The City of London Law Society

4 College Hill
London EC4R 2RB

Tel +44 (0)20 7329 2173
Fax +44 (0)20 7329 2190
DX 98936 – Cheapside 2

mail@citysolicitors.org.uk

www.citysolicitors.org.uk

European Securities and Markets Authority: Call for evidence on empty voting

The City of London Law Society (CLLS) represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees and in this case the response has been prepared by a working party of the CLLS Company Law Committee comprising senior and specialist corporate lawyers.

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Question 1: Please identify the different types of empty voting practices and the frequency with which you think they occur within the EU. Where possible, please provide data supporting your response.

We wish to comment on the examples of empty voting situations given in the Call for evidence.

The first example is an investor who borrows shares in order to vote at a general meeting of shareholders. The Call for evidence states that "his economic exposure does not correspond to the voting power he holds and he is not exposed to the long-term economic risk relating to the shares". This situation can be compared with that of a shareholder who has not borrowed shares but is intending to sell the shares he holds shortly after the general meeting takes place. Such a shareholder also does not have a long-term economic interest relating to the shares. The differentiating factor is that, in the latter case, the price at which the shares will be sold will reflect the outcome of the vote, whereas in the former it is unlikely to be affected by the outcome.

In the second example, an investor votes at a general meeting of shareholders even though he has sold his shares after the record date. In the UK, an investor who has sold shares after the record date is required, until it ceases to be the registered holder of the shares, to vote the shares sold in accordance with the instructions of the

purchaser of the shares if the purchaser gives instructions. We think that voting in such circumstances is appropriate and should not be considered empty voting.

Drawing on the above, we think that the description "empty voting" should be confined to cases where a shareholder votes shares when he:

(i) does not have any material economic interest in the shares at the time the vote is exercised; and

(ii) is voting other than (x) in accordance with the instructions of the person who does have that economic interest or who is entitled to give instructions as to voting the shares and (y) where the person who has the economic interest or who is entitled to give instructions as to voting the shares is aware of the way the vote is being exercised and does not take action to require the shareholder to change that vote.

We believe that identified examples of empty voting in the UK in recent years have been very rare indeed. We believe it is likely that listed issuers would raise any concerns they have that empty voting is affecting the outcome of resolutions so, in the absence of many publicised examples, we do not believe there is cause to assume that this has been a frequent problem. This may partly be because of the increased publicity that has been given to the desirability of institutions that lend shares calling those shares back so they can vote them at a general meeting. The Securities Lending: Agent Disclosure Code of Guidance (September 2010) includes guidance that the Lending Agent should discuss the lender's policy on voting and the potential impact as a result of a securities lending programme and the timelines needed to recall a security in order to maintain voting rights. The Securities Borrowing and Lending Code of Guidance issued by the Securities Lending and Repo Committee in July 2009 also explains that a lender must recall securities to vote them and says it is in the interests of both parties to understand each other's attitudes to voting from the outset. It also says there is a consensus in the market that securities should not be borrowed solely for the purpose of exercising the voting rights at a general meeting. It says lenders should consider their corporate governance responsibilities before lending stock over a period in which a general meeting is expected to be held and that beneficial owners need to ensure that agents responsible for voting and for securities lending act in a co-ordinated way.

In the Investment Management Association's Survey of Fund Managers' Engagement with Companies for the two years ended 30 June 2008, Table 17 looks at how stock lending is undertaken. Six firms did not do any stock lending and six firms said they anticipated contentious votes and blocked lending. 20 firms recalled lent stock when the resolution was contentious and certain other criteria applied. Under the Stewardship Code institutional investors should have a clear policy on voting and disclosure of voting activity.

Question 2: Please identify specific examples where empty voting practices have occurred within the EU. Where possible, please provide data supporting your response.

We have not been able to identify any specific examples where members of the committee have been involved since the adoption of the Codes of Guidance referred to in answer to Question 1 above.

Question 3:

(a) What in your view are the negative consequences that can occur as a result of empty voting (relating to e.g. transparency, corporate governance, market abuse)?

(b) To what extent do you consider those consequences to occur in practice?

(c) To what extent have you encountered those consequences in your own experience?

Where possible, please provide data supporting your response.

In the UK, the rules that implement the Transparency Directive requirements on notification of interests in voting rights above certain thresholds do not require a person who is entitled to exercise voting rights to disclose if they do not hold the economic rights attaching to those shares.

Where a shareholder with no economic interest in a company votes its shares it may (but will not necessarily) affect the outcome of a vote e.g. if it has a large enough shareholding to prevent a resolution being passed which would otherwise have been passed or vice versa. This may affect the company's long-term strategy e.g. where it prevents a particular action taking place. However, although the call for evidence states that "empty voting may result in a situation where an investor votes against the interest of the company and/or its other shareholders without or at minimum financial exposure in order to further its own interests", under UK law a shareholder is not generally under any duty (under common law, statute or other regulatory requirements) to vote their shares in the best interests of the company. They may chose to vote as they wish, subject only to any fiduciary duties, if they are holding the shares for another person, to act in that person's interests. Therefore, it is, entirely possible that shareholders who do have an economic interest in the company may take the same action as those that do not.

We understand that the law as to how a shareholder should vote and the considerations that should be taken into account differs between Member States. This should be taken into account before ESMA decides on any regulatory action.

We are not convinced that empty voting necessarily has a negative effect on corporate governance – which we understand to be both the processes the company applies to manage the business at board level and to report to shareholders on that management. We can see that, where shareholders have different views as to action the company should take, this may make it difficult for directors to promote an action that they

consider is in the best interests of shareholders, but this can also arise with shareholders with full economic interests.

We also do not believe that empty voting necessarily involves market abuse, although it is arguable that in some cases it does so. We think it is inherent in the concept of market abuse that the relevant behaviour falls below the standard reasonably expected in the market. In countries where shareholders may vote as they wish we think it is only in extreme cases that voting shares will constitute market abuse where either

(i) the shareholder has no economic interest in the company and is voting other than in accordance with instructions or where the person entitled to give instructions has acquiesced; or

(ii) the shareholder's economic interest in the shares it is voting is affected by some other interest the shareholder has, such as a derivative.

In such cases, market abuse will usually occur in conjunction with a wider pattern of behaviour. For example, if shares are used to vote down a resolution in conjunction with taking a larger short position that benefits from the failed vote – but only where the proposed exercise of the vote was both in itself price sensitive and undisclosed when taking the short position. Even here, any abusive market manipulation is in the execution of the short position rather than the exercise of votes. We think it is important, in such cases, that there is clear guidance as to how to determine the dividing line between behaviour which is acceptable and behaviour which is not.

Question 4:

(a) Do you believe that empty voting has influenced the results of voting at the general meeting of shareholders within the EU?

(b) Has this ever occurred in your own experience?

Where possible, please provide data supporting your response (including the type of empty voting that you are referring to).

We have not been able to identify any specific examples where members of the committee have been involved since the adoption of the Codes of Guidance referred to in the answer to Question 1 above.

Question 5: What kind of internal policies, if any, do you have governing the exercise of voting rights in respect of securities held as collateral or as a hedge against positions with another counterparty?

This committee is not a market participant, but notes the industry guidelines referred to in answer to Question 1 above. We also refer to the HFSB Standards[1] which make best practice recommendations to hedge fund managers against borrowing stock to vote.

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[1] [1] http://www.hfsb.org/files/final_standards_21_jan.pdf

Question 6: Do you think that regulatory action is needed and justifiable in cost-benefit terms? If so, which type of empty voting should be addressed and what are the potential options that could be used to do this? Please provide reasons for your answer. Kindly also provide an estimate of the associated costs and benefits in case of any proposed regulatory action.

On the basis of our experience and in view of the industry guidelines referred to in answer to Question 1 above, we are not persuaded that regulatory action is justified. We are concerned that, if regulatory action is proposed, there is a real risk that it would also constrain legitimate actions and behaviours. We therefore think it is extremely important that ESMA should identify more precisely the behaviour that causes a problem, identify why it is a problem and the best way to tackle the problem, before proposing any regulatory measure. We believe that it is likely to be most appropriate to use the market abuse regime to target any unacceptable behaviour, to deal with situations which occur relatively infrequently, are fact-specific and require judgement to determine whether the behaviour falls below acceptable standards.

We note that, in some cases, the perceived victims of empty voting have the ability to control the situation: if stock is lent and is then voted in a way that adversely affects a long-term holder, the lender may have created the problem for itself. We would therefore recommend reinforcing guidance for those involved in stock lending and the various initiatives to improve corporate governance, particularly those intended to encourage shareholders to vote the shares they hold.

If ESMA does decide to take action in relation to "empty voting", we think it will need to take into account the fact that there may be some difficulty in practice in determining when a vote should be treated as being exercised. Although a record date is set before the date of the meeting, in the UK a shareholder can appoint a proxy before the record date, who can be directed how to vote or given discretion, although the shareholder may revoke the proxy either by notice to the company or by attending the meeting in person.

Date: 24 November 2011