THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

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Commissioner Charles McCreevy
European Commission
DG Internal Market and Services
Unit F2, B-1049 Brussels
Belgium

By email: Markt-COMPLAW@cec.eu.int

Dear Mr McCreevy

THIRD CONSULTATION DOCUMENT OF THE EUROPEAN COMMISSIONS (EC) SERVICES OF THE DIRECTORATE GENERAL INTERNAL MARKETS AND SERVICES

The Institute of Chartered Accountants in England and Wales (ICAEW) welcomes the opportunity to comment on this consultation. The ICAEW actively contributes to corporate governance developments on a national and international level. This includes the publication of the Turnbull guidance on internal control in 1999, approved by the US Securities and Exchange Commission as a framework for compliance with s404 of the Sarbanes-Oxley Act, and the *Beyond the myth of Anglo-American corporate governance* initiative.

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We submitted responses to the initial consultation on shareholder rights in December 2004 and subsequently to the second consultation in July 2005. We support the Directive on Shareholder Rights aimed at facilitating more efficient cross-border investment across Member States. This will generally help to improve corporate governance and, in particular, cross-border voting practices. We also note that the UK corporate governance regime already provides for many of the Directive proposals on shareholder rights in company law, listing rules and through the Combined Code on Corporate Governance.

This response has been drafted after consultation with the ICAEW Corporate Governance Committee which is comprised of members from the business and investment communities and the ICAEW Company Law Committee.

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We have highlighted some general observations below and provide detailed answers to the consultation questions in the Appendix.

We support consistent standards of shareholder rights across the EU

We welcome this consultation to assess the need for further potential measures regarding shareholder rights across the EU. We understand that it may lead to the introduction of a separate non-binding Recommendation to supplement the Shareholder Rights Directive. We emphasise that any new recommendations be market-led and, in the case of the UK, be in the form of good practice guidelines. We note that the consultation proposes a number of recommendations which imply that Member States should ensure action on particular matters. This consultation is for the introduction of a Recommendation and as such should avoid direct Government intervention and instead rely on implementation through the use of good practice guidelines which are commonly endorsed by the market.

Financial intermediaries should act in the best interests of their clients

In the UK, shareowners have the legal right to oversee the stewardship of their investment and influence corporate governance. It is generally considered that such rights should be exercised responsibly, particularly in relation to voting. Share ownership in UK listed companies is widely dispersed relative to other Member States and typically held by institutional investors who are appointed by the ultimate beneficiaries to act on their behalf. Such institutions have a fiduciary responsibility to generate returns and vote in accordance with their clients' best interests. In the event that the shares are passed on to another intermediary, voting instructions from the beneficial owner should also be passed on.

The exercise of voting rights is not the primary purpose of stock lending

There are concerns that stock lending to manipulate voting decisions may have adverse consequences for corporate governance. However, this is generally not the primary reason for borrowing stock. Increasing restrictions on stock lending by reducing the ability of borrowers to use the ownership rights attached to the stock will reduce the attractiveness of stock lending in general leading to potentially adverse consequences for the market as a whole. When contentious issues arise, the onus should be on the lenders of the stock to exercise the option of recalling borrowed shares and vote in accordance with their stated investment and corporate governance policies.

We hope that our comments are useful. Please do not hesitate to contact me or my colleague Kerrie Waring (Corporate Governance Manager) if you wish to discuss this response in more detail.

Yours sincerely

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APPENDIX

Language of meeting documents

Q.1.1. Do you think there is a need for action in that area?

We believe there should be action but this should be left to individual companies and their investors to decide by special resolution at a general meeting.

Costs should be proportionate to the benefits associated with providing translated information. The benefits may include better investor relations and generally more efficient communication between companies and investors.

Q.1.2. If your answer is yes, do you think a recommendation along the following lines would go in 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 the language in the sphere of international finance, unless the General Meeting decides to the contrary.

We agree that the convocation for general meetings and the meeting agenda should be translated. However, we would stipulate that any other documentation required to be translated should be restricted to the Annual Report and Accounts and not supporting documentation for other matters on the agenda. As an exception, there may also be some benefit for companies to translate Articles of Association to help investors understand governance procedures.

We assume that the 'language in the sphere of international finance' refers to English. As such, UK listed companies would not be expected to translate information. Additionally, the translation of documentation into English (in addition to a local language) by companies within the EU would help English-speaking investors to better understand information about foreign companies. We note that many companies already provide information in a language other than the language local to the place of company registration and that such information is often easily accessible through the internet.

Point 1 should not apply to companies

- **that fulfil 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 7,300,000 and an average number of employees during the financial year of 50), or**

- **the 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."

We support the proposal that smaller listed companies that do not have a 'wide foreign shareholder base' would be excluded from translation requirements. However, we note that this would be difficult to determine in practice given that many

investors in the UK indirectly own their shares through intermediaries who are named on a company's register of members as the legally recognised owner.

It may be unrealistic to exempt companies from the requirement to translate meeting documents where they are not 'actively seeking foreign investment' as this would be difficult to ascertain and enforce in practice. The globalisation of capital flows and increased accessibility to cross-border investment means that even if companies are not actively seeking foreign investment they are likely to attract a degree of foreign investor interest.

Depositary Receipts

Q.2. Do you think a recommendation along the following lines would go in 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."

Yes, we support this recommendation. Depositary receipt holders are the legal and economic owner of the underlying shares and should be accorded the basic right to determine how such shares should be voted through specific instruction to the depositaries. We also appreciate that depositary receipt holders should be able to grant discretion to depositaries on how to vote.

Stock lending

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

Yes, we believe that there should be more guidance around what stock lending actually entails. In fact, stock lending is not about 'lending' stock but about 'selling' stock with the condition that the stock can be bought back. Therefore, the terminology of stock lending itself is confusing.

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 attached to the transferred shares.

We support this recommendation.

There should be clear provisions in stock lending agreements around the transfer of legal ownership rights from the lender to the borrower. This would reduce ambiguity and make it clear that once stock lending occurs the borrower is recognised as the legal owner on the company's register of members and, as such, has the right to vote.

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.

We support this recommendation.

It is common for custodian banks to encourage their clients, often incentivised through reduced fees, to permit future stock lending activity as part of a standard initial contract between the two parties. Subsequently stock lending can occur without the specific knowledge of the underlying investor. Custodian banks should disclose to investors when the stock is lent to ensure that investors have the opportunity to recall such stock if they wish to vote. We therefore support the recommendation that intermediaries can only lend stock where the investor has given explicit agreement.

We point out that, upon lending the stock, the legal ownership rights are transferred from the lender to the borrower who may wish to use the stock for a variety of purposes (including short-selling or to cast votes) and has the legal authority to do so.

3. Borrowed shares should not be voted, except where the voting rights are exercised on instructions from the lender.

We do not support this recommendation.

Stock lending contributes to the efficiency and liquidity of capital markets. The lender benefits from additional guaranteed short-term income while the borrower can generate returns, for example through the use of short-selling or hedging positions through the use of contracts for difference.

Upon lending the stock the lender effectively surrenders ownership rights, including the right to vote or receive a dividend, in return for earnings on the rental of the stock usually in the form of commission or interest. Placing unnecessary restrictions on stock lending by reducing the ability of borrowers to use the ownership rights attached to the stock will reduce the attractiveness of stock lending. More generally, regulatory stifling of innovation will lead to potentially adverse consequences for EU markets as a whole.

There are concerns that stock lending to manipulate voting decisions may have adverse consequences for corporate governance. However, this is generally not the primary reason for borrowing stock. When contentious issues arise, the onus is on lenders of the stock to exercise the option of recalling borrowed shares and vote in accordance with their stated investment and corporate governance policies. This would ensure that short-term borrowers do not vote shares in contradiction with the long-term best interests of the underlying shareholder. We point out that stock lending to influence voting outcomes is only likely to occur when the underlying investor is not interested in voting while active investors are more likely to recall stock and vote pursuit of their ownership responsibilities.

4. Stock lending agreements should provide that borrowers have to return equivalent shares to those borrowed promptly upon the lender's request."

We support this recommendation.

In practice in the UK, stock lending agreements often provide that custodians must return equivalent shares on a 'best endeavour' basis. This takes into account the fact that on occasion it may not be possible to return shares promptly. We would encourage the inclusion in stock lending agreements of a time period within which the borrower is required to return shares to the lender. This would strengthen the ability of lenders to recall stock in time to vote their shares.

Chain of intermediaries - duties of intermediaries

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

Yes, we believe that there could be more clarity around the identification of intermediaries in the voting process. However, the voting process itself and reliance on paper documentation to facilitate communication and cast votes are often inefficient. Therefore, it would be useful to place more emphasis on the improvement of voting processes to ensure votes are cast in accordance with the shareholders' instructions, rather than simply addressing the duties of intermediaries.

Further, there is confusion regarding what is meant by the word 'intermediary'. For the purpose of this consultation response it is assumed that it means 'custodian banks'. However, there are a number of other intermediaries between ultimate owners and those that exercise votes on their behalf, including fund managers and service providers, e.g. brokers, voting advisory agencies and research analysts. It is important that all agents and advisors within a chain of intermediaries recognise their fiduciary duties towards the underlying shareowner and act in their best interests.

Q.4.2. If your answer is yes, would you consider recommendations 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.

We support this recommendation.

In the UK, this recommendation is adequately provided for under Part 9 of the Companies Act 2006 which will come into force in October 2007. It takes into consideration the rights of underlying investors buying shares through an intermediary who is often named on the company's register of members. Section 145 of the Act makes it clear that companies can make provisions in their Articles for underlying investors to have information.

Sections 146-150 of the Act introduce new provisions for registered members to nominate the investor to receive company documents. In particular, Section 149 clarifies that *'the company, when sending a meeting notice to nominated persons [the underlying investor], to include a statement that the nominated person may have voting rights that he can exercise through a person who nominated him [the registered member]'.*

Intermediaries should be obliged to ensure that the contractual arrangement with the investor makes clear how information about the company will be obtained and how instructions around the voting of shares can be given. However, not all intermediaries have the capacity to offer such rights and therefore if investors are keen to influence governance they should choose an intermediary that allows them to do so.

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.

We support this recommendation.

The registered member is the legal owner of the share and as such enjoys governance rights including rights to vote, receive information about general meetings and receive dividends. Investors should have the right to vote and be able to instruct intermediaries regarding how a vote should be exercised. It is not always clear that the interests of investors and their voting instructions are maintained throughout the investment chain. Therefore, there should be better disclosure around how each intermediary reflects the interests of the underlying investor in voting decisions. This would improve accountability and help to facilitate communication along the chain of investment to better reflect the interests of the underlying investor.

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.

We support this recommendation.

We suggest that a three year retention period would be more appropriate. However, this should be a matter for inclusion in the contractual agreement between the intermediary and the underlying investor, assuming the latter requests such services. The use of electronic means to record and communicate such information would help to facilitate the process cost effectively.

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.

We do not support this recommendation.

The level of fees charged should be determined by the market and not be subject to price controls at a European Commission level. As such, fees should be proportionate to the time and effort required to offer the services provided by intermediaries. However, we would support increased transparency around the make-up of fees to help maintain quality services linked to performance.

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.

We do not support this recommendation.

Share ownership in UK publicly listed companies is widely dispersed relative to other Member States. Many underlying investors hold shares through nominee accounts managed by custodian banks whose names ultimately appear on the company's register of members. The person identified on the register of members is the legally recognised owner and as such enjoys ownership rights.

In the UK, it is not practical to ensure that intermediaries take measures to register their clients' names on the register of members. If such clients wished to receive ownership rights, they should choose intermediaries that have the capacity to nominate these rights under Part 9 of the UK Companies Act 2006 (as discussed under 4.2.1 above) but intermediaries should not be obliged to do so. UK company law and Takeover Panel Rules also already address potential transparency concerns by providing that companies may legally require members on the share register to disclose the identity of beneficial owners.

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."

We agree with this definition.

Chain of intermediaries - disclosure of investors

Q.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?

Yes, we agree that the Transparency Directive will give a breakdown of voting rights and that further action at a European Union level is not necessary. The 4th Company Law Directive also refers to disclosure requirements regarding the operation of general meetings, a description of shareholder rights and how they can be exercised. It is therefore our view that these matters, along with voting rights, are already adequately provided for and no further action is necessary.

Management companies of investment schemes

Q.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.

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 the other shares."

We support these recommendations.

Management companies should be able to cast split votes. This reflects the practical reality that there are often a number of beneficial owners whose shares are managed in a single collective account. Management companies should thus be able to vote in accordance with the instructions of the beneficial shareowners which may not always be consistent with each other.