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Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive

Dirk Zetzsche[*]

Abstract: This paper focuses on the low cross-border turnout of shareholders at shareholder meetings of European issuers. It presents the data that is yet available on cross-border voting and examines the reasons behind the low cross-border turnout, in relative terms. Opposing the traditional view among US law & economics scholars this paper holds that law matters in the efforts to facilitate cross-border voting. This is particularly true for procedural requirements. Thus, legislative action, such as the Shareholder Rights Directive, may indeed have beneficial effects on voting turnouts across Europe. In its second part, this paper examines the impact of the Shareholder Rights Directive on procedural costs of shareholders. The Directive seeks to lessen procedural costs through the use of the internet. While it does not force a kick-start of EC Member States into the digital age, it constitutes a significant step forward in harmonizing the procedure of shareholder meetings across Europe. From a procedural point of view cross-border investors are likely to benefit from the legal certainty that the Directive provides, as well as the lower costs for the digital exercise of shareholder rights in those states which have previously refrained from implementing digital options for shareholders. The third part of this paper assesses whether - and if so which - additional steps are necessary in order to further reduce procedural costs of cross-border voting. It holds that the Shareholder Rights Directive failed to mandate an efficient regime governing the identification and authorization of shareholders who hold their shares within a chain of intermediaries and suggests four remedies to be taken by the European Parliament.

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Table of Contents

A. Cross-border Voting and Shareholder Passivity

Since 2005, foreign investors have constituted the majority of shareholders in EC Member States, owning on average 33% of the total market capitalization in EC countries. However, foreign ownership differs significantly among EU countries. On the one hand, there are countries such as the Spain and Italy in which domestic investors still dominate. On the other, there are countries with a significant share of cross-border investment: in seven EC countries including Finland, Belgium, Estonia, Ireland, the Slovak Republic, the Netherlands and Hungary, domestic investors own even less than 50% of all shares listed[1] (In the UK, the proportion of shares held by foreign investors has risen from 16% in 1994 to 41% in 2006.)[2] Among the 25 largest Dutch issuers comprising the AEX-index only 15% of the shares were in Dutch

[1] Federation of European Securities Exchanges, *Share Ownership Structure in Europe* 2006 (February 2007). This is an increase of 4 percent since the end of 2003.

[2] Office of National Statistics (July 2007), available at <http://www.statistics.gov.uk/statbase/TSDtables1.asp>.

hands.[3] In fall 2007 foreign investors held 52.6% of the shares in the largest 30 German (DAX-)issuers altogether, up 20% from 2005.[4] However, the German DAX has a freefloat of app. 80%. Only 27% of the issued share capital is held by domestic investors.[5] Under these circumstances, barriers to cross-border voting are likely to have dire consequences on the voting turnout at shareholder meetings.

There is little empirical data available on cross-border voting in Europe.[6] The available evidence indicates that voting turnouts at shareholder meetings decrease in proportion to the increase of foreign ownership: In Finland, 18.46% of the shares owned by foreign investors participated in shareholder meetings, as compared to 54.12% of the shares owned by domestic shareholders.[7] In a sample of 14 large shareholder meetings of German issuers taken from the years 2003 through 2005, the relative voting propriety of foreign investors exceeded the voting propriety of German investors only once (Epcos AG). In the other cases on 1% of 'foreign' capital attending the shareholder meeting came between 1.11% and 267% of 'domestic' capital.

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[3] Manifest Information Services Ltd., *Proxy Voting 2007 – A Pan-European Perspective,* 2007, at 10.

[4] DW Online, *Foreign Ownership in German Firms Hits All-Time High*' (19 December 2007), available at: <http://www.dw-world.de/dw/article/0,2144,3012286,00.html>.

[5] Manifest, *supra*, n. 3, at 10.

[6] Academic work on the domestic level is also scarce. Some exceptions include T Baums & C Fraune, "Institutionelle Anleger und Publikumsgesellschaft: Eine empirische Untersuchung", (1995) 40:3 *Die Aktiengesellschaft* 97; M Belcredi, C Bellavite Pellegrini & A Penati, "Le assemblee delle società quotate: un'indagine empirica in 'Assemblea delle società quotate in un mercato che cambia", in (2001) 24 *Quaderni di Assogestioni*,, pp. 29-65, Editrice Bancaria, Roma; C Van der Elst, "Attendance of Shareholders and the Impact of Regulatory Corporate Governance Reforms: An Empirical Assessment of the Situation in Belgium", (2004) 5 *European Business Organization Law Review* 471; A de Jong, G Mertens & P Roosenboom, "Shareholders' Voting at General Meetings: Evidence from the Netherlands", (2006) 10:4 *Journal of Management and Governance* 353; DA Zetzsche, (2004) "Explicit and Implicit System of Corporate Control - A Convergence Theory of Shareholder Rights", available at: <http://ssrn.com/papers=600722>.

[7] European Comission, *Commission Staff Working Document - IMPACT ASSESSMENT* {COM(2005) 685 final}, 17 February 2006, at 227; data provided by the Finnish Central Securities Depository Ltd.

Figure 1: voting turnout ratio of foreign vs. domestic investors at some shareholder meetings of German Issuers.[8]

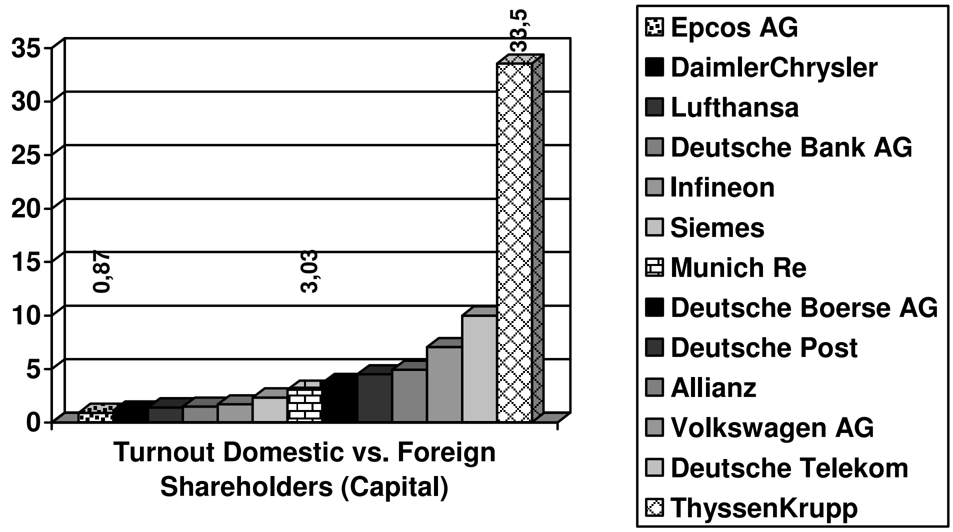
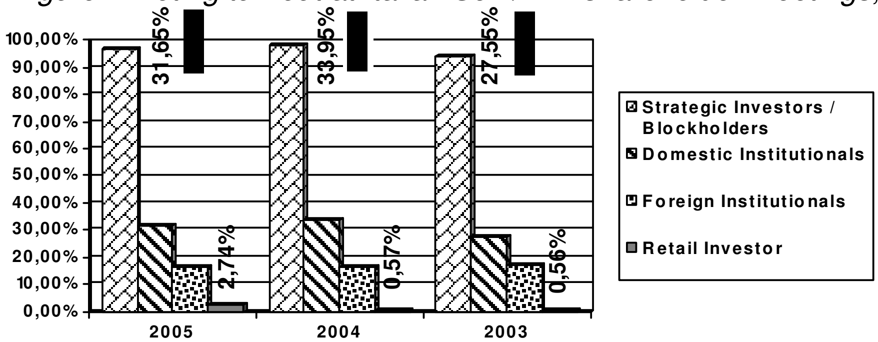


Figure 2 reports the median voting intensity of investors in the Italian blue chip index S&P/MIB from the year 2003 through 2005, in total and by sector, capturing 40 issuers with approximately 80% of the Italian domestic market capitalization. Pursuant to these data, Italian domestic institutions (that in 2005 held 12.46% of the share capital) exercise, on average, app. 31% of their voting rights, while foreign institutions' propensity to vote is approximately the half the propensity of its domestic peers (though foreign institutions held 19.47% of the share capital).

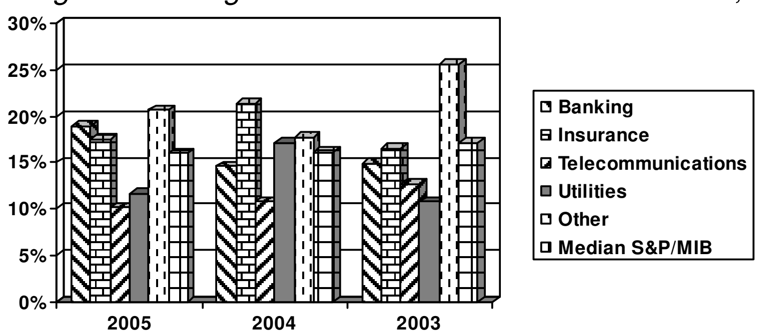
[8] Table based on European Comission, *Commission Staff Working Document - IMPACT ASSESSMENT* {COM(2005) 685 final}, 17 February 2006, at 226-227. Limitations apply. The sample is small, the data stem from different periods and does not test for extraordinary events on the company level. The data for MAN AG has been removed for formatting reasons, as the foreign / domestic turnout ratio was 1:267.

Figure 2: voting turnout at Italian S&P/MIB shareholder meetings, 2003-05.[9]



While the overall turnout of both shareholder groups is, in relative terms, consistent over time, a cross-sector analysis reveals remarkable variation in turnouts for both foreign and domestic shareholders.

Figure 3: Foreign Institutions at Italian S&P/MIB GMs, 2003-05.[10]



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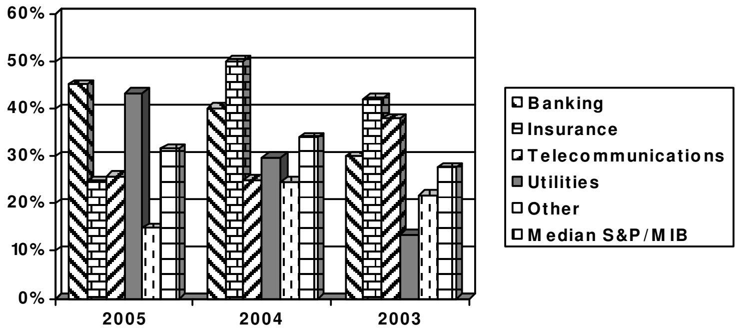
[9] See Georgeson Shareholder, *S&P/MIB - Evoluzione degli assetti proprietari ed attivismo assembleare delle minoranze con approfondimento della disciplina del 'Diritto di intervento in assemblea'*, 2006, at 14, 52, available at: <http://www.gscproxitalia.com/operazioni_pdf/StudieRicerche/S&P%20MIB.pdf>.

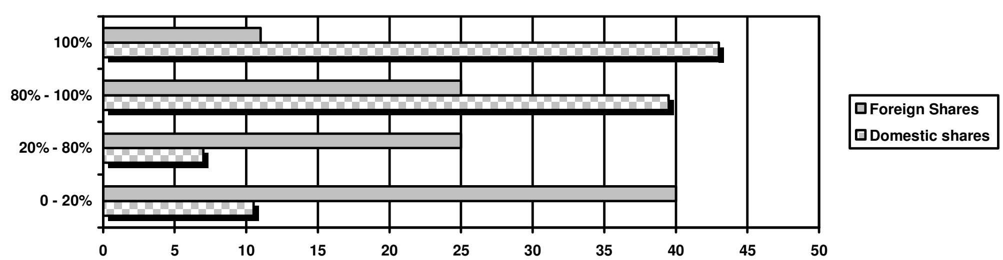
[10] See: Georgeson Shareholder, *supra*, n. 9, at 54.

Figure 4: Domestic Institutions at Italian S&P/MIB GMs, 2003-05.[11]



In 2007, more than 80% of primarily German investment funds holding 24% of their assets in domestic shares and 76% in foreign shares exercised their voting rights in domestic shares always or almost always (80% - 100% of the meetings). With respect to foreign shares, less than 40% of the funds surveyed always or almost always exercised their voting rights, and 40% of the funds tended to never or almost never exercise their voting rights (0% - 20%). This compared to a passivity rate of app. 10%, when domestic shares are concerned.

Figure 5: Voting propriety in shareholder meetings relating to holdings of German investment funds, by number of shareholder meetings: data of 2007.[12]



A study comprising 107 institutional investors (among them 92 pension funds) from eight different countries, with a focus on Dutch institutons (41%), examines the frequency and importance of shareholder activities with respect to domestic and foreign issuers, on a 1 to 5 scale (1 = never, or almost never;

[11] See Georgeson Shareholder, *supra*, n. 9, at 54.

[12] Survey by the German investor association Deutsche Schutzvereinigung fuer Wertpapierbesitz in cooperation with Feri Finance and Research; available at: <http://www.dsw-info.de/DSW-Fondsumfrage-2007.1217.0.html#c2149>. The sample of this survey is small (< 25 fund managers).

5 = always, or al most always). While this study reveals a gap between the estimated importance and the frequency of voting, in general, it is interesting to note that the gap is wider for the Dutch sample, as compared to their 'international'[13] peers (0.7 as compared to 0.4, for domestic shares). The gap widens when we focus on foreign issuers (1.3 as compared to 0.4). However, the Median value of 1 reveals that the *average* activity level is blurred by some very active Dutch institutions: Despite the fact that they deem voting important, in relative terms (Median value of 3), most Dutch institutions avoid voting foreign shares altogether.

Figure 6: Voting Frequency and Importance of Voting by (Dutch) Institutional Investors (scale of 1 to 5)[14]

	Dutch institutions		***International institutions***	
	Average	Median	Average	Median
Domestic voting				
Frequency	2,8	3	3,4	4
Importance	3,5	3	3,8	4,5
Foreign voting				
Frequency	2,1	1	3,1	3
Importance	3,4	3	3,5	4

The data above is consistent with the results of a 2006 study surveying 89 European institutional investors.[15] According to that study, 68% (UK: 40%) of the Continental European investors voted on less than half the foreign shares in their portfolio and only 9% (UK: 15%) participated in 90% or more of the votes that firms cast outside of their home market. In contrast, Canadian and U.S. investors voted always, or almost always, respectively, in 54% and 47% of the votes that foreign firms cast. Assuming that many Canadian investments comprise U.S. investments, and vice versa, while many

[13] The remainder of the – somewhat unbalanced - sample comprises institutions from Canada (17; 16%), the UK (17, 16%), the U.S. (13; 12%), Italy and Norway (6; 6% each), other (4; 4%).

[14] A de Jong, GMH Mertens, J van Oosterhout, HM Vletter-van-Dort, "Substance or Symbolism? - Corporate Governance practices of institutional investors", Report to Eumedion / Nederlandse Corporate Governance Stichting (April 2007), available at: < http://www.eumedion.nl/page/downloads/Eumedion_20rapport_20EUR_20_2823-04-2007_29_1_.pdf>.

[15] Institutional Shareholder Services, *2006 Global Investor Study*, at 26 (on file with author).

Continental and British asset managers invest within Europe, these data suggest significant cross-border voting passivity in Europe, in relative terms.

Figure 7: Percentage of investors voting outside of home market in percentage of votes that firms cast outside of their home market.[16]

	Investors participating in study	Less than 50% / don't know	50% - 75%	75% - 90%	90% or more
Continental Europe	34	68%	6%	18%	9%
UK	55	40%	16%	29%	15%
Canada	24	33%	33%	13%	54%
U.S.	58	28%	0%	26%	90%

In 2007, the average turnout at annual shareholder meetings of large issuers, comprising 18 European blue chip indices, was 53.1% of voting rights, with average turnout varying from 43.5% (SMI, Switzerland) to 68.5% (IBEX 35, Spain).[17] However, this is only part of the picture since the turnout at some shareholder meetings was as low as 3.5% of the voting rights.[18] This low turnout runs contrary to corporate governance theory which holds that an active shareholder base is widely expected to be a pre-condition for good corporate governance. This is due to the fact that shareholders encourage management to work hard, and keep management at bay in its efforts to gain excessively from profits provided on the back of shareholders (as holders of the residual claim) and lenders. These monitoring efforts are presumed to enhance firm value[19] and, through greater stability of the firm, as well as easier access to finance (which in turn enables innovation), benefit all constituencies interested in the corporation, and eventually society at large.

[16] See Institutional Shareholder Services, 2006 Global Investor Study, 26. Question: "Outside of your home market, would you say that your firm votes …?"

[17] Manifest, *supra*, n. 3, at 50. Voting turnout at extraordinary general meetings was, on average, higher.

[18] Manifest, *supra*, n. 3, at 56, referring to the turnout at the 2007 AGM of Charter European Trust PLC.

[19] Recent empirical studies support the value enhancing thesis, see for example PA Gompers, JL Ishii & A Metrick, "Corporate Governance and Equity Prices" (2003) 118:1 *Quarterly Journal of Economics*, 107 (finding that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions); JD Chi, "Understanding the Endogeneity between Firm Value and Shareholder Rights", (2005) 34:4 *Financial Management* 65; P Jiraporn et al., "Corporate Governance, Shareholder Rights and Firm Diversification: An Empirical Analysis", (2006) 30 *Journal of Banking and Finance* 947.

From the issuers' perspective, the voting turnout signals support for, or opposition against, management, respectively. A high turnout is deemed a reliable signal for a healthy shareholder – management relationship. If the law or the articles of association sets a minimum quorum,[20] a low turnout may also affect the validity of the meeting's decision.

While there is no empirical evidence, the data presented above suggests that the bulk of the passive shareholders constitute *foreign* investors, and, if so, their passivity can be attributed to problems with cross-border voting in Europe. The European Parliament sought to encourage cross-border shareholder participation through the European Directive on the Cross-border Exercise of Shareholders' Rights ['the Directive' or 'Shareholder Rights Directive'].[21] Member States are required to adopt the provisions of the Directive by 3 August 2009.

This article assesses the impact of the Shareholder Rights Directive on cross-border voting in Europe and assesses whether the Directive is likely to increase cross-border voting in Europe. It does so in three steps.

First, it asks whether law matters in the efforts to facilitate cross-border voting (Part B.). The costs of voting include costs for gathering and evaluating information, for decision-making and procedure. Given the certain costs and uncertain benefits of exercising voting rights, many commentators hold that shareholders' apathy with respect to voting is rational. Pursuant to this passivity thesis, voting is the result of a cost benefit analysis by individual investors in which the respective law hardly plays a role since it does not influence the information costs associated with voting: Shareholders intending to vote intelligently bear 100 % of the information costs while cashing in only on a fraction of the benefits in proportion to their shareholding. This article

[20] Examples for statutory quorums (referring to voting rights unless indicated otherwise) include Belgium (50% for certain decisions), the Czech Republic (30% of capital), Estonia (50% +1), France (25 % / 33,3 %), Greece (20% of capital), Hungary (50%), Italy (20% - 50% of capital), Lithuania (50%), Spain (25%), the UK (to be specified in articles and usually the quorum is trivial). In most remaining jurisdictions the articles of association may mandate a quorum. For details see European Comission, *Commission Staff Working Document - IMPACT ASSESSMENT*, {COM(2005) 685 final}, 17 February 2006, at 80-81.

[21] 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, O.J. L 184/07 (14.7.2007).

holds that with respect to institutional investors the passivity claim based on information costs is inconsistent. These investors are mandated to evaluate all publicly available information on their investments on an everyday basis. With respect to information costs, the voting decision freerides on the investment decision and need not impose additional costs on investors. Hence, the information-cost based argument is inconsistent with modern investment law and practice. In contrast, this paper holds that shareholder passivity primarily rests on the costs for decision-making and procedure. The costs for decision-making depend on the internal structure of institutional investors and decrease with the size, or professionalism, of the respective institution. Given increasing concentration in the European fund sector, these costs are likely to be insignificant.[22] The size of procedural costs, however, is correlated with the law regulating shareholder meetings across Europe. In this respect, law does indeed matter. It concludes that legislative action, such as the Shareholder Rights Directive, may indeed have beneficial effects on voting turnouts across Europe.

Secondly, this article examines the impact of the Shareholder Rights Directive on procedural costs of shareholders (Part C.). The Directive seeks to lessen procedural costs through the use of the internet. While it does not force a kick-start of EC Member States into the digital age, it constitutes a significant step forward in harmonizing the procedure of shareholder meetings across Europe: As to **information**, the company's website will become the informational focus-point for investors. As to **communication**, European shareholders will be entitled to exercise minority rights by electronic means. As to **voting**, companies must provide for one method of Electronic Proxy Voting and enable the choice of proxy; EC Member States must enable electronic participation of shareholders in shareholder meetings. The Directive provides a minimum standard for the use of electronic means, and encourages companies to find the ideal level (a maximum standard?) for the use of the internet. This one-dimensional mandatory approach may effectively hamper a race to the bottom competition while enabling a race to the top

[22] See in particular, BS Black, "Shareholder Passivity Reexamined", (1990) 89 *Michigan Law Review* 520, 566 et seq.

approach. From a procedural point of view cross-border investors are likely to benefit from the legal certainty that the Directive provides, as well as the lower costs for the digital exercise of shareholder rights in those states which have previously refrained from implementing digital options for shareholders.

Thirdly, this article assesses whether – and if so which – additional steps are necessary in order to further reduce procedural costs of shareholders exercising their rights in cross-border Europe (Part D. & E.). With respect to the traditional functions of shareholder meetings (information, communication and voting) there is no need for further legislative action. The differences among Member States are already minor in scope and scale; competition among EC Member States is likely to drive national corporate laws towards efficient results.

The Shareholder Rights Directive, however, failed to mandate an efficient regime governing the identification and authorization of shareholders who hold their shares within a chain of intermediaries. This is particularly unfortunate given that shareholder identification is at the heart of the issue that corporate practice faces with respect to cross-border voting. With respect to the identification and authentication of shareholders, it is suggested here that four basic principles be mandated on an EU-wide basis: (1) Custodians and Depositories should be required to assist investors to exercise their rights in shareholder meetings through the issuance of a 'security entitlement'; (2) Custodians and Depositories should be banned from charging investors fees for their cooperation on the exercise of voting rights; (3) Issuers and Custodians / Depositories should be mandated to enter into collective bargaining with respect to the procedure of shareholder identification and the standards of voting, in order to develop Europe-wide voting platforms. In particular, this relates to the technical standards used for data exchange with respect to shareholder certificates, proxy forms and other information exchange tools in the vicinity of shareholder meetings; (4) It should be clarified that the principles of proportionality and equality that apply to the corporate relationship between the company and the shareholder also apply to the banking relationship between the investors and Depositories, as well as the Custodians within the intermediary chain. The principles of proportionality and equality will limit the banks' discretion in tailoring procedures to the investors' detriment and mandate the implementation of new technologies. This paper does not argue in favour of a broad claim which would further uncertainty, but a limited and manageable one that properly incentivizes intermediaries to further the exercise of shareholders' rights.

B. Does law matter? Some theoretical considerations on shareholder passivity

Among corporate scholars it is generally said that shareholders would rather sell up and go away than vote. During the proxy season 2007, on average 56.42 % of the equity carrying voting rights participated directly or indirectly in shareholder meetings of German DAX 30-issuers.[23] What kept the remainder from exercising its voting rights?

1. Shareholders' rational apathy

In 1932, *Adolf Berle's* and *Gardiner Means* stated:

> 'The normal apathy of the small stockholder is such that he will either fail to return his proxy, or will sign on the dotted line [of the proxy form provided by management], returning his proxy to the office of the corporation.'[24] … 'As his personal vote will count for little or nothing at the meeting unless he has a very large block of stock, the stockholder is practically reduced to the alternative of not voting at all or else of handing over his vote to individuals over whom he has not control and in whose selection he did not participate.' [25]

50 years later, the former Dean of Harvard Law School *Robert Charles Clark* baptized this type of behaviour, which by then had become the paradigm of American corporate finance theory,[26] the shareholders' 'rational apathy'.[27]

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[23] See Deutsche Schutzvereinigung fuer Wertpapierbesitz (DSW), *HV-Praesenzen der DAX 30-Unternehmen* (1998-2007).

[24] AA Berle & GC Means, *The Modern Corporation and Private Property'* with a new introduction by M Weidenbaum & M Jensen, first publ. 1968, Transaction Publ., New Brunswick & London (2003), p. 76.

[25] *Ibid*, p. 80.

[26] See, eg, HG Manne, "Some Theoretical Aspects of Share Voting: An Essay in Honor of A. Berle", (1964) 64 *Columbia Law Review* 1427; EF Fama & MC Jensen, "Separation of Ownership and Control", (1983) 26 *Journal of Law and Economics* 301; EF Fama, "Agency Problems and the Theory of the Firm", (1980) 88 *Journal of Political Economy* 288, 292; MC Jensen & WH Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership structure", (1976) *3 Journal of Financial Economics* 305; European commentators, in contrast, were more sanguine about the governance impact of shareholder meetings. See eg D Kubis in B Kropff & J Semler (eds)., *Münchener Kommentar zum Aktiengesetz*, § 118 note 21; V Butzke*, Die Hauptversammlung der Aktiengesellschaft,* note A 26, emphasizing the positive governance impact of direct contact of management and shareholders. The vast

Easterbrook & Fischel expanded this basic argument into a general statement based on collective choice problems:

> 'When many are entitled to vote, none expects his votes to decide the contest. Consequently none of the voters has the appropriate incentive to study the firm's affairs and vote intelligently. If, for example, a given election could result in each voter gaining or losing $ 1,000, and if each is sure that the election will come out the same way whether or not he participates, then the voter's optimal investment in information is zero.'[28]

Here, *Easterbrook & Fischel* agree, management functions as an informational intermediary vis-à-vis the shareholders and as a collective information-generating agency. Furthermore, gains resulting from activism are expensive to produce, while other shareholders cannot be excluded from taking a pro rata share in the benefits created. Free-riding is therefore likely.

> 'Given the combination of a collective action problem and easy exit through the stock market, the rational strategy for most dissatisfied shareholders is to sell rather than incur costs in attempting to bring about change through votes.'[29]

Since the underlying economics of voting renders all policy efforts for more access to the ballots futile, *Easterbrook & Fischel* argue in favour of a passive legislature with respect to shareholders' access to the ballot. If these assumptions were true, one would expect the Shareholder Rights Directive to falter in its aim to raise voting turnouts, regardless of its content.

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amount of European literature devoted to the shareholder meeting, its function and regulation is evidence to this statement, see eg RC Nolan, "The Continuing Evolution of Shareholder Governance", (2006) 65:1 *Cambridge Law Journal* 92; U Noack & DA Zetzsche, "Corporate Governance Reform in Germany: The. Second Decade", (2004) 16:5 *European Business Law Review* 1033, 1036, with further references.

[27] RC Clark, "Vote Buying and Corporate Law", (1979) 29 Case Western Res. Law Review. 776, 779.

[28] FH Easterbrook & D Fischel, *The Economic Structure of Corporate Law,* Harvard University Press, Ca., MA & London, England, 1991, at 66-67; Easterbrook & Fischel, "Voting in Corporate Law", (1983) 26:2 Journal of Law & Economics 395.

[29] *Ibid*, at 83.

Where does the passivity claim leave us? A dysfunctional voting mechanism primarily subjects management to **market control.** In a nutshell, market control implies restrictions on the refinancing opportunities of firms provided by takeovers, competition among peers for financing terms depending on the profitability of the firm, as well as reputational restraints. Growth is at the core of this logic since it is presumed to further the management's reputational and financial benefits simultaneously and to render takeovers more costly. If management wants to increase firm size with external finance, it will have to follow market rules, offer a fair return and accept restrictions that investors impose on the firm.[30] Some firms, however, succeed in financing their projects internally; markets, in turn, periodically tend to price goods irrationally. Thus, relying entirely on market control leaves us with the uneasy feeling that in certain settings there is no control at all.

One obvious solution to the passivity claim is **concentrated ownership**. Given that the costs for voting with one share are the same as the costs for voting with all the shares, the more shares shareholders have, the more likely they are to exercise their rights. In this way, controlling shareholders tend to be good monitors. However, there are serious limitations to this apparent solution: large shareholders tend to pursue their own agenda, for example, as supplier of goods or dynastic rulers of a company. Large shareholders may also limit the expansion of the company despite the fact that there are profitable opportunities if these opportunities may come along with a loss of influence for the large shareholder through additional capital being supplied by outsiders.

During the early 1990s there was hope that the re-concentration of ownership in the hands of **institutional investors** may incentivize the former to act as watchdogs on behalf of all shareholders. The underlying logic was: the larger stake in the company that an institutional owns, the less relevant it renders the costs of voting. Cross-company economies of scale and an increasing level of coordination among institutional investors were expected to give

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[30] See RA Posner, *Economic Analysis of Law*, 6th ed., Aspen, New York, 2003, at 414 and 426 et seq.; Easterbrook & Fischel, *supra*, n. 28, at 13 et seq.; SM Bainbridge, "Shareholder Activism and Institutional Investors", UCLA School of Law, Law-Econ Research Paper No. 05-20 (September 2005), at 9. Available at <http://ssrn.com/abstract=796227>.

institutional shareholders a voice. These economics were anticipated to incentivize voting, in particular on questions of general corporate governance issues, and, to a lesser extent on company-specific issues.[31] However, euphoria evapourated in the wake of the dot com bubble: individual investments soared in light of apparently easy and fast profits that stock markets offered;[32] and institutions devoted little effort to monitoring management.[33] This should not come as a surprise: some institutions' vigilance may have been euthanized by conflicts of interest, given their affiliation with unions, banks, insurance companies, and the company itself.[34] Others were infected by dot com mania: institutional investors constitute the 'market'; if markets go wild, most institutions follow suit.

Prior to the subprime crisis and the credit crunch which followed these events, some scholars bet on a new **shareholder activism**.[35] Activist shareholders

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[31] AR Admati et al., "Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium", (1994) 102 *Journal of Political Economics* 1097; BS Black, "Agents Watching Agents: The Promise of Institutional Investor Voice", (1992) 30 *UCLA Law Review* 811; Black, *supra*, n. 22, at 524; RJ Gilson & R Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors", (1991-92) 43 *Stanford Law Review* 863; MJ Roe, *Strong Managers. Weak Owners: The Political Roots of American Corporate Finance*, Princeton Univ. Press, Princeton, New Jersey (U.S.) (1994), at 169, 187 et seq.; MJ Roe, "A Political Theory of American Corporate Finance", (1991) 91 *Columbia Law Review* 10. See also the less enthusiastic analysis by EB Rock, "The Logic and (Uncertain) Significance of Institutional Investor Activism", (1991) 79 *Georgetown Law Journal* 445.

[32] E.g. in Germany, the number of shareholders rose from 3,92 Mio. (1997) to 6,2 Mio. (2000). At the end of 2007, 4,05 Mio. Shareholders held shares in German companies. Simultaneously the number of investment fund investors soared. See Deutsches Aktieninstitut (DAI), *Zahl der Aktionäre,* www.dai.de .

[33] BS Black, "Shareholder Activism and Corporate Governance in the United States", in *The New Palgrave Dictionary of Economics and the Law*, Vol. 3, pp. 459-465 (1998); Rock, *supra*, n. 31, at 468.

[34] M Kahan & EB Rock, "Hedge Funds in Corporate Governance and Corporate Control", (2007) 155:5 *University of Pennsylvania Law Review* 1021, 1054. Empirical testing with respect to proxy voting shows inconclusive results, see GF Davis & EH Kim, "Business Ties and Proxy Voting by Mutual Funds", (2007) 85:2 Journal of Financial Economics 552.

[35] See WW Bratton, "Hedge Funds and Governance Targets" (2007) 95 *Georegetown Law .Journal* 1375 (2007), reprinted in (2007) 49 Corp. Prac. Commentator 581; A Klein & E Zur, "Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors", *The Journal of Finance* (forthcoming), available at <http://ssrn.com/abstract=913362>; M Becht, JR Franks, C Mayer, Colin & S Rossi, "Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund" *The Review of Financial Studies* forthcoming, available at RFS Advance Access (May 28, 2008); Kahan & Rock, *supra*, n. 34, at 1024. An analysis of pension fund activism provide D Del Guercio & J Hawkins, "The Motivation and Impact of Pension Fund Activism", (1999) 52 *Journal of Financial Economics* 293-340; studies on private equity summarize D Cumming, DS Siegel & M Wright, "Private equity, leveraged buyouts and governance", (2007) 13:4 *Journal of Corporate Finance* 439.

including illustrious figures in the investment scene, Hedge Funds that pursue activist strategies and private equity organisations were expected to fill the gap provided by shareholder passivism. Putting concerns about the conflict between short-termism and long-termism that Hedge Fund activists create aside,[36] the current market environment limits these organizations' abilities to gather influence. Since they typically rely on high leverage, debt is the basis of their voting power. This is regardless of whether they own (and keep) shares that are debt-financed – as Private Equity investors seem to prefer – or whether they gain influence through indirect ownership schemes (such as stock lending etc.) – as is associated with Hedge Funds and other activist investors.[37] Consequently, we would expect these vehicles to flourish when debt is easily available. This is consistent with the observation that, in an environment in which the credit spread between risky investments and riskless investments was narrowing down to almost zero, we have seen the most spectacular activist approaches succeed (such as the activities in the vicinity of the ABM AMRO split, or the frustrated Deutsche Boerse bid on the LSE) and the largest leveraged buy-outs occur. To the same extent that debt is becoming more scarce (due to refinancing issues on the side of the lending banks) and more expensive (due to high interest rates for risky investments) we can expect the new watchdogs' activism to disappear.

2. The premises of the passivity claim

Under this premise, the shareholder meeting turns out to be the worst form of governance apart from all the others that have been tried out. That is possibly the reason why all advanced corporate laws mandate shareholder meetings. Since no other institution is trustworthy, the shareholder meeting is a mediating institution that mandates the coming together of groups with

[36] JJ Katz, "Barbarians at the Ballot Box: the use of hedging to acquire low cost corporate influence and its effect on shareholder apathy", (2006) 28:3 *Cardozo Law Review* 1483, 1499, detailing the 'shorting against the ballot box'); HTC Hu & BS Black, "Hedge funds, insiders, and the decoupling of economic and voting ownership: Empty voting and hidden (morphable) ownership", (2007) 13:2-3 *Journal of Corporate Finance* 343; HTC Hu & BS Black, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership", (2006) 79 *Southern California Law Review* 811; HTC Hu & BS Black, "Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms", (2006) 61 *Business Lawyer* 1011.

[37] See on the different investment behaviour N Dai, "Does investor identity matter? An empirical examination of investments by venture capital funds and hedge funds in PIPEs", (2007) 13:4 *Journal of Corporate Finance* 538.

different interests, furthers the exchange of views, communication with management, and, eventually, the alignment of interests. Is anyone, and if so who, likely to come to this get-together? A closer look at the underlying premises of the passivity claim helps answer this question.

Please note that the issue addressed must not be confused with the debate on ‘shareholder activism’, including shareholder proposals, proxy fights, and contested takeovers.[38] While the discussion on shareholder activism offers useful starting points, a mere focus on voting strengthens the insight on the true barriers to cross-border voting.

a) A simplified shareholder constituency model

In short, the passivity claim deems voting a costly endeavour. Since the costs of voting exceed the benefits derived from voting, shareholders tend to refrain from exercising their rights. Let B_V describe the benefits of voting and C_V the costs of voting; shareholders will vote if

$$B_V > C_V$$

However, there may be alternatives to voting (selling shares, passivity) that render a non-voting strategy fruitful.[39] From a rational actor’s model, voting is likely if alternatives are not as beneficial to the shareholder as voting. Selling the stocks may be one of them [B_T] unless it comes along with other costs [C_T]. Voting may appeal to investors if trading creates lesser benefits. This may be due to trading discounts, transactions costs, forfeiture of future cash-flows (due to temporary market inefficiencies), or undue deviations from the index tracked. Remaining passive [B_P] avoids the former issues and may create income from stock lending,[40] but may prompt other costs [C_P] such as

[38] The US focus on hierarchical / aggressive, rather than cooperative, shareholder strategies is likely due to different ethics and the more generous rights to which European shareholders are entitled at shareholder meetings. See too, the former, DA Zetzsche, ”An Ethical Theory of Corporate Governance History”, *CBC-RPS* No. 0026 (February 2007). Available at: <http://ssrn.com/abstract=970909>, and the latter DA Zetzsche, “Shareholder Interaction Preceding Shareholder Meetings of Public Corporations - A Six Country Comparison”, (2005) 2:1 *European Company & Financial Law Review* 105.

[39] See A Hirschmann, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations, and States*, Cambridge, MA: Harvard University Press (1970), at *.

[40] See A de Jong et al., supra, n. 14, at 24, 32.

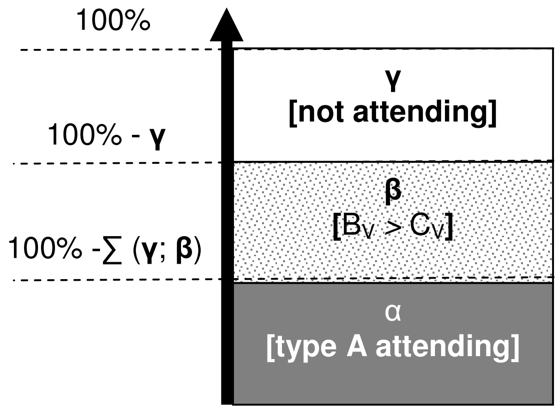
increasing the risk of unwanted outcomes, as well as managerial or regulatory pressure, if the law, or societal values,[41] mandate voting. Voting will occur, if:

$$B_V > C_V \textit{ and } B_V - C_V > B_T - C_{T;}\ B_P - C_P$$

However, not all shareholders decide (apparently) rationally. We can model this situation by assuming that there are three types of shareholders: Group A) comprises of shareholders who generally believe that their voting utility is greater than their costs (the benefits will be considered in the following section). From a practical perspective, we would expect large blockholders (banks, private non-financial companies, the public sector), well-organized minority groups such activist investors or retail investors that enjoy voting to be part of group A). From a legal policy perspective, this group is irrelevant since it exercises its shareholder rights anyway. B) The second group is cost-sensitive. Type B-shareholders may generally be willing to vote if they see some benefit (such as good governance), but they will remain passive if costs are too high. It is this group on which legal policy should focus. We would expect most institutional investors / collective investment schemes to be type B-shareholders. Group C) comprises the uninterested and financially illiterate shareholders, the 'freeriders', and those who believe that fellow shareholders (group A?) and / or the markets will monitor management sufficiently on their behalf. As long as some shareholders belong to group C), participation of *all* shareholders in a company at one shareholder meeting is very unlikely.

[41] *Ibid*, at 42: '…, society seems to perceive institutional shareholder activites as something that is morally required.' For an explanation, see DA Zetzsche, *supra*, n. 38 ("An Ethical Theory of Corporate Governance History".

Figure 8: a simplified model of shareholders' voting propensity



If the costs are zero, the expected maximum turnout [T] is the sum of the shares held by type A and type B shareholders:

$$T = \alpha + \beta$$

In order to influence the voting propensity of type B-shareholders and therefore the overall turnout, it is crucial to either increase benefits of voting or decrease the costs associated with voting.

b) The benefits of voting

From the rational actor's perspective,[42] by voting shareholders may accrue derivative benefits (derived from aggregate net benefits to the company) and individual benefits.

The derivative benefits of voting depend on the shareholders' estimate of the probability that their decision to participate will result in aggregate net benefits to the company. Assuming that management and controlling shareholders are faithful, all shareholders will benefit in proportion to the percentage of the company's shares that they own. Let p describe the probability, b the aggregate net benefits to the company, and x the shareholder's proportion in the company. The shareholder's benefits derived from an increase in value of the corporation [B_{corp}] are:

[42] This simplified model borrows from Black, *supra*, n. 22, at 575; Rock, *supra*, n. 31, at 453; J Grundfest, "Just Vote No, A Minimalist Strategy for Dealing with Barbarians Inside the Gates", (1993) 45 *Stanford Law Review* 857, 910; JW Verret, "Pandora's Ballot Box, or a Proxy With Moxie? Majority Voting, Corporate Ballot Access, and The Legend of Martin Lipton Reexamined", (2007) 62 *Business Lawyer* 1007, 1030.

$$B_{corp} = p * x * b$$

Shareholders are expected to vote if:

$$B_{corp} > C_V \textit{ and } B_V - C_V > B_T - C_{T;}\ B_P - C_P$$

Apart from this corporatist model, voting may also be due to private benefits, including private benefits of control, an activist reputation, or pleasure. Subject to the limitations provided by law[43] large shareholders may grant self-dealing transactions their approval, or investors being short on the company's stock (such as is discussed with respect to Hedge Funds)[44] may favour proposals with negative impact on the company. Institutional investors that, in above terms, over-invest in voting at one issuer's shareholder meeting may do so since over-investments may act as a deterrent at other shareholder meetings, enhancing managerial discipline in their respective portfolio. For example, shareholders may line up for the first shareholder meeting of the proxy season, in order to discipline management in one specific industry (e.g. banking). Only shareholders that hold shares in several banks will benefit. The same logic applies to the same issuer's meetings in following years, as long as the voting coalition remains stable. In addition, real life is not always about rational choice. In most cases retail shareholders cannot rationally expect to influence the outcome of the vote by their participation. Some of these may enjoy voting simply because it makes them feel important. Let B_{priv} describe these private benefits. Shareholders are expected to vote if:

$$B_{corp} + B_{priv} > C_V \textit{ and } B_V - C_V > B_T - C_{T;}\ B_P - C_P$$

Between the corporatist and the private benefit poles, many questions remain unanswered. Is voting merely a device for exercising control? Do small stakes of individual shareholders being voted without achieving a majority add to a greater picture of shareholder involvement and to overall benefits? Does the sentiment expressed by these minority votes matter in any respect, for example as an indication of a shareholder base willing to assist, or oppose, management in contested takeovers, or as an indicator for management's

[43] These limitations include fiduciary duties being owed to the corporation, and/or other shareholders as well as the German and Portuguese law on corporate groups ('Konzernrecht').

[44] See references cited *supra*, n. 36.

reputation? Is it also true that "symbols have consequences"[45]? Which additional utility does voting create for shareholders stemming from a social environment in which voting is deemed a moral obligation, or an integral part of 'citizenship'? In the absence of a takeover bid, why do corporations pay for their shareholders voting, through proxy agencies and the organisation of expensive shareholder meetings?

To cut a long story short, it is far from obvious whether, and to what extent, voting, in fact, benefits shareholders and / or the company itself. For the purposes of this article, however, we can refrain from answering these questions. This is due to the fact that voting is an individual decision. The fact that, in practice, some shareholders with even very small holdings (but not all of them) vote, suggests that the utility function of voting differs for each shareholder, depending on the size of his/her holdings, the social background, the infrastructure and skills at hand etc. General claims are not warranted.

c) The cost of voting

With the benefits uncertain, attention must all the more focus on the costs. Decisions create implementing costs on the issuer's level, which will eventually be paid out of shareholders' pockets.[46] In the absence of extreme cases (spin-offs, mergers), corporate practice suggests that shareholders' are not impressed with implementing costs of matters within the routine purview of shareholder meetings. Either the law mandates a decision (for example, on dividends, or the directors' discharge), in which case there will be costs either way, or shareholders focus on the benefits and disregard implementing costs,

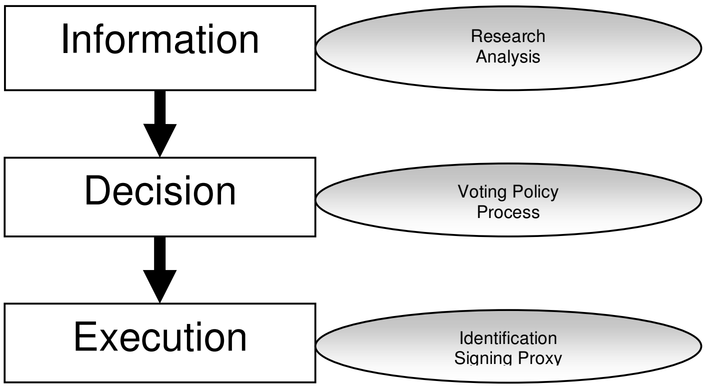
[45] Grundfest, *supra*, n. 42, at 866. Empirical tests indicate surprising effects of 'just vote no' – campaigns on CEO-turnover, see D Del Guercio, LJ Seery, & T Woidtke, "Do Board Members Pay Attention When Institutional Investors 'Just Vote No'? CEO and Director Turnover Associated with Shareholder Activism", (2008) *Journal of Financial Economics* forthcoming. Available at: <http://ssrn.com/abstract=575242>; RS Thomas & JF Cotter, "Shareholder proposals in the new millennium: Shareholder support, board response, and market reaction", (2007) 13:2-3 *Journal of Corporate Finnance* 368, hold that shareholder proposals under Rule 14a-8 have an emerging role in reducing agency costs.

[46] Black, *supra*, n. 22, at 575.

assuming that the gains will outweigh the costs.[47] So do I, for purposes of simplification.

Voting intelligently requires essentially a **three-step process comprising (1) information; (2) decision, and (3) execution**.

Figure 9: the three steps of voting



(1) The first step of voting is **information** about how to exercise voting rights. Informed voting incurs information costs for research and analysis of information. Long before the company issues the convocation notice, shareholders receive plenty of information through quarterly and annual reports, as well as current change reports on the company. The information contained in the convocation notice / proxy statement / meeting agenda as well as information provided by proxy advisers / proxy voting firms supplements the Year-round disclosure.

(2) The second step is **decision**. Shareholders need to make up their minds whether, and if so how, they intend to vote. This deliberation may result in consent, opposition, abstention, or the launch of other activities.[48] The

[47] See A de Jong et al., *supra*, n. 14, at 52: '… investors believe that measuring costs and benefits of their shareholder activities is relatively unimportant in deciding whether or not to become active on their shareholdings.' A de Jong et al. follow that Dutch institutions are driven by the symbolic and ceremonial dimension of shareholder activities. I believe that this apparently irrational behaviour is due to information asymmetries as to the size of these costs (shareholders don't trust management's estimate), and the redistributive nature of most shareholder initiatives (from management to shareholders; from some shareholders to others; or else).

[48] The European Social Investment Forum's report 'Active Share Ownership in Europe – 2006 European Handbook', at 11, available at: <http://www.eurosif.org/publications/active_share_ownership_handbook>, identifies 6 dimensions of active share ownership: voting, dialogue with management, external

decision may be made by an individual (for example, the corporate governance officer or the fund's CEO) or be the result of a voting committee's lengthy deliberation. Consideration will be given to industry-wide standards, and the adopted voting policy, and to a lesser extent to potential risks stemming from that decision (for example, the risk of being deemed a 'group' or acting in concert, or the risk of management retaliation).[49]

(3) The third step constitutes **execution**, the technical process of voting. Shareholders must provide evidence of their shareholding (authorization), enter their decision in either a ballot form or a form of proxy, and send this information to the recipient (issuer or the proxy acting on behalf of the shareholder).[50]

Let B_V describe the benefits of voting, C_V the costs of voting altogether, C_I the information costs, C_D the decision-making costs and C_P the costs for the technical voting process. We would expect voting to occur if

$$B_V < [C_I + C_D + C_P]$$

In light of the uncertainties surrounding the benefits of voting, cost sensitive type B)-shareholders (see above) are likely to vote if:

$$[C_I + C_D + C_P] \rightarrow 0$$

This is the case if:

$$C_I; C_D; C_P \rightarrow 0$$

This very basic formula provides us with three insights: first, if neither information, nor deliberation nor procedure prompted any costs, and we assume that there is some benefit whatsoever in participation in the vote, we would expect all shareholders to vote. Obviously, the state according to which the sum of all costs is zero is fictitious because there will always be some costs in terms of time, effort etc. involved with voting. Secondly: the passivity

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communication, shareholder resolutions, communications with regulators, and collaborations / coalitions and outreach to other investors.

[49] In this respect, voting differs from shareholder activism where the evidence that US scholarship provides on regulatory and retaliation risk abounds, see *supra*, n. 42.

[50] Expenses for enforcing the shareholders' decision through involvement in judicial or administrative reviews are deemed part of the technical process of voting.

proponents[51] argue that information costs render investor passivity rational. Because corporate disclosure rarely gives a full picture, additional and more costly monitoring mechanisms (hence, information devices) are said to be necessary. Furthermore, in order to be good monitors, activist institutions must monitor *all* of their portfolio firms. In a very simplified manner, it is argued that B_V is fixed while $C_I \rightarrow \infty$.[52] If this assumption is correct, cost-oriented type B-shareholders will indeed remain passive because B_V will always be less than C_V. Thirdly: if the assumption that $C_I \rightarrow \infty$ is *not* correct and C_I is a fixed amount (of whatever size) a reduction of both the decision costs [C_D] or the costs for the technical voting process [C_P] is likely to attract *some* greater voting turnout.

3. The passivity claim re-examined

A closer look at the type of costs involved provide us with further insight about whether law matters with respect to voting turnouts. The heart of the issue is whether the passivity claim is true with its assessment of the relevance of information costs: if the passivity claim is correct with its statement that B_V is fixed while $C \rightarrow \infty$, the cost-oriented type B-shareholders will remain passive (regardless of any law) because B_V will always be less than C_V.

Information costs consist partly of research costs. With respect to the availability of information, law may assist shareholders by requiring excess disclosure and the definition of a joint-access point for all issuer-related information. Both have happened, or are well on their way: the former through measures implementing the European Transparency Directive[53] and the Market Abuse Directive,[54] and the latter through the establishment of national corporate registers; the European Company Register is in the making.[55]

[51] For example, Bainbridge, *supra*, n. 30, at 12.

[52] The author is aware that the dimension of information costs is not endless, in the mathematical use of the word. The term is used for descriptive reasons, only.

[53] Directive 2004/109/EC of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, OJ L 390/38 (31.12.2004).

[54] Directive 2003/6/EC of 28 January 2003 on insider dealing and market manipulation (market abuse), OJ L 96/16 (12.4.2003).

[55] See Ulrich Noack, "Digital Disclosure of Company Data in Germany and Europe - Regarding the Implementation of the Disclosure Directive (2003) and the Transparency Directive in Germany", *CBC-RPS No. 0002* (2004), available at: <http://ssrn.com/abstract=610001>.

Research costs have therefore become insignificant. We can reasonably expect the costs incurred by reading and analysis of information previously achieved to be more significant. Law can do little in speeding-up the analysis of information. Thus if these costs are significant, we would expect investors to indeed remain passive.

However, a closer look warrants a distinction between retail investors and institutional investors. Retail investors are not required to digest the information provided. They are free to vote uninformed; they may disregard any good voting habits and vote with the crowd or against it, equally arbitrarily. If they invest in research and analysis they will in fact bear significant costs with uncertain returns. Retail investors are doomed to remain passive. The situation is essentially different with respect to institutional investors. These investors are under a fiduciary obligation to their beneficiaries. Uninformed action would run counter to the "prudent person", or "prudent investor", standard, respectively, which governs the fiduciary relationship of institutional investors to their beneficiaries. Consequently, these investors are mandated to research and analyse information disclosed by the issuer (including annual reports, the meeting agenda, shareholder proposals, and proxy statements, if any) before exercising their voting rights.[56] They are also obliged to invest in a prudent level of research.[57] This procedural requirement substitutes for checks whether the voting decision

[56] EU: with respect to Pension Plans, Art. 18 (1) of Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision (IORPs); with respect to mutual funds, the same fiduciary relationship follows implicitly from the existing law. For example, Art. 5b of the UCITS-framework, implemented by Council Directive 2001/107/EC, UCITS III ('Management Directive'), requires a Member States' competent authority to 'take into account the need for sound and prudent management,' when authorising a fund management company. Furthermore, each Member State is mandated to draw up 'prudential rules' for management companies (Art. 5f UCITS framework). S. 9 of the German Investmentgesetz refers to the German complement of the 'prudent person' standard ('ordentlicher Kaufmann'). Under s. 253 of the British Financial Markets Services Act of 2000, '[an]y provision of the trust deed of an authorised unit trust scheme is void in so far as it would have the effect of exempting the manager or trustee from liability for any failure to exercise due care and diligence in the discharge of his functions in respect of the scheme.' US: for bank trusts ss. 804, 809 of the Uniform Trust Code (Rev'd 2005); s. 1, 2 of the Uniform Prudent Investor Act (Rev'd 1995). For private pension funds 29 U.S.C. s 1104(a) [Employees Retirement Income Security Act (ERISA)]; for mutual funds s. 36 (b) of the Investment Company Act of 1940.

[57] See, e.g., s. 2 (d) of the Uniform Prudent Investor Act (Rev'd 1995): 'A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.).

itself was correct: if the institutions live up to that standard clients of institutional investors will be prevented from suing the institutions, or their managers, for ‘wrongful voting’. One could therefore assume that the fiduciary duty mandating informed voting prevents, rather than incentivizes, institutional investors to vote.

Such an assumption, however, disregards the incremental connection between the investment decision and the decision to vote. The investment decision is a permanent decision of whether to buy, hold or sell the respective assets. Similar to the information required for voting, institutional investors are under a fiduciary obligation to secure sufficient information to understand the investment prior to making, and during the term of, the investment. Prudent investment management mandates steady research and analysis of information available about the company. This includes the meeting agenda, shareholder proposals, and proxy statements (if any), as these actions may well influence the value, or future price of the assets. If institutions have to research and analyze all available information in any case, the additional information costs for voting are negligible. The voting decision freerides on the trading decision.[58]

Even if the expertise is split up between different people inside the institutional investor – the fund manager focusing on the investment decision, the corporate governance manager focusing on voting[59] – information costs are negligible; the corporate governance manager can rely on the fund manager’s expertise. If institutions outsource asset management to a professional manager – a frequent phenomenon -,[60] the same consideration applies to the asset manager. In light of the above we may reasonably assume that C(i) →

[58] Please note that this statement is true regardless of the fund size and economies of scale among related funds. With all information being considered for trading, there is little room for additional costs for voting information (which Black, *supra*, n. 22, at 590, seems to indicate).

[59] Pursuant to the data provided by German investment funds, *supra*, n. 12, the fund manager decides how to vote in 36% of the funds; in 29% of the funds, the fund’s CEO decides, in 9% of the funds, the corporate governance manager votes (other: 26%). In US mutual funds, fund managers are said to ‘still have a say in how votes are cast, but the voting policy set by the committee annually is the default position’, see K Whitehouse, ”A Changing Story: How Funds Vote Your Shares”, *Wall Street Journal*, May 7, 2007.

[60] A de Jong et al., *supra*, n. 14, at 38, hold that 74% of the Dutch, and 78% of the foreign pension funds rely on external asset management.

0. Consequently, the voting function for institutional shareholders is more likely to look like:

$$B_V > [C_D + C_P]$$

Now, let's consider C_D. Law may strongly influence the costs for **decision-making**. Under some laws, institutions must assign the voting process to an independent committee, issue and develop voting strategies and disclose, and explain, their voting strategies to their investors. All these measures impose costs on the fund and its investors. These costs offset profits derived from investment activity (if any), in turn reducing the fund manager's end-of-year premium, and the fund's competitiveness. Empirical data support this assumption. Involvement of institutional investors is greater in jurisdictions that regulate institutional activity less stringently.[61]

If this was all of the truth fund managers would want to avoid voting altogether. However, as previously argued,[62] the above costs are subject to significant economies of scale and scope. The modern fund universe comprises of fund families with multiple funds belonging to the fund family holding shares of the same issuer. The greater the investment of the fund family altogether in one issuer, the lower the decision-making costs, in proportion to portfolio size. There is evidence that cross-border financial integration in the European fund industry is likely to go hand-in-hand with concentration of the asset management industry.[63] The European Commission also seeks to facilitate concentration of the European investment funds industry.[64] Therefore even in the absence of law, we can assume that

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[61] See BS Black & JC Coffee, "Hail Britannia?: Institutional Investor Behavior Under Limited Regulation", (1994) 92 *Michigan Law Review* 1997.

[62] Black, *supra*, n. 22, at 580 et seq.; Rock, *supra*, n. 31, at 457.

[63] Observatoire de l'Epargne Européenne & Zentrum für Europäische Wirtschaftsforschung, "Current Trends in the European Asset Management Industry Lot 1 – Report to the European Commission", October 2006, at 18 report an increasing number of fund mergers; Oxera, "Current Trends in the European Asset Management Industry Lot 2", at 66, reports geographical concentration of core Asset Management functions; further, at 48, it is predicted that pension reforms across Europe may further concentration of the asset management industries.

[64] European Commission, *Green Paper on the Enhancement of the EUR Framework for Investment Funds*, COM(2005) 314, at 7; *White Paper on Enhancing the Single Market Framework for Investment Funds*, COM(2006) 686, at 6, proposing additions to the UCITS Directive to create the appropriate legal and regulatory conditions for the merger of funds.

for members of a fund family, or very large funds, C_D is less relevant, hence $C_D \rightarrow 0$.

Adjusted to these insights, the voting function for large institutional investors, or members of a fund family, is:

$$B_V > C_P$$

In a nutshell, it is all about the process. Whether $C_P \rightarrow 0$ or $C_P \rightarrow \infty$, partly depends on the law governing issuers and shareholders, and partly on the voting infrastructure developed under the influence of the law of the respective jurisdiction. While there are significant economies of scale in the voting process in a harmonized legal environment (and concentration among voting service providers on the domestic level proceeds), these economies cannot drive corporate voting towards efficiency as long as legal barriers exist. Voting infrastructure is path dependent. The local optima created by the various corporate laws and the infrastructure being customized thereon create immense barriers for designing cross-border voting platforms.

As an intermediary result, we would expect retail investors to remain passive due to high information costs associated with voting. Whether institutional investors vote, however, primarily depends on the costs for the technical process of voting. In this respect, law matters.

4. In particular: cross-border voting

The application of the cost-benefit analysis to the cross-border setting provides some uncomfortable insights. Procedural costs in a cross-border setting are significant: exercising shareholder rights across borders requires, in many instances, coping with different languages, laws, banking systems, technical standards, and possibly the resistance of blockholders and incumbents in their efforts to restrain the influence of new entrants.[65] As long as these barriers exist high voting turnouts in Europe are unlikely.

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[65] Manifest Information Services Ltd., "Cross-Border Voting in Europe – A Manifest Investigation into the practical problems of informed voting across EU borders" (May 2007), at 4, identifies 15 key issues to crosss-border voting, inter alia: share blocking, power of attorney, re-registration of shares, record date, length and inefficiency of the chain of intermediary, availability and timeliness of information, custodian / sub-custodian cut-off date, etc.; Institutional Design, "Cross-border voting in Europa – Case Studies from the 2002 proxy

This assumption is consistent with the figures cited in this article according to which domestic shareholders tend to exercise their voting rights, whereas foreign shareholders do not. For domestic shareholders, the laws of most EC Member States provide local optima, resulting in smooth and efficient infrastructure driven by economies of scale on the domestic level. The costs of voting domestic shares here look like $C_P \rightarrow 0$. However, across Member States, due to different corporate laws, efficient voting infrastructure for *cross-border voting* has not yet developed. The costs of voting foreign shares here look like $C_P \rightarrow \infty$. Passivity of foreign institutional shareholders at cross-border shareholder meetings is rational. The assumption above is also consistent with the basic number that we have for both turnout and ownership structure in Europe.[66] Under the shareholder constituency model, we would expect domestic blockholders to belong to type A-shareholders. These comprise of the public sector (5% of the equity), the private sector (16%) and banks (7%). In addition, my cost-benefit analysis suggests that domestic institutional investors, holding 24% of the equity, generally tend to vote. Simultaneously, retail investors (16%) and foreign investors (33%) are expected to remain passive. Under the constituency model, the expected turnout at shareholder meetings is therefore app. 52%. This is remarkably close to the 53% turnout reported for firms constituting 18 European blue chip indices,[67] and adds to the picture that foreign investors in European issuers rarely vote.

Why do we care? On the one hand, it is counter-intuitive that corporate law mandates a get-together of shareholders, for the purposes of information, communication and decision-making across all shareholder groups (which was named above as the purpose of shareholder meetings), and

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season", available at: <www.icgn.org>, at 15, identifies 8 key issues including timing/ deadline, share blocking, local protocols, inadequate materials, language difficulties, vote confirmation, unfair / inadequate voting rights as well as the lack of uniformity of law and practice across borders.

[66] The calculation is based on the data provided by Manifest, *supra*, n. 3, and FESE, *supra*, n. 1, at 6.

[67] There are serious limitations to this calculation stemming from the inconsistency of the data used. The turnout data only refers to attendance at firms comprising 18 blue chip indices, and it is measured in votes. The FESE-data on the ownership structure owns comprises all European stock exchanges and is based on equity.

simultaneously prevents some shareholders from participating. On the other hand, this chasm is likely to harm the flow of capital towards the most efficient use, hindering capital market efficiency altogether: one would expect type A-shareholders to be interested in a low turnout of type B-shareholders because the relative value of a vote is a fraction of the overall turnout at the meeting, comprising of the shares of type A- and type B-shareholders. Hence, the relative value of type A-votes is less the higher the turnout of type B-shareholders is, and vice versa. Consequently, if certain (type B-) investors are disfranchised, other (type A-) investors achieve influence beyond their economic interest. Whether distortions between capital invested and control are disruptive for a firm's governance and whether they increase agency costs, is widely discussed.[68] In some respect, the situation is analogous to that of empty voting[69] and multiple share classes carrying differential voting rights. While the empirical evidence is inconclusive about whether dual-class share structures, in fact, destroy a company's value,[70] studies unanimously agree that institutional investors dislike these structures and avoid investment in non-voting shares.[71] However, in contrast to multiple share classes, in a cross-border setting all shares formally carry the same weight. Markets cannot set different prices to each class of shares or price the event prompting the 'emptiness' of some shares (options, fees for stock lending) separately. It is only the investors' origin that creates the distortions regarding potential control.

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[68] See, for example, EF Fama & MC Jensen, "Separation of Ownership and Control", (1983) 26 *Journal of Law and Economics* 301; LA Bebchuk, R Kraakman & G Triantis, "Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Creation and Agency Costs of Separating Control from Cash Flow Rights", in R Morck (ed.), *Concentrated Corporate Ownership*, pp. 445-460 (2000); H Ashbaugh Skaife, DW Collins & R LaFond, "Corporate Governance and the Cost of Equity Capital", *The Accounting Review* forthcoming. Available at: <http://ssrn.com/abstract=639681>.

[69] See references cited *supra*, n. 36.

[70] See on the 'One share, one vote' controversy the studies commissioned by the European Commission available at: <http://ec.europa.eu/internal_market/company/shareholders/indexb_en.htm >.

[71] See K Li, H Ortiz-Molina & S Zhao, "Do Voting Rights Affect Institutional Investment Decisions? Evidence from Dual-Class Firms", (2008) *Financial Management* forthcoming, showing that, on average, level of institutional investment in firms with dual-class structures is app. 3% lower than in firms with one share class.

The fact that some shareholders benefit from inexpensive national voting infrastructures while cross-border investors are forced to bear significant procedural costs for exercising their rights is an argument against cross-border investments. This statement is true, regardless of whether one believes that institutions exercise cross-border their rights if the costs of doing so are low, or whether one believes that institutions put weight on the mere *availability* of voting as value-enhancing option.[72] Long-term oriented investors are likely to shun cross-border investments, leaving the stage for incumbents and short-term oriented investors. More significantly, all else being equal, we would expect domestic shareholders to assign greater value and cross-border investors to assign lesser value to the same share. Then, shareholders in Europe would tilt their portfolios towards domestic shares. The current increase in cross-border holdings is thus accruable to other, possibly more visible needs, such as diversification,[73] strategic investments into new markets, etc. However, at a certain point in time, these additional factors will cease to have an effect on investment behaviour; home-bias[74] is likely to persist restraining firms' access to external finance. In short, the uneven distribution of procedural costs is likely to distort the pricing at European capital markets.

The different voting costs may also drive wedges between national and foreign institutional investors. One may argue that the latter are better monitors, which is due to the fact that foreign investors are less prone to conflicts stemming from 'national' / social interests, banking relationships etc.[75] (On the other hand, these investors may be more destructive to finding

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[72] See A de Jong et al., *supra*, n. 14, at 52.

[73] The 'prudent investor' rule, *supra*, n. 56, requires a sound level of diversification. For the benefits, see G De Santis & B Gerard, "International asset pricing and portfolio diversification with time-varying risk", (1997) 52 *Journal of Finance* 1881.

[74] See KR French & JM Poterba, "Investor Diversification and International Equity Markets'", (1991) 81 *American Economic Review* 222; JD Coval & TJ Moskowitz, "Home Bias at Home: Local Equity Preference in Domestic Portfolios",,(1999) 54 *Journal of Finance* 2045. Recent studies focused on cross-country differences in corporate governance regimes, see M Dahlquist, L Pinkowitz, RM Stulz & R Williamson, "Corporate Governance and the Home Bias", (2003) 38 *Journal of Financial and Quantitative Analysis* 87; BC Kho, RM Stulz & FE Warnock, "Financial Globalization, Governance, and the Evolution of the Home Bias," (2006) *NBER Working Paper No. 12389*. The obstacles to exercising shareholder rights across borders add to that picture, and suggest a new emphasis as to the discussion.

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the local optimum when a cooperative approach prevails in the respective society.) Separating the latter from the former may make management the laughing third: Obstacles to cross-border voting enable 'divide et impera' (divide and rule) – strategies and, thus, weaken shareholder influence, in general.

C. The Shareholder Rights Directive

It is here where the Shareholder Rights Directive comes into play that seeks to **strengthen the rights of shareholders**, and b) **enable cross-border voting**.[76] In particular, the Commission established that

> … an effective regime for the protection of shareholders and their rights, protecting the savings and pensions of millions of people and strengthening the foundations of capital markets for the long term in a context of diversified shareholding within the EU, is essential if companies are to raise capital at the lowest cost. [77]

Further, the Commission emphasized that

> .. specific problems relating to cross-border voting should be solved urgently. The Commission considers that the necessary framework should be developed in a Directive, since an effective exercise of these rights requires a number of legal difficulties to be solved.[78]

In the same vein, the Shareholder Rights Directive emphasizes the idea of a cross-border constituency:

> Non-resident shareholders should be able to exercise their rights in relation to the general meeting as easily as shareholders who reside in the Member State in which the Company has its registered office. This requires that existing obstacles which hinder the access of non-resident shareholders to the information relevant to the general meeting and the exercise of voting rights without physically attending the general meeting be removed. The removal of these obstacles should also benefit resident shareholders who do not or cannot attend the general meeting.[79]

If the European Parliament strives for a border-less corporate Europe as far as shareholder rights are concerned, does the Directive keep up with these far-reaching ambitions? Shareholder meetings typically comprise four steps that include Shareholder Identification and Authorization, Information,

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[76] European Commission, Communication to the Council and the European Parliament *Modernising Company Law and Enhancing Corporate Governance – A Plan to Move Forward,* COM (2003) 284 final (21 May 2003). Adopted by the European Parliament's resolution of April 21, 2004, OJ C 104 E of April 30, 2004, p. 426.

[77] *Ibid*, ¶ 2.1.

[78] *Ibid*, ¶ 2.1.

[79] Recital (5) of the Shareholder Rights Directive, *supra*, n. 21.

Communication and Voting.[80] The Shareholder Rights Directive's mandatory rules affect all of these steps (sub 1. through 4.). With respect to the use of web-based technologies, however, the Directive refrains discretion into Member States and / or Management (sub 5.).

1. Shareholder identification & authentication

With respect to shareholder authentication, the Directive deals with the relationship of the shareholders to their company. However, as to the relationship of intermediaries to the company and the shareholders, it remains silent.

a) Investor vs. Company

With respect to the identification of shareholders within the corporate – investor relationship, the Directive (1) mandates the use of a record date-based shareholder authentication; (2) bans share blocking, and (3) establishes the principle of proportionality.

(1) The Directive requires Member States to introduce **a record date requirement** into their corporate laws for all firms that are not able to identify their shareholders from a current register of shareholders on the day of the general meeting.[81] Under a record date requirement, the rights of shareholders to exercise their rights in a general meeting are determined with respect to the shares held by that shareholder on a specified point in time prior to the general meeting. According to the Directive, this date must lie at least 8 days after the convocation, and it must not lie more than 30 days before the day of the general meeting. Both the 8 day interval and the 30 day limit should make sure that economic and formal entitlement with respect to the rights attached to the shares stays closely aligned. In particular, the eight-

[80] In addition, shareholder meetings are often subject of judicial review. The Directive, however, explicitly refrains from discussing the legal consequences of a company's failure to meet its mandatory requirements, see Article 14 (3) of the Shareholder Rights Directive, *supra*, n. 21, with respect to the disclosure of voting results. Thus, the *effet utile* principle applies, see European Court of Justice, Case C-465/93, *Atlanta v. Bundesamt für Ernährung*, 1995 E.C.R. I-*3761*; Case C-312/93, *Peterbroeck*, 1995 E.C.R. I-4599 ff., ¶ 12; Case C-6/99 and C-9/90, *Francovich*, 1991 E.C.R. I-5357, ¶ 43; Case C-217/88, *Commission v. Bundesrepublik Deutschland*, 1990 E.C.R. I-2879; Case 123/87 and 330/87, *Jeunehomme*, 1988 E.C.R. I-4517, ¶, 17.; Case 106/77, *Simmenthal II*, 1978 E.C.R. I-629, ¶ 14; Case 14/68, *Walt Wilhelm*, 1969 E.C.R. I- 14.

[81] Article 7 (2) and (3) of the Shareholder Rights Directive, *supra*, n. 21.

day period pays tribute to concerns that stock lending may cater to low voting turnouts and greaten the divide between formally-entitled shareholders (which in the case of stock lending is the borrower) on the one side, and investors with an economic stake in the shares (the lender) on the other.[82] The thirty-day period should make sure that there are not too many who hold their shares at the record date, but not at the day of the meeting. Reality is even more restrictive: British and German issuers of registered shares set their record dates sometimes at 48 hours prior to the meeting. Interestingly, the U.S. securities regulation takes a different approach: the NYSE Listed Company Manual recommends a *minimum* interval of thirty days between record and meeting dates "so as to give ample time for the solicitation of proxies."[83]

(2) Simultaneously, the Directive **prohibits share blocking** and any other measure that restricts shareholders to sell or otherwise transfer shares during the period between the record date and the general meeting.[84] Under a share blocking scheme, investors need to deposit their shares for a certain period in advance until the end of the meeting. Such techniques, which the laws of some Member States required either on the corporate or the intermediary level, constituted the frequently-used alternative to a record date system for shareholder authentication in Europe. It prevented, however, many institutional investors from exercising their voting rights, because these investors want and / or are required to retain their ability to respond to market reactions (by trading their shares).[85]

(3) Finally, the relationship between the company and its shareholders as to shareholder identification is now subject to the **principle of proportionality:**

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[82] Theoretically, if the record date is too close to the date of the notice of the meeting, the investor is prevented from retrieving the shares lent (hence, that are transferred to another legal entity) until the date of record and thus effectively from voting. S. 401.02 of the NYSE Listed Company Manual requires a ten days period between the day of notice and the record date.

[83] S. 401.03 of the NYSE Listed Company Manual

[84] Article 7 (1) of the Directive.

[85] Editorial: "Institutional Investors and Cross-border voting", Corporate Governance: An International Review 11 (2003), S. 89: Institutional Design, *supra*, n. 65, at 18; Manifest, *supra*, n. 65, at 20.

> "Proof of qualification as a shareholder may be made subject only to such requirements as are necessary in order to ensure the identification of shareholders and only to the extent that they are proportionate to achieving that objective." [86]

It is foreseeable that that which exactly constitutes that which is proportionate to identify shareholders will be subject to an intense debate.

b) Chain of intermediaries

In the modern corporate world, securities are held and transferred in a paperless way. This is the consequence of either the custodian-driven *demobilization*, or a legislature-driven *dematerialization* of securities.[87] In both cases, securities are eventually held through a chain of intermediaries. This chain typically comprises their Depositary bank (which runs the customer's share deposit) and custodians through which the Depositary is connected to the Central Securities Depositary (CSD). The CSD administers the custody of shares on behalf of the issuer on the one side and the banks on the other.

While the Recitals[88] of the Directive recognize that it is important that custodians and the Depository facilitate the exercise of shareholder rights, the Directive itself does not contain any provisions that directly extend to the intermediaries within the chain. The Directive requires the European Commission to consider this issue in the context of a Recommendation, hence a non-binding legislative measure. This is due to the fact that the questions of who is the shareholder, in which way evidence of an investor's

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[86] Article 7 (4) of the Directive.

[87] See on the efforts of harmonization with respect to international private law The Hague Securities Convention (*Convention on the law applicable to certain rights in respect of Securities Held with an intermediary),* available at http://www.hcch.net/index_en.php?act=conventions.pdf&cid=72 (11 April 2007). Switzerland and the U.S.A. signed the convention on 5 July 2006. UNIDROIT, *Preliminary Draft Convention on Substantive Rules Regarding Intermediated Securities* , available at http://www.unidroit.org/english/publications/proceedings/2006/contents.htm (11 April 2007); UNIDROIT (ed.), ENHANCING LEGAL CERTAINTY OVER INVESTMENT SECURITIES HELD WITH AN INTERMEDIARY, Uniform Law Review, Vol. X, 2005-1/2; UNIDROIT (ed.), *Intermediated Securities* (Study LXXVIII, 2006). Article 8 of the American *Uniform Commercial Code* (U.C.C.), available at http://www.law.cornell.edu/ucc/8/ (11 April 2007) provides for a property rights regime which relies on entitlements by bank account holders vis-à-vis their intermediaries. The U.C.C. is a model law for the American states.

[88] Recital 11 of the Shareholder Rights Directive, *supra*, n. 21.

voting entitlement should be sent to issuer, and who should bear the costs for the authentication procedure across borders were contentiously discussed.

However, in a merely indirect way, the Directive also addresses some outer layers of the intermediary problem. Article 13 effectively extends the principle of proportionality to the relationship between a nominee (hence, an intermediary who is formally deemed a shareholder) and the corporation. It does so by limiting which information the intermediary must disclose to the corporation as a prerequisite of exercising its client's voting rights on behalf of the client. The applicable law may only require disclosure to the company of a list disclosing the client's identity and the number of his/her shares. This is in line with corporate practice in the UK (and Germany, as well).

In addition, procedural requirements may seek to verify the content of voting instructions, to the extent necessary for the verification of the instructions purported by the intermediary. Furthermore, the national laws must not preclude the intermediary from voting differently for each client or assigning a proxy to each client, respectively. These measures make sure that a nominee shareholder can comply with his client's instructions as far as voting is concerned. With respect to other rights, such as the right to add agenda items, to table draft resolutions or the right to ask questions, the Directive remains silent.

2. Information

On a European level, the issue of shareholders' access to meeting-related procedural information was first addressed by the Transparency Directive. The Transparency Directive requires issuers to make available information on the place, time and agenda of meetings, the total number of shares and voting rights and the rights of holders to participate in meetings.[89] Article 5 of the Shareholder Rights Directive extends these requirements. In order to enable shareholders "to cast informed votes at, or in advance of, the general meeting, no matter where they reside,"[90] the Directive requires timely notice

[89] Article 17 (2) (a) of the Transparency Directive, *supra*, n. **Fehler! Textmarke nicht definiert.**.

[90] Recital 6 of the Shareholder Rights Directive, *supra*, n. 21.

and complete information as to the agenda items and as to the necessary procedures for exercising shareholder rights.

The company may provide information to shareholders via two different methods. First, a company may make information available to shareholders who may access the information at the pre-determined place ("pull" method). Alternatively, a company may be obliged to send or supply information to the recipient ("push" method).

a) Pull

In order to provide sufficient "pull" information, companies have to post on their website not later than 21 days previous to the meeting the following information:[91]

- Convocation, with specifics on the time, place and agenda of the meeting, the record date for shareholder identification, and a clear and precise description of the procedures necessary for exercising shareholder rights in the general meeting. The latter must include
  - the particularities (such as deadlines) on the rights to put an item onto the agenda and to table draft resolutions, if these rights can be exercised after the convocation, as well as the right to ask questions at, or in advance of, the meeting.
  - the proxy voting procedures, in particular proxy forms and the means by which the company is prepared to accept electronic notifications of proxy appointments; and
  - where applicable, the procedures for casting votes by correspondence (voting by mail) or by electronic means ;
  - the source for the documents (such as annual reports) and management's draft resolutions to be submitted to the general meeting;
  - an Internet address with additional meeting-related information

[91] Article 5 (3) and (4) of the Shareholder Rights Directive, *supra*, n. 21.

- Number of shares and voting rights (separate for each class, if applicable);
- Documents to be submitted to the general meeting, such as Annual Reports and Special Investigation Reports;
- Draft resolutions and recommendations or comments, respectively, by the company's administrative, managerial or supervisory bodies;
- Proxy forms and forms for voting by correspondence (vote by mail), unless these are directly sent to the shareholders. [92]

Within a period not exceeding 15 days after the general meeting, the company must disclose on its website the voting results.[93]

b) Push

As a minimum standard, Member States must mandate that companies distribute the convocation notice in a manner ensuring fast access to it on a non-discriminatory basis.[94] The wording is analogous to the dissemination of information for market relevant information under Article 21 (2) of the Transparency Directive [Intermediary-based Dissemination].[95] However companies with a current share register may be excluded from the Intermediary-based Dissemination if they are obliged to send the convocation to each of its registered shareholders. In either case, the company may not charge any specific cost for issuing the convocation in the prescribed manner. Member States may require additional methods of information dissemination under their national laws.

[92] Without specifically mentioning the corporate website, Article 17 (2) (b) of the Transparency Directive, *supra*, n. note **Fehler! Textmarke nicht definiert.**, requires that the issuers 'make available a proxy form, on paper or, where applicable, by electronic means, *to each person entitled to vote* at a shareholders' meeting, together with the notice concerning the meeting or, on request, after an announcement of the meeting.'

[93] Article 14 (2) of the Shareholder Rights Directive, *supra*, n. 21.

[94] Article 5 (2) of the Shareholder Rights Directive, *supra*, n. 21.

[95] See also the further specification in Article 12 of Commission Directive 2007/14/EC of 8 March 2007 laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.

The Intermediary-based Dissemination requires companies to forward the respective information to an information intermediary which – in return – is free to decide whether it wishes to publish the information. If understood in the same manner as under the Transparency Directive, the Intermediary-based Dissemination of the convocation notice will create to four issues: first, information intermediaries are unlikely to deem convocation notices of regular shareholder meetings a matter that will be prominently reported. In this regard, the situation is different with respect to information that is relevant to the market. Secondly, in a world with RSS feed and self-functioning Internet search engines, requiring companies to forward news to *intermediaries* (who are likely to have modern information technologies and thereby could rely on RSS feed for achieving the information costless) is an outdated and unnecessary costly burden upon companies. Third, Intermediary-based Dissemination does not address the issue of shareholder apathy which the *investor*-directed push-information counters more effectively. Consequently, advanced corporate laws require the company to send (at least) the notice of the meeting with the proxy-related materials to their shareholders, by postal or electronic means.[96] The Shareholder Rights Directive, however, does not (nor does it require information of beneficial owners). Finally, Intermediary-based Dissemination does not provide equal access to meeting-related information in a cross-border context, as is required by Article 4 of the Directive. This is due to the fact that some intermediaries may charge costs for access to their data bases while others do not. Convocation notices of global players will typically be accessible through major free-of-charge websites. However, small

[96] Canada: s. 135 (1), 253 of the *Canada Business Corporation Act*; France: Art. L225.108 *Code de Commerce* and Art. 120-1, 124 (registered shares), 125 Decree dated March 23, 1967, as amended by the 'NRE' decree n°2002-803 (May 3, 2002); Germany: s. 125 (1), (2) of the *Aktiengesetz (Stock Corporation Act)* for shareholders of record, s. 128 (1) of the *Aktiengesetz* for beneficial owners holding registered shares and shareholders holding bearer shares; Switzerland: Art. 696 (2) *Obligationenrecht* (registered shareholders); UK: ss. 308, 309 *Companies Act 2006*; U.S.: Rule 14a-3 under the Securities Exchange Act of 1934 for record shareholders; Rule 14b-1/2 and Rule 14a-13(c) for non-objecting and consenting beneficial owners (NOBO and COBO-lists); Rule 14a-13(d) for certain employee-shareholders; depositories are required to forward information to other shareholders according to Rules 14a-13(a) (preparation) and 14b-1(b) and 14b-2(b) (execution); ss. 222 (b), 229, 230 of the *Delaware General Corporation Law*; ss. § 7.05-06 of the Revised Model Business Corporation Act. W.r.t. the latest U.S. developments, see JN Gordon, "Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy", (2008) 61 *Vanderbilt Law Review* 475.

corporations beyond the focus of the press might be disregarded in the information flow of websites which create their income through advertising fees that depend on traffic. Thus, Member States should provide for free access, through their respective Federal Electronic Bulletins.

c) Transmission

Further, the Directive seeks to exploit "the possibilities which modern technologies offer to make information instantly accessible."[97] It does so, however, on a voluntary basis. Member States are required to abolish any legal requirements that prevent companies from offering to their shareholders the real-time transmission of the general meeting. [98]

3. Communication

a) Minimum communication rights

With respect to communication, the Directive requires that shareholders are entitled to exercise three types of minority rights: (1) the right to put items on the agenda, (2) the right to table draft resolutions for items that are already on the agenda, [99] and (3) the right of an individual shareholder to ask questions that are related to items on the agenda and the corresponding obligation of management to answer them.[100] With respect to the former two entitlements, the Directive establishes two "basic rules":[101]

- 5% of the company's share capital is the highest possible threshold for exercising these rights;
- The final version of the agenda must be made available to all shareholders in sufficient time to prepare for the discussion and voting.

Member States may regulate the details as to these rights, with three exceptions: first, Member States must set deadlines for the exercise of these rights, "with reference to a specified number of days prior to the general

[97] Recital 6 of the Shareholder Rights Directive, *supra*, n. 21.

[98] Article 8 (1) (a) of the Shareholder Rights Directive, *supra*, n. 21.

[99] Art. 6 of the Shareholder Rights Directive, *supra*, n. 21.

[100] Art. 9 (1) of the Shareholder Rights Directive, *supra*, n. 21.

[101] Recital 7 of the Shareholder Rights Directive, *supra*, n. 21.

meeting or the convocation." Second, if the exercise of these rights prompts amendments to the agenda, the revised agenda must be "made available" on the Internet website pursuant to Article 5 (4) of the Directive, before the record day.[102] Whether the Directive requires dissemination pursuant to Article 5 (2) of the Directive or mandates even stricter distribution requirements under national laws is not obvious. Since the words "make available" are exclusively used in Article 5 (4) of the Directive I hold, however, that dissemination / distribution is not required.

Third, while Member States may require that the right to add an item to the agenda or to table draft resolutions to an agenda item be exercised "in writing," the Directive mandates that "writing" be understood as submission by post **or electronic means**. Consequently, **European law entitles shareholders to use electronic means for their submissions**. Yet, the laws of some Member States vest discretion in management as to whether shareholders may submit their proposals via electronic means.

With respect to the right to ask questions, other than the establishment of the general principle, the "rules on how and when questions are asked and answered should be left to be determined by Member States."[103]

b) Digital two-way communication

With respect to digital two-way communication, the Directive takes a liberal stance. Member States shall permit companies to offer to their shareholders methods of real-time two-way communication which enable shareholders to address the general meeting from a remote location.[104]

4. Voting

In the context of voting, the Shareholder Rights Directive emphasizes the need for web-based technologies in cross-border voting:

> 'Companies should face no legal obstacles in offering to their shareholders any means of electronic participation in the general meeting. Voting without attending the general meeting in person, whether by correspondence or by electronic

[102] Article 6 (4) of the Shareholder Rights Directive, *supra*, n. 21.

[103] Recital 8 of the Shareholder Rights Directive, *supra*, n. 21.

[104] Article 8 (1) (b) of the Shareholder Rights Directive, *supra* 21.

> means, should not be subject to constraints other than those necessary for the verification of identity and the security of communications.'[105]

Three digital voting types have yet been identified in advanced corporate laws:[106] Electronic Proxy Voting ['EPV'], Electronic Direct Voting ['EDV'] and Virtual Shareholder Meetings. EPV refers to the electronic *issuing*, *authentication* and *submission* of proxy appointments to the corporation. EDV systems enable shareholders to vote directly over the Internet, without a proxy connecting the "web-" and the "physical sphere". While both EPV and EDV are "add-ons" to a physical shareholder meeting, a virtual shareholder meeting does not take place at any physical place. Rather, it takes place in "the web" – wherever this is. Shareholders would not be able to attend the meeting physically. The Directive contains details as to all of these types.

a) Electronic Proxy Voting

With respect to EPV, the Directive continues from where the Transparency Directive leaves off. Pursuant to Article 17 (2) (sub b) of the Transparency Directive, issuers must make available proxy forms on paper or by electronic means to each person entitled to vote at shareholder meetings. However, neither does the Transparency Directive require that voting facilities and related information are available in all Member States – the home Member State suffices –, nor does it mandate issuers to offer to their shareholders electronic proxy voting.

Based on the assumption that "a smooth and effective process of proxy voting"[107] positively influences corporate governance, the Directive takes one step further. It mandates not only that shareholders are able to issue, or revoke, a proxy to the proxy-holder by written[108] electronic means (e.g. by email), it also requires companies to offer to their shareholders at least one effective method for giving notice to the company about the appointment, or

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[105] Recital 9 of the Shareholder Rights Directive, *supra*, n. 21.

[106] For details see DA Zetzsche, "Virtual Shareholder Meetings and the European Shareholder Rights Directive – Challenges and Opportunities", in Instituto Valores Mobiliários (ed.), - Vol. VIII (2008).

[107] Recital 10 of the Shareholder Rights Directive, *supra*, n. 21.

[108] Article 11 (2) of the Shareholder Rights Directive, *supra*, n. 21.

the revocation, of the proxy by written electronic means.[109] In addition, the Directive seeks to abolish some existing limitations and constraints in the laws of the Member States which make proxy voting cumbersome and costly. In particular, Article 10 of the Directive establishes "an unfettered right"[110] of shareholders to appoint any legal entity as a proxy-holder who will enjoy the same rights at the meeting as the shareholder and who votes at the meeting according to the shareholder's directions, regardless of whether the proxy-holder simultaneously represents other shareholders.[111] Further, the Directive limits Member States' jurisdiction to measures with which they seek to address issues of proxy voting arising from potential conflict of interests as well as potential abuses of the proxy.[112]

The effect of Article 10 and 11 of the Directive on Member States is significant: with the Directive's coming-into-force, all European public companies must offer some type of electronic proxy voting system to their shareholders, and, using the system, the shareholder is free to choose whether it wishes to grant its proxy to a corporate representative or any person that it so designates. In order to enable shareholders to respond to "situations where new circumstances occur or are revealed after a shareholder has cast his/her vote by correspondence or by electronic means,"[113] the same principle applies to the revocation of the proxy. This is a step ahead of what corporations across Europe offer to their shareholders today. However, the Directive clearly limits its scope to the corporate relationship between the shareholder and the company, since it does not impose any obligation on companies to verify that proxy-holders cast votes in accordance with the voting instructions of the appointing shareholders. This is a wise decision, given the obstacles that issuers would face in verifying inter- and intra-intermediary communication.

[109] Article 11 (1) of the Shareholder Rights Directive, *supra*, n. 21. Further restrictions result from the adoption of the proportionality principle, see below at D.3.a).

[110] Recital 10 of the Shareholder Rights Directive, *supra*, n. 21.

[111] This provision seeks to address restrictions in some Member States. For example, pursuant to some laws only attorneys, management or shareholders may be proxy-holders.

[112] Article 10 (3) of the Shareholder Rights Directive, *supra*, n. 21.

[113] Recital 9 of the Shareholder Rights Directive, *supra*, n. 21.

b) Electronic Direct Voting

In contrast to the mandatory approach to electronic proxy voting, the Directive follows an *enabling approach* towards electronic direct voting:

> Member States shall permit *companies* to offer to their shareholders any form of participation in the general meeting by electronic means …[114]

The Directive mentions specifically the casting of votes without the need to appoint a proxy-holder who is physically present at the meeting.[115] Member States' jurisdiction is limited to legal constraints that are "necessary in order to ensure the identification of shareholders and the security of the electronic communication, and only to the extent that they are proportionate to achieving those objectives."

c) Virtual Shareholder Meetings

Article 8 of the Directive relates to the participation in physical shareholder meetings. It does not make reference to entirely Virtual Shareholder Meetings. However, the Directive explicitly entitles Member States to further develop the rules on electronic participation in the corporate decision-making process.[116]

5. Discretion as to the use of web technologies

Aside from these **minimum requirements**,[117] the Directive empowers Member States, the companies and shareholders to decide to what extent and how they want to facilitate the exercise of the shareholder rights to which the Directive refers.

a) Member States

As far as procedure is concerned, most legislative powers remain with the Member States:

[114] Article 8 (1) of the Shareholder Rights Directive, *supra*, n. 21.

[115] Article 8 (1) (c) of the Shareholder Rights Directive, *supra*, n. 21.

[116] Article 8 (2) (sub 2) of the Shareholder Rights Directive, *supra*, n. 21.

[117] EC Member States may facilitate the exercise of shareholder rights through other means, see Article 3 of the Shareholder Rights Directive, *supra*, n. 21.

- As “an important matter of corporate governance”, the Directive mentions the timing of disclosure of votes cast in advance of the general meeting electronically or by correspondence.[118]

- In contrast to the 21-day-convocation requirement for annual meetings, Member States may entitle a 2/3 majority of the shareholder meeting to introduce a 14-day notice requirement for extraordinary annual meetings if the company offers the facility for shareholders to vote by electronic means that are accessible to all shareholders.[119]

- Member States may limit the right to add an item to the agenda to annual general meetings, if shareholders are entitled to call extraordinary meetings with an agenda that includes at least all the items requested by those shareholders.

- With respect to individual information rights, Member States have jurisdiction over the details on how and when shareholders can ask and management must answer questions. This may include the use of Internet-based technologies. In particular, “Member States may provide that a response shall be deemed to be given if the relevant information is available on the company's Internet site in a question and answer format.”[120] Beyond this procedural decision, the jurisdiction of Member States is limited to measures that are necessary to ensure the identification of shareholders, the good order of the meeting, and the protection of confidentiality and business interests of companies.[121]

- With respect to proxy voting, Member States may
  - limit the appointment of a proxy-holder to a single meeting, or to such meetings as may be held during a specified period;
  - limit the number of persons whom a shareholder may appoint as proxy-holders in relation to any one general meeting, subject to the

[118] Recital 12 of the Shareholder Rights Directive, *supra*, n. 21.

[119] Article 5 (1) s. 2 of the Shareholder Rights Directive, *supra*, n. 21.

[120] Art. 9 (2) of the Shareholder Rights Directive, *supra*, n. 21.

[121] Art. 9 (2) of the Shareholder Rights Directive, *supra*, n. 21.

condition that shareholders can appoint one proxy-holder for each securities account in which shares of the company are held;

- require proxy-holders to keep a record of the voting instructions for a defined minimum period and to confirm on request that the voting instructions have been carried out,[122]
- impose preventive measures against, and sanctions for, fraudulent use of proxies collected; [123]
- impose preventive measures against possible abuse of proxies by persons who actively engage in the collection of proxies or who have in fact collected more than a certain significant number of proxies, notably to ensure an adequate degree of reliability and transparency. [124]

b) The Company

Regarding two significant questions, the Directive mandates that Member States empower the company to decide upon which way of exercising shareholder rights it deems most appropriate. These two important aspects include:

- The question of whether a company wants to introduce voting by correspondence (vote by mail).[125] This type of voting *in absentia* is widely used e.g. in France, while other jurisdictions were more restrictive, given the requirements of a 'meeting' or 'voting in person or by proxy' in the laws of these Member States.[126]
- The electronic participation of shareholders in physically-held shareholder meetings, as discussed above. In particular, companies - rather than the legislature - are to decide whether they want to provide

[122] Article 10 (4) of the Shareholder Rights Directive, *supra*, n. 21.

[123] Recital 10 of the Shareholder Rights Directive, *supra*, n. 21.

[124] Recital 10 of the Shareholder Rights Directive, *supra*, n. 21.

[125] Article 12 of the Shareholder Rights Directive, *supra*, n. 21.

[126] For the UK see Nolan, *supra*, n. 26, at 101, 109 pp. The same is true for Germany on the basis of s. 118 of the *Aktiengesetz*.

for real-time transmission, real-time two way communication and electronic direct voting.

D. Analysis

1. Incomplete solution for shareholder authentication

The Shareholder Rights Directive imposes Europe-wide rules on the relevant record date, including a proportionality requirement governing the relationship between the company and investors. However, it does not mandate the custodians' and Depositories' cooperation as to the exercise of shareholder rights.

One of the key hurdles that hampers effective cross-border voting in Europe lies in the passivity and unwillingness of the custodians and depository banks to be involved in the voting process. This should not surprise. Custodians and Depositories typically do not generate income by issuing voting entitlements or proxy cards to their customers. Further, nominees and custodians along the chain typically do not have an economic stake in the shares.[127] Consequently, these intermediaries show no propensity to support the exercise of their customers' voting rights, and – while the company-level is widely digitalized – little money is invested in modernizing the technical infrastructure for voting at the intermediary level.

A manifold of obstacles is already observed in the national context.[128] For the UK and the U.S., it is reported that, even where an intermediary is instructed by the investor to vote shares held for him, the instructions are often not executed.[129] Further, votes are frequently lost within the English chain of

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[127] See RC Nolan, "Shareholder Rights in Britain", (2006) 7 *European Business Organisation Law Review* 549, 570 et seq.

[128] For example, I Gómez-Sancha Trueba, "Indirect holdings of securities and exercise of shareholder rights (a Spanish perspective)", (2008) 3 *Oxford University Capital Markets Law Journal* 32.

[129] *Report of the Committee of Enquiry into UK Vote Execution* (London, National Association of Pension Funds 1999) § 1.7.; SM Klein, "Rule 14b-2: Does it Actually Lead to the Prompt Forwarding of Communications to beneficial Owners of Securities?", (1997) 23 *Journal of Corporation Law* 155. Rule 14b-2(b)(3) under the SEA 1934 requires nominees to grant, or effectively transfer, a proxy to the beneficiary, or else to solicit voting instructions from the beneficiary and then act on such instructions as are given. Black, *supra*, n. 22, at 561; Kahan & Rock, *supra*, n. 34, at 1079.

intermediaries.[130] U.S. corporate scholars deem voting results within the U.S. system that are closer than 5 percent of the overall votes counted at a poll unreliable.[131]

Recent studies indicate that the issues are even more significant in a cross-border setting where the particulars are beyond the reach of national legislators: the length and inefficiency of the chain of intermediaries is deemed to bring about manifold obstacles including

> 'time taken in passing information up and down the chain, lack of transparency in vote reporting, bundling of voting services, dissatisfaction in bundled service provision, lost votes in pooled account-based voting and lack of sufficient robust audit trails.' [132]

As main obstacles were identified

> 'the manual intervention in the voting process, incompetence of securities intermediaries in voting, miscommunication in the chain and lack of resources for voting.' [133]

Consequently, the silence of the Directive with regard to intermediaries' participation is particularly unfortunate. This statement is still true in light of some Member States' securities regulation mandating intermediaries to communicate with investors:[134] national laws do not solve cross-border issues.

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[130] Paul Myners, *Review of the impediments to voting UK shares – report to the Shareholder Voting Working Group* (1/2004), 14 et seq. Unilever carried out an audit to uncover the scale of votes that were still missing following its AGM on May 0, 2006. It was discovered that 6,7% of the entire vote were lost or were never voted in accordance with directions given by the beneficial holders. See Georgeson Shareholders, 'Stand Up and be Counted / Unilever Vote Audit', available at <http://www.georgeson.com/emea/resources_case_studies.php>. In an article published in September 2007 a Computershare estimate is cited according to which app. 8% of votes by institutional investors do not get counted, see Charles Orton-Jones, 'The promise of e-proxy voting', Real IR, Sept 2007, at 12.

[131] G Sparks, cited from M Kahan & E Rock, "The Hanging Chads of corporate voting,", (2008) 96 *The Georgetown Law Journal* 1227, at 1279. Kahan & Rock define seven pathologies of the American voting system.

[132] Manifest, *supra*, n. 3, at 12.

[133] Manifest, *supra*, n. 3, at 12. 7 out of 15 obstacles to cross-border voting regarded the chain of intermediaries.

[134] See for Germany ss. 125, 128, 135 of the *Aktiengesetz*; for the UK Principles for Business (FSA Handbook, PRIN 2.1), No. 7 and The New Conduct of Business Rules (FSA Handbook, COBS), Chapter 4, as well as the reform proposals by RC Nolan, "Indirect Investors: A Greater Say in the Company?", (2003) 3:1 *Journal of Corporate Law Studies* 73, 90 et seq..

2. Electronic participation: Pandora's Box opened

Aside from mandating *a* method for electronic proxy voting, the Directive is likely to spur progress with respect to shareholder rights in another respect as well: it is important to note that Member States have no discretion with respect to the basic question of whether companies are entitled to use methods of electronic participation. The Directive takes this decision out of the Member States' hands and either mandates the use of modern technology for all shareholders (e.g. information on the website, electronic proxy voting), or vests discretion to the company. Consequently, while European law provides for the *groundfloor* of digital shareholder rights in Europe, Member States are prohibited from artificially creating *ceilings* that prevent companies from experimenting with new technologies.[135] This regulatory technique gives rise to hopes that companies will soon begin to open Pandora's Box with respect to shareholder rights and engage in a fruitful competition for the most beneficial shareholder rights regime. It is here where we will likely see the traditional UK enabling approach[136] at work.

3. Proportionality and Equality of Shareholders

While the provisions of the Directive are, in many respects, drafted in broad-language terms, and, thus, they vest significant discretion to Member States, the Directive establishes two key rationales which the legislature of the Member States and the European courts are likely to consider when testing the conformity of a national provision with the Shareholder Rights Directive. These are (1) the Principle of Proportionality, and (2) the Principle of Equal Treatment of Shareholders.

a) Principle of proportionality

Even if formal rights are established, procedural details may render any cross-border voting attempts futile. In light of this insight, the Directive requires Proportionality between the procedure required by the company and / or the Member State and the purpose achieved in four respects: shareholder

[135] It is arguable that the UK Companies Act 2006, Schedule 5, by narrowly defining methods of permissible communication between a company and its shareholders, may be too restrictive and needs to be amended accordingly.
[136] See Nolan, *supra*, n. 26.

identification, in particular the proof of qualification as a shareholder;[137] the issue and exercise of proxy voting;[138] restrictions on electronic participation,[139] and vote by mail.

These four dimensions of Proportionality reflect the key objective of the Shareholder Rights Directive which is to ensure that shareholders can obtain access under the least burdensome, hence least costly conditions. Under the Directive, this key rationale governs the overall relationship between Member States and companies, on the one side, and shareholders, on the other side. The proportionality-requirement as an overarching principle also governs these relationship where it is not explicitly stated, for example with respect to information of shareholders. It mandates a legal environment in which information is disseminated and distributed to shareholders as inexpensively and practically as possible. While

> 'a law suit is of little use to a small shareholder. To him an automatic right is worth a thousand lawsuits',[140]

a detailed regulation of identification procedures is either likely to miss important aspects or hamper innovation. Thus, the prospect of issuers to be kept up in litigation over apparently 'un-proportional procedures' reduces incentives to increase costs for foreign shareholders through the implementation of formalities.

b) Equal treatment of shareholders

With respect to rights related to financial participation in the company's profits,[141] take-overs[142] and information that is relevant for the investment

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[137] Article 7 (4) of the Shareholder Rights Directive, *supra*, n. 21.

[138] Article 11 (2) sent. 2 of the Shareholder Rights Directive, *supra*, n. 21.

[139] Article 8 (2) of the Shareholder Rights Directive, *supra*, n. 21.

[140] Berle & Means, *supra*, n. 24, at 161.

[141] Article 42 of the Second Council Directive 77/91/EEC of 13 December 1976 on 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, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent (hereinafter Capital Directive).

[142] Article 3 (1) (a) of Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids.

decision,[143] European law has previously required the company to treat all shareholders within the same position equally. The Shareholder Rights Directive extends the equality-principle to the participation and the exercise of voting rights in the general meeting.[144] As the equality principle is a typical minority right, Article 4 of the Directive limits the management's and the general meeting's power vis-à-vis the **individual shareholders**. A few examples may demonstrate its effect:

- As to information: if the company discloses the numbers of votes cast in advance of the meeting to one shareholder, it has to make these figures available (e.g. on its website) to all shareholders that hold voting rights.
- As to communication: if the company provides for methods of real-time two-way communication between a shareholder and the general meeting, it has to offer the same possibility of electronic participation to any other shareholder who is in the same position. I hold that the characteristics which specify "the same position" may be determined in the Articles of Association, subject to the overarching Principle of Proportionality, as mentioned above. In this regard, the size of shareholdings and language[145] may be acceptable criteria. Distinguishing according to the shareholders' home Member State, however, would constitute a violation of European law.
- As to voting: if the company provides for electronic voting facilities, it has to do so for all shareholders in the same position.

[143] Article 17 (1) of the Transparency Directive, *supra*, n. note **Fehler! Textmarke nicht definiert.**. Though less clear than in Article 17 (1), the same principle could be tracked down to the predecessors of the Transparency Directive, see DA Zetzsche, *Aktionärsinformation in der börsennotierten Aktiengesellschaft,* Heymann, Cologne, (2006), at 283.

[144] Article 4 of the Shareholder Rights Directive, *supra*, n. 21.

[145] Example: A distinction between shareholders who can speak and understand German, French, Slovak etc, hence who can benefit from a real-time translation, and others who may follow the discussion in the original language may be justified.

E. Policy Considerations

1. Procedures: regulatory competition

As to the shareholder meeting itself, two deficiencies of the Directive are identified: (1) With respect to push-information, I criticized that under the Directive regime, active investors will find the information necessary on the corporate website, while investors that are generally passive but willing to vote when voting is easy (hence, inexpensive!) – these likely comprise the bulk of type B-shareholders from the simplified constituency model above – are left out in the cold. (2) With respect to communication, the Directive does not mandate Member States to further inter-shareholder communication in advance of the shareholder meeting, e.g. by providing a platform on a private (e.g. the corporate) website, or an official website, respectively (like Germany's digital Federal Bulletin).

However, the Directive is merely thought to provide a minimum standard for the use of electronic means, and encourages EC Member States to find the ideal ceiling (a maximum standard) for the use of the Internet. Consequently, it effectively hampers a race to the bottom competition while enabling a race to the top approach on shareholder rights. In light of this lopsided legislative approach, further legislative action requires careful reasoning. While it is unlikely that these relatively-minor aspects of the overall corporate legislation which I pointed out above may affect investor decisions of where to incorporate, and where to invest, EC Member States may enter into experiments in order to demonstrate to investors that they are willing and able to adapt to new technological challenges and that they are interested in high voting turnouts. Thus, we may assume that the national legislatures will, in fact, use their discretion to look out for the optimal level of digital involvement of shareholders in the decision making process.

2. Shareholder identification: The need for legislative action

However, there remains one field in which national legislatures are unlikely to succeed: the chain of intermediaries in a cross-border setting.

Let's keep in mind that under our constituency model, the greater the barriers for Group B are, the greater is the influence of type A-shareholders, hence the value of the votes by blockholders and well-organized minority groups (such as activist investors). Certain investors are disfranchised, while others achieve influence that is beyond their economic interest. Let's further keep in mind that companies, and thus indirectly society benefits from good corporate governance; corporate governance is a public good. One would thus presume that solutions to the issue of shareholder identification are imminent.

Unfortunately, such a presumption is not warranted. While **national legislatures** sought to improve the situation, their influence is limited to their national jurisdiction. Supra-national treaties[146] have not yet come to the assistance of foreign shareholders. **Markets** had plenty of time to come up with solutions, and did not do so. At first glance this is surprising, given the said economies of scale in the voting infrastructure. A second glance reduces our level of surprise: neither management nor banks are truly interested in high voting turnouts (and strict shareholder control) from international investors. The former must deal with the different corporate culture of the new investors while the latter must provide the services necessary for voting. Both sides struggle to agree on costly solutions when the benefits of their investments are externalized - a situation that we often find in the context of public goods. Further, consider the path dependency of voting infrastructure that is vested in the legal tradition of 27 EC Member States. Consequently with respect to the identification of shareholders in a custodian chain there is a need for legislative action on the EU level.

Is mandatory action necessary? The Directive indicates that the Commission will put forward recommendations to address the issues within the chain of intermediaries. A Commission-brokered recommendation is, however, insufficient for the very reason that it is non-binding upon the EC Member

[146] See on the efforts of harmonization with respect to international private law The Hague Securities Convention (*Convention on the law applicable to certain rights in respect of Securities Held with an intermediary),* available at http://www.hcch.net/index_en.php?act=conventions.pdf&cid=72 (11 April 2007). Switzerland and the U.S.A. signed the convention on 5 July 2006. UNIDROIT, *Preliminary Draft Convention on Substantive Rules Regarding Intermediated Securities* , available at http://www.unidroit.org/english/publications/proceedings/2006/contents.htm (11 April 2007); UNIDROIT (ed.), ENHANCING LEGAL CERTAINTY OVER INVESTMENT SECURITIES HELD WITH AN INTERMEDIARY, Uniform Law Review, Vol. X, 2005-1/2; UNIDROIT (ed.), *Intermediated Securities* (Study LXXVIII, 2006).

States, and is thus unlikely to overcome said path dependency. Instead, the great need for harmonization would require the most stringent European legal device for the harmonization of law: a Regulation.

3. Four steps towards a smooth shareholder identification

While mandatory law requires specific justification in light of the Anglo-Saxon enabling approach, the practical difficulties associated with the chain of intermediaries provides strong arguments in favour of mandatory law. One may argue that investors can sort out voting issues by contract. However, investors cannot effectively negotiate vis-à-vis their banks, due to collective action problems and the bundling problem. At least retail investors face collective action problems, but institutional investors have not succeeded in amending bank practices either. Bundling problems are particularly severe for institutional investors: voting is just one minor aspect of many services provided by the bank to their clients; other services include stock lending, financing, asset management.

Further, investors have merely contractual relationships with their respective Depository, and typically, neither the investors nor the Depositories know who the intermediaries down the particular custodian chain are through which the investors' shares are held. Consequently, it is virtually impossible for investors to negotiate contracts with all intermediaries in the chain.[147] The reluctance of one intermediary to provide voting support renders all other agreements useless, and the voting chain dysfunctional.

I hold that four measures on the intermediary level are particularly important:

The first aspect pertains to giving investors the chance to exercise their rights by **making sure that all investors receive voting entitlements**. With respect to bearer shares (which nowadays are usually administered in book-entry systems provided by the Depositaries), this includes Depositories' obligation to certify the investors' shareholding, hence voting entitlement; with respect to registered shares, Depositories must make sure that the investor

[147] See Jaap Winter, "The shareholders' rights directive and cross-border voting", Memorandum prepared for European Corporate Governance Forum (June 2006), at 4; Annex to the recommendation of 24 July 2006, available at: <http://ec.europa.eu/internal_market/company/ecgforum/index_de.htm>.

receives a proxy card which entitles the investor to exercise the rights on behalf of the respective nominee. The alternative solution – mandating intermediaries to solicit proxies – is less efficient, given that it doubles the necessary communication: communication must flow up the chain (for the intermediary's solicitation), and down again (for the investor's instruction). As the U.S. example demonstrates, many issues may result from such a two-way communication in the short time-frame preceding shareholder meetings.[148]

While an 'active investors only' approach that benefits type A-shareholders would require Depositories to act only upon request, an approach considering less active investors, hence cost-oriented type B-shareholders, a valuable factor for corporate stability may require Depositories to issue the above voting certificates, or proxy cards, respectively and disseminate them to all investors for every shareholder meeting. In this respect, European corporate governance is facing the Great Divide; which way should be taken must carefully be considered.[149] The possible distortions for European capital markets that I foresee suggest that a pro-active approach is warranted in Europe's struggle for cross-border governance.

Secondly, **prohibit Depositories and banks to charge investors for voting support separately.**[150] As I pointed out above, many investors will not be able to negotiate a market-adequate fee structure. In the absence of such a ban, the additional costs will prevent cost-sensitive shareholders from exercising their rights, and banks will not invest in cost-reducing technologies, due to a lack of mass-scale demand. Cross-border Europe is currently stalemated: without mass-scale demand (and due to the absence of future cash flows from voting), intermediaries do not invest in cross-border voting technology. Without technology, there will be no cross-border voting, hence demand.

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[148] Kahan & Rock, *supra*, n. 131, at 1248 et seq.

[149] With respect to other shareholder rights than voting rights, shareholder canvassing was remarkably successful. Pursuant to Georgeson Shareholders, "Shareholder Canvassing", available at <http://www.georgeson.com/emea/fact_sheets_brochures/Factsheet%209)%20Shareholder%20Canvassing.pdf>, shareholder canvassing increases participation by 10- 12% in non-renounceable rights issues and 10-15% in share purchase plans.

[150] Nolan, *supra*, n. 134, at 90 pp., argues against loading the costs for shareholder identification on issuers.

Please note that the costs of adopting cross-border voting technology are fixed, sunk costs, while the marginal costs of continuing such an organization are low. Once the technology is implemented, ongoing use will be inexpensive. The ban on separate fees prises the current stalemate open. It avoids that the first group of users is required to assume the bulk of the entry costs (which few would do), while the intermediaries would profit from the low marginal cost in hindsight. This is all the more warranted because the demobilization of securities particularly benefits the banks that otherwise were forced to organize paper delivery. European law supports this request. Banks typically refrain from charging domestic investors fees for exercising rights in domestic companies. European law generally prohibits price discrimination of investors based on the investors' origin. In this regard, the Directive on Payment Services (PSD)[151] leads the way. A single 'European Voting Area' would be the logical consequence of the SEPA ("Single Euro Payment Area").

If this ban was implemented we would expect banks to consider the voting costs in their pricing of depository and custody services, subject to restrictions by inter-bank competition. Thereby, voting costs would effectively be socialized. This is consistent with the social good structure of corporate governance. Furthermore, the passive shareholders would subsidize the active shareholders for taking on the burden to vote. The former who are freeriding on the latter's monitoring efforts somewhat compensate the latter for their monitoring work.

Thirdly, **extend the principles of proportionality and equality from the corporate relationship** between the shareholders and the company **to the banking relationship** between the investors and their Depository and all other custodians in the intermediary chain. This is necessary since both management and banks are not keen on giving shareholders lenient ways to vote. The said principles provide shareholders with a legal perspective for taking action against their banks, or the companies, respectively.

[151] Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC. O.J. *L 319/1 (5 December 2007).*

Fourthly, **companies, custodians and Depositories as well as representatives of institutional investors must be encouraged to negotiate technical standards and technological advancements regarding shareholder identification and shareholder voting platforms on a regularly basis**. From the perspective of issuers and banks, voting is a (costly) technicality. Mass scale cross-border voting should run as smoothly as the mass scale cross-border stock trades that we observe today. In order to identify economies of scale and scope tri-party negotiations brokered under the hospice of the European Commission may assist the transfer of know-how between the users of the voting platforms and the two parties with the best information as to the details of the voting chain.

The remaining details of the voting can be worked out by the market. When, under the preconditions set out herein, mass scale voting becomes a routine matter, the said economies of scale in the market for voting infrastructure will drive the voting process towards efficiency.

F. Conclusion

The costs of voting comprise information costs, decision-making costs and procedural costs. In contrast to an opinion widely shared among law & economics scholars, the information costs for informed voting are negligible for institutional investors, given that the law already requires institutional investors to research and analyse all information for their investment decision. Instead, this paper holds that the costs for the technical process of voting are likely to constitute the bulk of the voting costs. These costs drive some institutional shareholders that would generally be inclined to vote towards passivity.

For cross-border voting the Shareholder Rights Directive seeks to lessen these procedural costs. While the details remain in the jurisdiction of the Member States and / or the companies, the Directive establishes basic principles with respect to the identification of shareholders, information, communication and voting. Further, it reduces the costs for cross-border voting through the harmonization of certain rules as well as through the mandatory use of webbased technologies. As some shareholders are attentive to voting costs, we may reasonably expect cross-border turnouts at shareholder meetings in Europe to rise following the implementation of the Shareholder Rights Directive. Thus, the Shareholder Rights Directive is a step into the right direction.

However, the Shareholder Rights Directive fails to achieve its purpose with respect to one significant aspect of procedure which is the identification and authorization of shareholders at the level of the custodian chain of intermediaries. In this respect market forces have failed to achieve a smooth cross-border voting process. Four steps are necessary. These include: (1) Mandate banks to issue certificates of voting entitlements to all non-intermediary account holders; (2) Prohibit separate fees charged by intermediaries to investors for voting support; (3) Extend the principles of proportionality and equality from the corporate relationship between the shareholders and the company to the banking relationship between the investors and their Depository and all other custodians in the intermediary chain, and (4) encourage regular discussions among interested parties as to how voting platforms could be made more efficient.