Statement of the European Corporate Governance Forum on Proportionality

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.