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27 July 2007

DG MARKT
Unit F2
European Commission
B-1049 Brussels
Belgium

Via: Markt-COMPLAW@cec.eu.int

Re: Fostering an Appropriate Regime for Shareholders' Rights

Dear DG MARKT,

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre" or the "Centre")[1], in consultation with the 11 volunteer professionals on its Capital Markets Policy Council (the "CMPC"), is pleased to comment on the European Commission's (the "Commission") consultation document, *Fostering an Appropriate Regime for Shareholders' Rights* (the "Consultation"). The CFA Institute Centre represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the efficiency and integrity of global financial markets.

Summary of the Consultation

The Commission announced in a 2004 explanatory memorandum[2] (the "2004 Directive") the possibility for a "separate non-binding instrument on shareholders' rights" to supplement the 2004 Directive. The Consultation notes that a number of factors that influence the voting process, such as the language of the meeting documents, stock lending, and depositary receipts, were raised in the 2004 memorandum but not resolved. Furthermore, the Commission became aware of concerns regarding the role of intermediaries in the voting process.

[1] The CFA Institute Centre for Financial Market Integrity is a part of CFA Institute. With headquarters in Charlottesville, Virginia, USA, and regional offices in London, Hong Kong, and New York, CFA Institute, is a global, no, not-for-profit professional association of more than 93,000 financial analysts, portfolio managers, and other investment professionals in 134 countries and territories, of whom more than 79,000 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 134 member societies and Chapters in 55 countries and territories.

[2] "Proposal for a directive of the European Parliament and of the Council on the exercise of voting rights by shareholders of companies having their registered office in a Member State and whose shares are admitted to trading on a regulated market and amending Directive 2004/109/EC {COM(2005) 685 final}"

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The Centre understands that in this Consultation, the Commission has presented possible recommendations that it may make to the European Parliament with regard to a Directive on shareowner rights. These recommendations, if adopted, would therefore become required practice by listed companies that are incorporated in the EU.

The Centre agrees that these matters are important elements in the voting of shares and supports the Commission's decision to address these matters through this Consultation. The answers below are structured to provide an immediate answer to the question along with the Centre's reasoning for this view followed by, where applicable, a brief summary of the issues considered.

Language of the Meeting Documents

Question 1. *Do you think there is a need for action in that area?*

1.2. If yes, do you think a recommendation along the following lines would go into the right direction?

> *1. "Companies should make available to their shareholders the convocation for a general meeting, the meeting agenda and the documents to be submitted to the general meeting at least also in a language customary in the sphere of international finance, unless the General Meeting decides to the contrary.*
>
> *2. Point 1 should not apply to companies*
>
> > *- that fulfill at least two of the criteria established by Article 11 of the Fourth Company Law Directive on annual accounts (not exceeding a balance sheet total of EUR 3 650 000, a net turnover of EUR 7 30 000 and an average number of employees during the financial year of 50), or*
> >
> > *- that neither have a wide foreign shareholder base (on average under 10% of the subscribed capital) nor are actively seeking foreign investment.*
>
> *For these companies, the obligation referred to in point 1 should only apply where this is requested by shareholders representing at least 1/3 of the subscribed capital."*

The Centre supports the proposed recommendation, though it does not support the provision allowing a vote at the General Meeting to overrule the requirement.

Increasingly, shareowners from across the European Union and elsewhere invest in companies listed on regulated European exchanges. Not all of these individuals may speak the language of the home member state of the company. Nevertheless, these shareowners deserve the full rights of ownership in the manner that any other shareowner does. If the company does not publish the documents relating to its annual general meeting ("AGM") in a language that is customary in international finance, it could inhibit the rights of the non-native shareowners in favour of the native ones.

Regarding the Centre's objection to the ability of companies to override this language requirement by a vote of the AGM, the Centre notes that companies with significant insider holdings have used such tactics in other instances, for example, to restrict the access of ordinary shareowners to information regarding executive compensation.[3] Consequently, the Centre foresees the use of similar tactics with regard to the AGM documents as a means to impair the ability of non-native investors from exercising their voting rights.

Depositary Receipts

Question 2: *Do you think a recommendation along the following lines would go into the right direction?*

> *"The depositary agreement should provide that the depositary is not allowed to vote on the shares without instructions given by the depositary receipt holder, unless the latter has given the depositary explicitly such discretion."*

The Centre supports the recommendation and the recommended language as it relates to depositaries. However, a separate recommendation relating to the rights of depositary receipt holders ("Holders") should be recommended, as well.

The Centre's support is based on its interpretation that the recommendation will effectively cause depositaries to recognize the rights of Holders as shareowners even if individual companies have yet to eliminate voting restrictions for Holders. Nevertheless, the Centre is concerned that this may not provide Holders with full voting rights, particularly if the issuing company refuses to recognize such votes. As noted in the Consultation, some companies do not have to recognize Holders as the ultimate shareowners. In such cases, companies may not recognize the votes of depositaries who split their votes in a proxy resolution.

The Centre stated in its letter[4] responding to the Commission's 2005 consultation — issued under the same name as the current Consultation — that it believes that the votes associated with shares underlying depositary receipts ("DR") should rest with the Holders — whether a natural person or a fund — whose investment is at risk. Without this right, others, with interests potentially adverse to those of the Holder, could vote the shares in a manner that could undermine the Holder's interests. It appears in the Consultation that the Commission has similar views about the ownership of DR voting rights.

The Commission notes in the Consultation that an increasing number of companies have eliminated restrictions on DR and now treat Holders as shareowners though these rights are not yet universal. Therefore, investors would benefit from the Commission's formal granting of the right to decide how the votes on the underlying shares are voted.

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[3] International Shareholder Services, *Exit Pay: Best Practices in Practice*, p.6 ("Continental Europe: Disclosure is a Hot Topic").
[4] http://www.cfainstitute.org/centre/issues/comment/2005/pdf/ShareholderRts.pdf

Stock Lending

Question 3:

Q 3.1: Do you believe that stock lending needs to be addressed at [the] EU level? Please give your reasons.

Q 3.2: If your answer is yes, would you support recommendations along the following lines?

> *1. Stock lending agreements should contain provisions informing the relevant parties of the effect of the agreement with regard to the voting rights attaching to the transferred shares.*
>
> *2. Member States should ensure that shares can only be lent by financial intermediaries where the investor has explicitly agreed to his shares being used for stock lending in the framework agreement with his financial intermediary.*
>
> *3. Borrowed shares should not be voted, except where the voting rights are exercised on instructions from the lender.*
>
> *4. Stock lending agreements should provide that the borrowers have to return equivalent shares to those borrowed promptly upon the lender's request.*

The CFA Institute Centre supports a recommendation on stock-lending that includes points 1 and 2 in the question above, but does not support a recommendation that contains points 3 and 4.

As noted in the Consultation, stock lending is subject to contracts and codes of best practice. These market-based solutions permit lenders to recall their shares as specified and agreed to between the parties. Typically lending agreements enable borrowers and lenders to respond relatively quickly to changes in market practices and conditions by amending such agreements as needed.

Institutional investors generally lend shares to earn the interest/fees from the borrower, thereby boosting returns for their clients and beneficiaries. Retail investors, too, lend shares, though typically as part of a provision in the agreements they have signed with their bank/broker.

Investors borrow shares for a variety of reasons. In most cases, they do so to sell the shares short in anticipation of a decline in price for the shares, after which they can repurchase the shares at a discount, return the shares to the lender with interest, and pocket the profit. In rare cases, some have borrowed shares to acquire rights to one-time special dividends, only to return the shares with interest after being recorded as entitled to the dividend.

The Consultation notes another use of borrowed shares; namely to acquire control of the voting right. Such practices, the Consultation notes, "distort votes" and "should be discouraged as much as the recall of lent stock ahead of general meetings should be encouraged." The Centre understands the Commission's view that such activities can constitute potential distortion of shareowner votes.

The Centre believes that the parties to share-lending agreements — retail investors in particular — should be made aware of how such agreements may affect their voting rights. Likewise, investors should have to explicitly agree to participate in a share-lending program before a financial intermediary is permitted to lend those shares. And while the Centre agrees that share borrowers should return shares equivalent to those borrowed upon the lenders' requests, it does not support point 4 because such matters should remain the subject of contractual agreements between the lender and borrower.

The Centre does not support point 3 of the Consultation's proposal either under the belief that it would interfere with the rights of two parties to create and agree to terms of a legal contract between them. More importantly, though, the proposal potentially creates problems that would be more frequent and severe than the ones it intends to prevent.

For one, it would impair the ability of sophisticated and institutional investors from entering into legal contracts of their own choosing. In cases where one investor borrows shares from another to gain access to the vote, the lender benefits from the interest received while the borrower expects to gain from influencing the shareowner vote. In many ways, this is little different from the situation wherein a lender receives interest for lending shares to a short seller who in turn hopes to influence the share's price. In both cases, the lender is seeking interest to boost its returns while the borrower is seeking to influence a vote either on the value of the shares in the market or on a specific proposal at a shareowners' meeting.

Moreover, the proposed solution would create other distortions. For example, under the provisions suggested in point 3, the votes attached to shares which are lent to an investor who immediately sells them into the market would remain with the lender rather than the counterparty to the short-seller's transaction. As a consequence, this provision would create a new derivative security, one which is like the borrowed share in all respects except for the voting right. The buying counterparty to the short seller's trade would likely not know that the security conveys the voting rights back to another party until after the transaction is completed, and thus may overpay for what is effectively a nonvoting share. Furthermore, by ensuring that the votes stay with the lender, such a provision would give the lender an unfair advantage by allowing it to retain the voting interests even while collecting interest, but also would impair its interest-earning capacity from the borrowed-shares market.

One suggested solution is to require borrowers to declare the purpose for which they are borrowing the shares. The votes would stay with the lender unless the borrower shorts the shares. The Centre has concerns with this approach, as well. Beyond those issues noted above, there is the question of who would collect the declaration of intentions and how they would protect the privacy of the borrowers. By requiring borrowers to declare their intentions ahead of time, such a provision would put a name to a short-selling strategy, thus putting those borrowers at risk of reprisals from insiders at issuing companies and short squeezes from other investors. Moreover, it would impair the flexibility of the borrower by reducing its ability to change strategies after borrowing the shares. Such outcomes would adversely affect the ability of investors to engage in short selling and thus impair both market liquidity and price determination.

So while borrowed votes can have a distorting effect, the Centre is concerned that any solutions designed to freeze voting rights in the lender could potentially undermine the legitimate return-enhancing strategy of securities lending conducted by many institutional investors. Consequently, the Centre suggests that the Commission recommend the provisions contained in points 1 and 2 and refrain from recommending points 3 and 4.

Chain of Intermediaries

Question 4:

Q 4.1: Do you consider that the duties of intermediaries in the voting process need addressing?

Q. 4.2: If yes, would you consider recommending along the following lines as adequate?

> *1. Member States should ensure that before entering into relevant agreements, intermediaries explain to clients whether, and if so how, they will be able to give instructions about the exercise of voting rights.*
>
> *2. Where a client is entitled to give instructions about the exercise of the voting right, Member States should ensure that financial intermediaries that are part of the chain of intermediaries between that client and the issuer either cast votes attached to shares in accordance with the clients' voting instructions or transfer the voting instructions to another intermediary higher up in the chain.*
>
> *3. Financial intermediaries should keep a record of the instructions and provide confirmation that they have been carried out or passed on for a period of at least one year.*
>
> *4. Member States should ensure that fees charged by intermediaries for the services referred to above do not exceed substantially the actual costs incurred by that intermediary.*
>
> *5. Member States should ensure that intermediaries take the necessary measures to have the client's name registered in the register of companies which have issued registered shares. This obligation should not apply where the client objects to his name being registered*
>
> *6. "Client" within the meaning of this provision is the natural or legal person on whose behalf another natural or legal person holds shares in the course of a business.*

The Centre believes that the duties of intermediaries in the voting process should be addressed at the EU level. Moreover, the Centre supports each of the points with the exception of point 4.

The Centre supports addressing this issue at the EU level because it believes that either the broker/dealer through whom an investor buys shares, or the depositary holding the shares on behalf of the investor, should register the shares for the investor.

It would be difficult, costly, and inefficient to have individual investors complete the legal process of notifying the share registry after every trade. On the other hand, broker/dealers and/or depositories regularly engage in such activities and therefore can provide such services efficiently and at a reasonable cost to the client.

The Centre shares the concerns raised by point 4 that some intermediaries may raise the price of such services as a means of discouraging voting by investors outside the issuer's home market. Nevertheless, the Centre's objection to point 4 is that following the recommendation in this point would interfere both with the market pricing of such activities and with the ability of two parties to enter into a legal contract amongst themselves. If such fees are adequately disclosed by all firms — as suggested in point 1 of this recommendation — then it should not be too difficult for investors who acquire the shares by going through brokerage firms to take the time to compare the prices and costs of different intermediaries.

Disclosure of Investors

***Question 5**: Would you agree that the transparency directive, once implemented, will give a breakdown of voting rights and that further action at EU level would be premature?*

In this case, the Consultation refers to the requirement of shareowners to alert share issuers when they have acquired enough shares to exceed certain thresholds. In the case of the transparency directive, the first disclosure threshold occurs when an investor acquires 5% or more of an issuer's shares. Member States have the ability to require even lower thresholds.

But, as the Consultation notes, the transparency directive was to be included in the national law of each of the Member States on 20 January 2007. Consequently, how well the directive's disclosure requirements work may not be known for some time yet.

Based on the Centre's prior reviews of the transparency directive, it concurs that the Commission should delay further action on such disclosures until the market better understands whether the transparency directive fulfills its objectives.

Management Companies of Investment Schemes

***Question 6:** Do you think there is a need for a recommendation along the following lines:*

1. *Management companies, the regular business of which is the management of collective investment schemes, shall be deemed to be "clients" for the purposes of the draft recommendations set out in Section V.1 [Question 4, point 6]?*
2. *Member States should ensure that management companies referred to in point 1 shall be permitted to cast votes attaching to some of the shares differently from votes attaching to other shares.*

The Centre supports these provisions. In particular, point 2 of the proposal contained in Question 6 would ensure that a management company is able to reflect the relative views of a shareowners' meeting agenda item. It is unlikely that all investors who hire a management company will agree 100% of the time on how to vote with regard to specific agenda items.

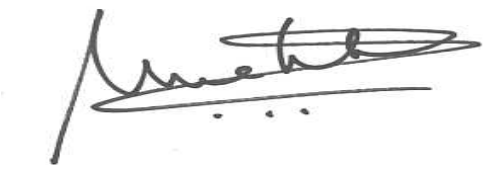
A good example of the potential need for split votes is highlighted in Question 2 above. As noted in the 2004 Directive, depositary receipt holders should be considered the ultimate owners of the shares represented by the DRs but held by the intermediaries. In such cases, the Holders likely will vote differently on specific agenda items depending on their interests and objectives. The intermediary, therefore, would need the flexibility to vote the shares differently based on the direction of the ultimate owner.

Similarly, management companies need flexibility to vote in the interests of their clients. A firm with a limited number of clients may have to vote the shares of a company in different ways to serve their clients. Without the provision suggested in point 2, it is possible that an issuer would not recognize the votes cast by the management company on behalf of its clients.

Concluding Comments

The Centre appreciates the opportunity to comment to the Commission on its consultation, *Fostering an Appropriate Regime for Shareholders' Rights*. If you or your staff have questions or seek clarification of our views, please feel free to contact James C. Allen, CFA, at +1.434.951.5558 or james.allen@cfainstitute.org.

Sincerely,



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