though the transparency requirements of the Transparency Directive, the takeover bids directive and the annual corporate governance statement constitute an improvement in this area. The High Level Group of Experts on Company Law recommended, however, that in view of the weak position of the minority shareholders in the companies included in pyramidal groups, that national authorities should be required not to admit to listing companies belonging to abusive pyramids[62]. The Group defined them as holding companies whose sole or main assets are their shareholding in another listed company, but made an exception for cases where the economic value of such admission is clearly demonstrated, thereby recognising that the definition of what constitutes an abusive pyramid required further consideration. The High Level Group also suggested that operators of stock indices should properly take into account the free float in determining the respective weight of each company.

  According to the ISS study, the Italian Stock Exchange Regulation already prohibits the listing of box-companies (pure holding), i.e. companies whose main asset or revenues are the shareholding in another listed company. In the UK also the use of pure holdings in certain cases is prohibited or restricted.

  This issue was specifically addressed in the 2006 consultation on the priorities regarding the Commission's action plan on company law. The vast majority of respondents, however, considered that no action was advisable in this regard.

(iv) Rules on the involvement of independent/non-executive directors.

Boards are less likely to exercise efficient monitoring if they are staffed with people either with close links to the management or lacking appropriate expertise. Independence is particularly crucial in areas which involve a potential conflict of interest between managers and shareholders: nomination of the management, manager's pay and audit of the company's performance – itself an indicator of the performance of the manager[63]. This is why the Commission adopted a recommendation in 2005 promoting the presence and role of non-

[62] See the 2002 report by the High Level Group of Company Law Experts, p. 98 and seq.

[63] Commission staff working document of 13.7.2007 (SEC(2007)1021), Report on the application by the Member States of the EU of the Commission Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, p. 2.

executive or supervisory directors on boards[64]. The main principles of the recommendation are:

- (1) Separation of the role of chief executive director and (supervisory) board chairman: the separation of past and present chief executive and chairmanship functions is widely considered as a crucial condition for ensuring that management is subject to efficient and independent supervision. The Recommendation states that it should be avoided that the chief executive immediately becomes the chairman of the (supervisory) board. Furthermore, the Recommendation requires disclosure of safeguards put in place if a company chooses to combine the roles of chairman and chief executive or to immediately appoint as chairman of the (supervisory) board the former chief executive.

- (2) Sufficient number of independent directors on the (supervisory) board: it is recommended that a sufficient number of independent non-executive or supervisory directors should be elected to the (supervisory) board of companies to ensure that any material conflicts of interest involving directors will be properly dealt with. Independent directors also have a role to play in companies where a controlling shareholder may exert strong control over the management. In such cases, conflicts of interest may arise between the majority and minority shareholders. Independence from the controlling shareholder may be an efficient way of alleviating such conflicts.

- (3) Creation of board committees for dealing with issues raising conflict of interest: the Recommendation encourages the creation of nomination, remuneration and audit committees within the (supervisory) boards where these tasks are not the direct responsibility of shareholders.

- (4) Strong presence of independent directors in board committees and clear delineation of the role of such bodies: the Recommendation emphasises the need for a strong presence of independent non-executive directors in board committees. It is recommended that the nomination committee should be composed of at least a majority of independent non-executive or supervisory directors, and that the remuneration and the audit committees, in turn, should comprise exclusively non-executive or supervisory directors, a majority of whom should be independent. Furthermore, the Recommendation establishes a long list of functions for such bodies.

- (5) Transparency on independent board members: disclosure of the competences of individual directors and of adequate information on the board's determination of the directors' independence is recommended.

- (6) High standards on qualifications and commitment of (supervisory) board members: In order to boost the efficiency of the (supervisory) board, it is recommended that it be composed of members who, taken together, have the required diversity of knowledge, judgement and experience to properly complete their tasks. Members of the audit committee should have specific financial and accounting knowledge in order to adequately fulfil their duties. Directors should be committed to their duties and devote sufficient time and attention to their work. As a consequence this may imply that they limit their other

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[64] Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies an on the committees of supervisory boards, OJ L 52, 25.2.2005, p.51.

commitments. Other assignments and significant professional commitments should be disclosed.

Regrettably, a significant number of Member States do not recommend the presence of independent directors in all board committees[65]. It is alarming that the law or the corporate governance code in some Member States do not recommend a strong presence of independent members in remuneration and audit committees[66]. In these Member States, managers may still be able to have a major influence on their own remuneration and control over the company's accounts may be insufficient. The costs for the company and risk of abuse may remain high.

(v) Minority protection rules in the context of take-over bids (e.g. mandatory bid rule, board neutrality rule, sell-out rights).

Minority shareholders are protected from possible conflicts of interest in a number of ways under the takeover bids Directive, but notably through the mandatory bid rule, the sell-out right and the board neutrality rule.

The **mandatory bid rule** provides that if a person acquires control over a company, he/she is obliged to make a full takeover bid for all the remaining voting securities of this company at an equitable price (Article 5). This rule protects minority shareholders by granting them a right to sell their shares in the event of a change of control as well as the benefit of the premium paid for the controlling stake. The introduction of the mandatory bid obligation and/or the equitable price rule in those Member States where such a rule did not apply before transposition and the setting of a threshold lower than the one applied before transposition will increase minority shareholders' rights in some Member States[67]. The threshold above which control is deemed to have been acquired is defined at national level (these thresholds vary from 25% to 66% of voting rights. Most Member States have set the threshold at 30%).

> Article 5 of the Directive on takeover bids
>
> Protection of minority shareholders, the mandatory bid and the equitable price
>
> 1.Where a natural or legal person, as a result of his/her own acquisition or the acquisition by persons acting in concert with him/her, holds securities of a company as referred to in Article 1(1) which, added to any existing holdings of those securities of his/hers and the holdings of those securities of persons acting in concert with him/her, directly or indirectly give him/her a specified percentage of voting rights in that company, giving him/her control of that company, Member States shall ensure that such a person is required to make a bid as a means of protecting the minority shareholders of that

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65 Commission staff working document of 13.7.2007 (SEC(2007)1021), Report on the application by the Member States of the EU of the Commission Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, p. 4.

66 The creation of a remuneration committee is generally required on a "comply or explain" basis at national level (nomination committees are normally only recommended in Member States). Article 41 of Directive 2006/43/EC (the so-called Eight Company Law Directive), which is to be transposed by end of June 2008, has extended to all listed EU companies the obligation to have an audit committee or a body performing equivalent functions.

67 It should be noted, however, that Member States have widely used the flexibility provided by the Directive to derogate from the Directive's provisions in order to maintain their exceptions from the mandatory bid rule. Some of these exceptions are necessary to ensure that this obligation applies only where the holding actually confers control, while others are more far-reaching. Furthermore, in some Member States, supervisory authorities seem to have extensive powers to grant exceptions from the rule. See generally the Commission staff working document of 21.12.2007 (SEC(2007)268), Report on the implementation of the directive on Takeover Bids, p.9 and seq. and annexes 2 and 3.

company. Such a bid shall be addressed at the earliest opportunity to all the holders of those securities for all their holdings at the equitable price as defined in paragraph 4.

2.Where control has been acquired following a voluntary bid made in accordance with this Directive to all the holders of securities for all their holdings, the obligation laid down in paragraph 1 to launch a bid shall no longer apply.

3.The percentage of voting rights which confers control for the purposes of paragraph 1 and the method of its calculation shall be determined by the rules of the Member State in which the company has its registered office.

4.The highest price paid for the same securities by the offeror, or by persons acting in concert with him/her, over a period, to be determined by Member States, of not less than six months and not more than 12 before the bid referred to in paragraph 1 shall be regarded as the equitable price. If, after the bid has been made public and before the offer closes for acceptance, the offeror or any person acting in concert with him/her purchases securities at a price higher than the offer price, the offeror shall increase his/her offer so that it is not less than the highest price paid for the securities so acquired.

Provided that the general principles laid down in Article 3(1) are respected, Member States may authorise their supervisory authorities to adjust the price referred to in the first subparagraph in circumstances and in accordance with criteria that are clearly determined. To that end, they may draw up a list of circumstances in which the highest price may be adjusted either upwards or downwards, for example where the highest price was set by agreement between the purchaser and a seller, where the market prices of the securities in question have been manipulated, where market prices in general or certain market prices in particular have been affected by exceptional occurrences, or in order to enable a firm in difficulty to be rescued. They may also determine the criteria to be applied in such cases, for example the average market value over a particular period, the break-up value of the company or other objective valuation criteria generally used in financial analysis.

Any decision by a supervisory authority to adjust the equitable price shall be substantiated and made public.

5.By way of consideration the offeror may offer securities, cash or a combination of both.

However, where the consideration offered by the offeror does not consist of liquid securities admitted to trading on a regulated market, it shall include a cash alternative.

In any event, the offeror shall offer a cash consideration at least as an alternative where he/she or persons acting in concert with him/her, over a period beginning at the same time as the period determined by the Member State in accordance with paragraph 4 and ending when the offer closes for acceptance, has purchased for cash securities carrying 5 % or more of the voting rights in the offeree company.

Member States may provide that a cash consideration must be offered, at least as an alternative, in all cases.

6.In addition to the protection provided for in paragraph 1, Member States may provide for further instruments intended to protect the interests of the holders of securities in so far as those instruments do not hinder the normal course of a bid.

Sell-out right (Articles 15 and 16). The sell-out right provides minority shareholders with a counterpart to the squeeze-out right: it allows them to force the majority shareholder to buy their shares at a fair price. Such a rule protects minorities from abuse by the majority shareholder of his dominant position, where such protection is not available below the sell-out threshold in national law. Furthermore, the obligation to fairly compensate minorities may offer them a better price for their shares than the one set by a potentially illiquid market.

Article 16 of the Directive on takeover bids

The right of sell-out

1.Member States shall ensure that, following a bid made to all the holders of the offeree company's securities for all of their securities, paragraphs 2 and 3 apply.

2.Member States shall ensure that a holder of remaining securities is able to require the offeror to buy his/her securities from him/her at a fair price under the same circumstances as provided for in Article 15(2).

3.Article 15(3) to (5) shall apply mutatis mutandis .

Article 15 of the Directive on takeover bids

3.Member States shall ensure that rules are in force that make it possible to calculate when the threshold is reached.

Where the offeree company has issued more than one class of securities, Member States may provide that the right of squeeze-out can be exercised only in the class in which the threshold laid down in paragraph 2 has been reached.

4.If the offeror wishes to exercise the right of squeeze-out he/she shall do so within three months of the end of the time allowed for acceptance of the bid referred to in Article 7.

5.Member States shall ensure that a fair price is guaranteed. That price shall take the same form as the consideration offered in the bid or shall be in cash. Member States may provide that cash shall be offered at least as an alternative.

Following a voluntary bid, in both of the cases referred to in paragraph 2(a) and (b), the consideration offered in the bid shall be presumed to be fair where, through acceptance of the bid, the offeror has acquired securities representing not less than 90 % of the capital carrying voting rights comprised in the bid.

Following a mandatory bid, the consideration offered in the bid shall be presumed to be fair.

The **board neutrality rule** (article 9) provides that during the bid period the board of the target company must obtain prior authorisation from the general meeting of shareholders before taking any action which may result in the frustration of the bid. This rule may facilitate takeover activity by limiting the board's power to raise obstacles to hostile takeovers to the detriment of shareholders' interests. It safeguards shareholders against opportunistic behaviour of the incumbent management and ensures that it is indeed the owners who decide on the future of the company.

Indeed, managers are faced with a significant conflict of interests if a takeover bid is made. Often their own performance and plans are brought into question and their own jobs are in jeopardy. Their interest is in saving their jobs and reputation instead of maximising the value of the company for shareholders. Their claims to represent the interests of shareholders or other stakeholders are likely to be tainted by self-interest[68].

Article 9 of the Directive on takeover bids

Obligations of the board of the offeree company

1.Member States shall ensure that the rules laid down in paragraphs 2 to 5 are complied with.

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[68] See the 2002 Report of the High Level Group of Company Law experts on issues related to takeover bids, p. 21.

2.During the period referred to in the second subparagraph, the board of the offeree company shall obtain the prior authorisation of the general meeting of shareholders given for this purpose before taking any action, other than seeking alternative bids, which may result in the frustration of the bid and in particular before issuing any shares which may result in a lasting impediment to the offeror's acquiring control of the offeree company.

Such authorisation shall be mandatory at least from the time the board of the offeree company receives the information referred to in the first sentence of Article 6(1) concerning the bid and until the result of the bid is made public or the bid lapses. Member States may require that such authorisation be obtained at an earlier stage, for example as soon as the board of the offeree company becomes aware that the bid is imminent.

3.As regards decisions taken before the beginning of the period referred to in the second subparagraph of paragraph 2 and not yet partly or fully implemented, the general meeting of shareholders shall approve or confirm any decision which does not form part of the normal course of the company's business and the implementation of which may result in the frustration of the bid.

4.For the purpose of obtaining the prior authorisation, approval or confirmation of the holders of securities referred to in paragraphs 2 and 3, Member States may adopt rules allowing a general meeting of shareholders to be called at short notice, provided that the meeting does not take place within two weeks of notification's being given.

5.The board of the offeree company shall draw up and make public a document setting out its opinion of the bid and the reasons on which it is based, including its views on the effects of implementation of the bid on all the company's interests and specifically employment, and on the offeror's strategic plans for the offeree company and their likely repercussions on employment and the locations of the company's places of business as set out in the offer document in accordance with Article 6(3)(i). The board of the offeree company shall at the same time communicate that opinion to the representatives of its employees or, where there are no such representatives, to the employees themselves. Where the board of the offeree company receives in good time a separate opinion from the representatives of its employees on the effects of the bid on employment, that opinion shall be appended to the document.

6.For the purposes of paragraph 2, where a company has a two-tier board structure «board» shall mean both the management board and the supervisory board.

(vi) Rules on statutory audit

The new 8th Company Law Directive on statutory audit[69] aims at reinforcing and harmonising the statutory audit function throughout the EU. Its objectives are to restore credibility of financial reporting and to enhance the EU's protection against the type of scandals that occurred in the past at companies such as Parmalat and Ahold. This directive sets out principles for public supervision in all Member States. It also introduces a requirement for external quality assurance and clarifies the duties of statutory auditors. Moreover, sound and harmonised principles of independence applicable to all statutory auditors through the EU have been defined. The Directive further improves the independence of auditors by requiring listed companies to set up an audit committee (or a similar body) with clear functions to perform. It also foresees the use of international standards on auditing for all statutory audits conducted in the EU.

The Commission is actively involved in facilitating the timely implementation of this Directive by the Member States, which is due by 29 June 2009. In this regard, the

[69] Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, OJ L 157, 9.6.2006, p. 87.

Commission launched in January 2007 two public consultations on the treatment of third country auditors and on the reform of liability regimes in the EU[70]. This consultation is based on the study carried out for the Commission by the consultant London Economics which was published in early October 2006.

(vii) Rules on the prevention of market abuse

A 2003 EC Directive on market abuse[71] (a short name for insider trading and securities fraud) contains disclosure provisions aimed at preventing it. First, the Directive extends the definition of inside price-sensitive information that requires immediate disclosure. Second, it requires disclosure of trading activity on a company's shares by its directors and persons closely connected with them. The directive covers both insider dealing and market manipulation. The same framework applies to both categories of market abuse. The Directive applies to all transactions concerning those instruments, whether those transactions are undertaken on regulated markets or elsewhere. The Market Abuse Directive is a framework Directive laying down the essential principles. It has been completed by several Commission's 'implementing measures'.

(3) Transparency on and around CEMs

There are **disclosure requirements which aim at providing transparency** on the use of CEMs and on practices related to the exercise of voting rights. These transparency rules relate to:

- (i) disclosure obligations for listed companies. They apply at different moments: when creating the company (or modifying the articles of association), when listing the company or periodically afterwards;
- (ii) disclosure obligations for voting rights holders; and
- (iii) disclosure obligations for holders of financial instruments

Disclosure obligations are subject to strict **supervision by securities markets regulators**. **Penalties** can be imposed for failure to comply. In addition, normal procedures before courts are also possible.

In addition to these rules, the different **national corporate governance codes** are being voluntarily applied by listed companies. This is leading to **best practices** for companies.

(i) Disclosure obligations for listed companies

There are specific **disclosure obligations for listed companies in the EU**, which apply at different moments: when creating the company (or modifying the articles of association), when listing the company or periodically afterwards:

[70] The replies and the summaries of both consultations have been published in the Commission's website: http://ec.europa.eu/internal_market/auditing/index_en.htm

[71] Directive 2003/06/EC of 28 January 2003 on insider dealing and market manipulation (market abuse), OJ L 96, 12.4.2003, p. 16.

Companies (also non listed companies) should disclose their **articles of association (and statutes)** to the registry referred to in the First Company Directive. They should also disclose the modifications to the articles of association (and statutes). In the specific case of listed companies, they should communicate the changes to the articles of association (and statutes) to the supervisory authorities (cf. Article 19 TD). Those registries are publicly accessible and therefore, certain transparency on the existence of Corporate CEMs is achieved. In practice, many listed companies may disclose those documents in the website of the company too.

> Directive 68/151/EEC, as last amended by Directive 2003/58/EC, on co-coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community.
>
> "Article 2(1). Member States shall take the measures required to ensure compulsory disclosure by companies of a least the following documents and particulars
>
> (a) The instrument of constitution, and the statutes if they are contained in a separate instrument;
>
> (b) any amendments ot the instruments mentioned in (a), including any extension of the duration of the company;
>
> (c) After every amendment of the instrument of constitution or of the statutes, the complete text of the instrument or statutes as amended to date; […]"
>
> "Article 3(1). In each Member State, a file shall be opened in a central register, commercial register or companies register, for each of the companies registered therein. "
>
> "Article 3(2). All documents and particular which must be disclosed pursuant to Article 2 shall be kept in the file, or entered in the register; […]"

When admitted to listing, companies should also prepare documentation to be disclosed to the competent authorities and market participants, pursuant to EC legislation on prospectuses[72]. **Admission documentation** notably concerns the prospectus which contain the information which, according to the particular nature of the issuer and of the securities offered to the public or admitted to trading on a regulated market, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and more importantly of the rights attaching to such securities. Admission documentation should be provided again in case of increases of capital.

Additionally, Article 10 of the Prospectus Directive requires issuers, at least annually, to provide a document that contains or refers to all information that they have published or made available to the public over the preceding 12 months in one or more Member States and in third countries in compliance with their obligations under Community and national laws and rules dealing with the regulation of securities, issuers of securities and securities markets.

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[72] See Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, OJ L 345, 31.12.2003, p. 64 and Commission Regulation (EC) No 809/2004.

Listed companies should also provide **periodic financial reporting**. The annual report and half-yearly report[73]) contain a management report and an interim management report, respectively. According to the Transparency Directive (Article 4(5)), the management report shall be drawn up in accordance with Article 46 of Directive 78/660/EEC and, if the issuer is required to prepare consolidated accounts, in accordance with Article 36 of Directive 83/349/EEC. The interim management report (cf. Article 5(4) of the Transparency Directive) shall include at least an indication of important events that have occurred during the first six months of the financial year, and their impact on the condensed set of financial statements, together with a description of the principal risks and uncertainties for the remaining six months of the financial year. For issuers of shares, the interim management report shall also include major related party transactions. The audit report shall be disclosed with the annual financial report. If the half-yearly report has been audited, the audit report shall also be disclosed.

Corporate governance statement. In reply to the corporate governance scandals that emerged in the beginning of this century, Member States were encouraged 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. 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 for non-compliance by the board.

Article 46a of the Fourth Company Law Directive, as amended by Directive 2006/46/EC[74], establishes a step beyond. It requests listed companies to provide information on their corporate governance practices, in particular by reference to the compliance with the corporate governance codes where they are applicable. The new obligation established by Directive 2006/46/EC will have to be transposed into national law by September 2008.

Article 46a of the Fourth Company Law Directive

1. A company whose securities are admitted to trading on a regulated market within the meaning of Article 4(1), point (14) of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments shall include a corporate governance statement in its annual report. That statement shall be included as a specific section of the annual report and shall contain at least the following information:

(a) a reference to:

(i) the corporate governance code to which the company is subject,

and/or

(ii) the corporate governance code which the company may have voluntarily decided to apply,

[73] Quarterly reports or interim management statements are also disclosed by listed companies, but these are less relevant for the subject of this document.

[74] Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings, OJ L 224, 16.8.2006, p. 1.

and/or

(iii) all relevant information about the corporate governance practices applied beyond the requirements under national law.

Where points (i) and (ii) apply, the company shall also indicate where the relevant texts are publicly available; where point (iii) applies, the company shall make its corporate governance practices publicly available;

(b) to the extent to which a company, in accordance with national law, departs from a corporate governance code referred to under points (a)(i) or (ii), an explanation by the company as to which parts of the corporate governance code it departs from and the reasons for doing so. Where the company has decided not to apply any provisions of a corporate governance code referred to under points (a)(i) or (ii), it shall explain its reasons for doing so;

(c) a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process;

(d) the information required by Article 10(1), points (c), (d), (f), (h) and (i) of Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, where the company is subject to that Directive;

(e) unless the information is already fully provided for in national laws or regulations, the operation of the shareholder meeting and its key powers, and a description of shareholders' rights and how they can be exercised;

(f) the composition and operation of the administrative, management and supervisory bodies and their committees.

2. Member States may permit the information required by this Article to be set out in a separate report published together with the annual report in the manner set out in Article 47 or by means of a reference in the annual report where such document is publicly available on the company's website. In the event of a separate report, the corporate governance statement may contain a reference to the annual report where the information required in paragraph 1, point (d) is made available. Article 51(1), second subparagraph shall apply to the provisions of paragraph 1, points (c) and (d) of this Article. For the remaining information, the statutory auditor shall check that the corporate governance statement has been produced.

3. Member States may exempt companies which have only issued securities other than shares admitted to trading on a regulated market, within the meaning of Article 4(1), point (14) of Directive 2004/39/EC, from the application of the provisions of paragraph 1, points (a), (b), (e) and (f), unless such companies have issued shares which are traded in a multilateral trading facility, within the meaning of Article 4(1), point (15) of Directive 2004/39/EC

Article 36 (Annual report) of 7th Company Law Directive

2. In respect of those undertakings, the report shall also give an indication of:

(f) a description of the main features of the group's internal control and risk management systems in relation to the process for preparing consolidated accounts, where an undertaking has its securities admitted to trading on a regulated market within the meaning of Article 4(1), point (14) of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (1). In the event that the consolidated annual report and the annual report are presented as a single report, this information must be included in the section of the report containing the corporate governance statement as provided for by Article 46a of Directive 78/660/EEC. If a Member State permits the information required by paragraph 1 of Article 46a of Directive 78/660/EEC to be set out in a separate report published together with the annual report in the manner prescribed by Article 47 of that Directive, the information provided under the first subparagraph shall also form part of that separate report. Article 37(1), second subparagraph of this Directive shall apply.

The quality of the information provided in the corporate governance statement is key for the success of the "comply or explain" principle in the corporate governance context. Companies need to provide extensive, good quality information to the market for investors to take appropriate investment decisions and hence contribute to a better allocation of capital and higher economic efficiency.

It should also be noted where a shareholder controls the board and the shareholder meeting through the use of CEMs, the "comply or explain" mechanism for corporate practices may not be as effective. Such a controlling shareholder sets the corporate governance policy, and in fact basically explains to itself what compliance with or deviations from the governance code are acceptable. Notwithstanding that the market may criticise the policy adopted, outside shareholders cannot effectively change the policy adopted by the controlling shareholder. This results in a reduced incentive to strive for good corporate governance practices. It is true that this effect also occurs where a controlling shareholder derives proportionate control from his holdings of say 51% of the company´s share capital. However, use of CEMs 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 smaller shareholding.

Closely related to the Corporate Governance Statement, **Article 10 of the Take-over bids directive** requires Member States to ensure that listed companies publish detailed information on a number of issues connected with the exercise of voting rights. This information shall be published in the company's annual report as provided for in Article 46 of Directive 78/660/EEC and Article 36 of Directive 83/349/EEC (see also point (d) of Article 46a of Directive 78/660/EC).

Article 10 of the Takeover Directive

"1.Member States shall ensure that companies as referred to in Article 1(1) publish detailed information on the following:

(a) the structure of their capital, including securities which are not admitted to trading on a regulated market in a Member State, where appropriate with an indication of the different classes of shares and, for each class of shares, the rights and obligations attaching to it and the percentage of total share capital that it represents;

(b) any restrictions on the transfer of securities, such as limitations on the holding of securities or the need to obtain the approval of the company or other holders of securities, without prejudice to Article 46 of Directive 2001/34/EC;

(c) significant direct and indirect shareholdings (including indirect shareholdings through pyramid structures and cross-shareholdings) within the meaning of Article 85 of Directive 2001/34/EC [currently Articles 9 and seq. of Directive 2004/109/EC];

(d) the holders of any securities with special control rights and a description of those rights;

(e) the system of control of any employee share scheme where the control rights are not exercised directly by the employees;

(f) any restrictions on voting rights, such as limitations of the voting rights of holders of a given percentage or number of votes, deadlines for exercising voting rights, or systems whereby, with the company's cooperation, the financial rights attaching to securities are separated from the holding of securities;

> (g) any agreements between shareholders which are known to the company and may result in restrictions on the transfer of securities and/or voting rights within the meaning of Directive 2001/34/EC;
>
> (h) the rules governing the appointment and replacement of board members and the amendment of the articles of association;
>
> (i) the powers of board members, and in particular the power to issue or buy back shares;
>
> (j) any significant agreements to which the company is a party and which take effect, alter or terminate upon a change of control of the company following a takeover bid, and the effects thereof, except where their nature is such that their disclosure would be seriously prejudicial to the company; this exception shall not apply where the company is specifically obliged to disclose such information on the basis of other legal requirements;
>
> (k) any agreements between the company and its board members or employees providing for compensation if they resign or are made redundant without valid reason or if their employment ceases because of a takeover bid."

Disclosures by companies with regard to voting rights. There are of fourth types of disclosure by listed companies with regard to voting rights:

- First, a monthly disclosure (if changes) of the total number of voting rights in the company (cf. Article 15 of the Transparency Directive). While this would normally happen only in case of a one-off event such as increase of capital, it could provide a tool for addressing the current lack of transparency associated with the loyalty shares of the type used in France. Currently, it is almost impossible for the holder of shares/voting rights to know the exact number of total voting rights and therefore to calculate the exact percentage of capital held.

> Article 9 of the Transparency Directive (extract)
>
> "2. The home Member States shall ensure that the shareholders notify the issuer of the proportion of voting rights, where that proportion reaches, exceeds or falls below the thresholds provided for in paragraph 1, as a result of events changing the breakdown of voting rights, and on the basis of the information disclosed pursuant to Article 15. Where the issuer is incorporated in a third country, the notification shall be made for equivalent events."

- Second, a specific disclosure of the total number of shares and voting rights at the date of the convocation of the general meeting (including separate totals for each class of shares where the company's capital is divided into two or more classes of shares) (cf. Article 5(4)(b) of Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies).

- Third, disclosure of own shares when the 5% or the 10% threshold is reached or crossed, whether upwards or downwards (cf. Article 14 of the Transparency Directive).

- Fourth, disclosure to the public (and to the competent authorities) of major voting rights holdings as communicated to them by the shareholders or voting rights holders (cf. Article 12(6) of the Transparency Directive).

- Fifth, disclosure to the public of any changes in the rights attaching to the various classes of shares, including changes in the rights attaching to derivative securities issued by the issuer itself and giving access to the shares of that issuer (cf. Article 16 of the Transparency Directive).

Finally, depending on the national listing rules of stock exchanges or on the supervisory practice, listed companies may be required to produce additional disclosure in order to ensure the smooth operation of markets.

(ii) Disclosure obligations for voting rights holders

There are also specific **transparency obligations for voting rights holders** of listed companies when certain thresholds are reached or crossed. The Transparency Directive sets the lowest threshold at 5%, then at 10, 15%, 20%, 25% (or 33%) etc. In some countries, the initial threshold is lower (Italy: 2%; Germany, the UK and Spain (3%).

Holders of shares with voting rights attached must notify of the acquisition or disposal of major holdings (cf. Article 9 of the Transparency Directive).

> Article 9 of the Transparency Directive (extract): Notification of the acquisition or disposal of major holdings
>
> "1. The home Member State shall ensure that, where a shareholder acquires or disposes of shares of an issuer whose shares are admitted to trading on a regulated market and to which voting rights are attached, such shareholder notifies the issuer of the proportion of voting rights of the issuer held by the shareholder as a result of the acquisition or disposal where that proportion reaches, exceeds or falls below the thresholds of 5 %, 10 %, 15 %, 20 %, 25 %, 30 %, 50 % and 75 %.
>
> The voting rights shall be calculated on the basis of all the shares to which voting rights are attached even if the exercise thereof is suspended. Moreover this information shall also be given in respect of all the shares which are in the same class and to which voting rights are attached."

Holders of voting rights (without the shares). The same obligation applies to holders of voting rights in specific circumstances (cf. Article 10 of the Transparency Directive).

> Article 10 of the Transparency Directive: Acquisition or disposal of major proportions of voting rights
>
> "The notification requirements defined in paragraphs 1 and 2 of Article 9 shall also apply to a natural person or legal entity to the extent it is entitled to acquire, to dispose of, or to exercise voting rights in any of the following cases or a combination of them:
>
> (a) voting rights held by a third party with whom that person or entity has concluded an agreement, which obliges them to adopt, by concerted exercise of the voting rights they hold, a lasting common policy towards the management of the issuer in question;
>
> (b) voting rights held by a third party under an agreement concluded with that person or entity providing for the temporary transfer for consideration of the voting rights in question;
>
> (c) voting rights attaching to shares which are lodged as collateral with that person or entity, provided the person or entity controls the voting rights and declares its intention of exercising them;
>
> (d) voting rights attaching to shares in which that person or entity has the life interest;
>
> (e) voting rights which are held, or may be exercised within the meaning of points (a) to (d), by an undertaking controlled by that person or entity;
>
> (f) voting rights attaching to shares deposited with that person or entity which the person or entity can exercise at its discretion in the absence of specific instructions from the shareholders;
>
> (g) voting rights held by a third party in its own name on behalf of that person or entity;

> (h) voting rights which that person or entity may exercise as a proxy where the person or entity can exercise the voting rights at its discretion in the absence of specific instructions from the shareholders."

Shareholders agreements. The Transparency Directive requires in particular the notification of voting rights held through shareholders' agreements if the relevant thresholds are crossed (cf. Article 10 a) of the Transparency Directive)

> Article 10 of the Transparency Directive (extract)
>
> "The notification requirements defined in paragraphs 1 and 2 of Article 9 shall also apply to a natural person or legal entity to the extent it is entitled to acquire, to dispose of, or to exercise voting rights in any of the following cases or a combination of them:
>
> (a) voting rights held by a third party with whom that person or entity has concluded an agreement, which obliges them to adopt, by concerted exercise of the voting rights they hold, a lasting common policy towards the management of the issuer in question;"

The question of **pyramids**. The Transparency Directive requires that the notification of major holdings identifies the chain of controlled undertakings through which voting rights are effectively held, when applicable (cf. Article 12(1)(b)). Disclosure duties in the case of joint control over a intermediary company in a pyramid are, however, unclear. According to some views, the control test applied by the directive (cf. Article 2)(1)(f)) would require to hold 51% of the voting rights in the controlled undertaking. In the cases of joint control of an intermediary undertaking, the disclosure obligation would not be triggered for the controlling shareholders of that undertaking. As a result, the transparency over the ultimately investor diminishes. From that perspective, there is room for improving the transparency requirements. For other views, the directive also foresees that a controlled undertaking is one over which a natural person or legal entity has the power to exercise, or actually exercises, dominant influence or control. In a joint control situation, this (secondary) test is likely to be satisfied in most cases. This second interpretation would possibly require some clarification from supervisory authorities.

EU legislation does not impose particular requirements on transparency about **foundations** that have the right to exercise voting rights: e.g. they are at the top of a pyramid or they hold shares underlying depository receipts sponsored by the issuer. It is argued in this respect that transparency of voting rights notifications is limited when the foundation is not subject to any transparency measure itself. It has been therefore suggested that foundations holding a significant umber of voting rights in listed companies should be requested to disclose (in a manner similar to the obligations arising from the 1st Company Law Directive for companies) the governing rules of the foundation, the powers of the governing board, the members of the board etc. However, a recent report prepared for the Commission shows that in the vast majority of Member States there are legal provisions requiring the registration of foundations, the deposit of the statutes, the identification of the person(s) who control or direct the foundation and the regular update of this information. Only Greece and Sweden are identified as countries where registration of foundations is not provided for. Most Member States also require independent auditing of annual reports. Although the report perspective is different (it focuses of the risk of foundations for terrorist financing and money laundering purposes),

interestingly the report does not recommend further transparency measures for foundations, except with regard to the independent auditing of annual reports[75].

Measuring separation between cash flow rights and voting rights. The requirements of the Transparency Directive do not impose disclosure of the measure of shareholder separation between investments and voting rights. While some Member States (such as Sweden) require investors to disclose the number of shares held further to the disclosure of voting rights, this requirement is not imposed in all MS. Such disclosure would however be valuable as it would allow to measure separation between the cash flow rights (e.g.; economic risks) and the voting rights in the case of shareholders holding a significant block.

(iii) Disclosure obligations for holders of financial instruments

The transparency obligations on disclosure of holdings also extend to **holders of financial instruments** that result in an entitlement to acquire on such holder's own initiative alone, under a formal agreement, shares to which voting rights are attached, already issued, of an issuer whose shares are admitted to trading on a regulated market. This covers call/put options.

Concerning the particular question of securities lending, despite its name there is full transfer of the legal title of the shares. Therefore, this kind of transaction should normally fall under Article 9 of the Transparency Directive (see above). It would appear, however, that this obligation does not seem to be clear enough in some jurisdictions. In a recent call for evidence, CESR has expressed that it might undertake level 3 work on this issue to clarify the application of the disclosure requirements to securities lending.

(iv) Limitations of the transparency rules

The transparency provided by the tools described above is not absolute. It does not go beyond the description of the situation. In particular it does not require those benefiting from CEMs (or alterative mechanisms) to explain to the other voting rights holders which are the reasons for pursuing that policy. From that perspective, the accountability towards minority shareholders is limited[76].

- Concerning corporate CEMs, the question of why institutional arrangements are used by the company or which are the specific benefits that the company (not the controlling shareholder) derives from them are not addressed by current transparency requirements.

- Concerning controlling shareholders and/or other investors, it could be foreseen to require shareholders who derive a voting position from non-proportionate mechanisms exceeding a relevant threshold of the total votes that can be cast in a meeting and shareholders who hold specific control right, such as the right to make binding nominations for board position, to provide insight into the size and nature of their shareholdings as well as the policy they have on the exercise of powers attached to their holdings. This kind of disclosure would also be relevant to provide explanations on the particular (not necessarily

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[75] Cf. Savona et al. (2007), Cost Benefit Analysis of Transparency Requirements in the Company/Corporate Field and Banking Sector relevant for the Fight against Money Laundering and other Financial Crime, section 16. This report is not yet public.

[76] See in particular the Statement by the European Corporate Governance Forum of 12 September 2007 on Proportionality.

of exclusive profit-making nature) objectives they try to further by using this kind of alternative mechanisms to enhance control.

- Concerning the use of securities lending, call/put options, contracts for difference and similar financial instruments allowing for the decoupling of voting rights from economic ownership, further disclosure requirements could be foreseen for shareholders. These requirements would apply either generally whenever shareholders are invited to vote on resolutions, or specifically, when certain corporate events occur (such as the announcement of a takeover bid for the company. In such a case, shareholders holding in excess of a certain percentage of outstanding share capital (for instance 1% or 3%) could be required to disclose to what extent and by what means they have reduced their economic risk resulting from such shareholding.

Finally, it should be recalled that some investors who replied to the ISS study survey made additional comments calling for more transparency on CEMs in order to improve the information they have on the existence and impact of any CEM[77].

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[77] Cf. ISS Study, p. 94 to 96.