Brussels, 29 June 2006

Submission to the Working Group of the European Parliament on the proposed Shareholders' Rights Directive

Background to Hermes

Hermes Investment Management Limited ("Hermes") is owned by, and is the principal fund manager for, the BT (British Telecom) Pension Scheme, the UK's largest. Hermes also manages portfolios for over 200 other clients including many major pension schemes. In total, Hermes manages approximately €95 billion (31 March 2006). As part of its Equity Ownership Services (EOS), Hermes also advises clients on responsible ownership and corporate governance matters in respect of a further €13 billion (31 March 2006).

Hermes is an acknowledged global leader in the field of corporate governance and shareholder responsibility. We actively exercise our clients' rights and responsibilities as share owners worldwide, which includes voting at general meetings of portfolio companies and engaging with selected companies throughout the year to promote long term value and to preserve good company relationships with employees, suppliers, customers and the wider environment. We also get involved in the development of policy and best practice at the global and national level.

We are grateful for today's opportunity to present our views on the proposed Shareholders' Rights Directive ("the Directive") to the working group of the European Parliament. In section 1. of this submission, we consider the scope of the proposed Directive and comment on the wider EU corporate governance and company law reform agenda. In section 2. we make comments on selected articles of the proposed Directive.

1. Scope of the proposed Shareholders' Rights Directive and the wider EU corporate governance and company law reform agenda

We congratulate the Commission for the recently introduced Recommendations on non-executive directors and remuneration, for setting up the European Corporate Governance Forum and the Advisory Group on Corporate Governance and Company Law and for pushing forward the proposed Directive. We welcome the European Parliament's support for the Directive. In our view, the implementation of the short term measures set out in the Commission's Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward ("the Action Plan") of 2003 has been successful.

Scope of the Directive

The proposed Directive would serve a vital role in setting a positive context for the active involvement of shareholders in ensuring that companies and their

boards are accountable. As such, we have submitted two detailed responses during the Commission's consultation on the Directive, which are available on our website (www.hermes.co.uk). We welcome the proposed Directive, which deals with many of the most urgent issues, such as:

- the abolition of share-blocking;
- the provision of a sensible time frame for convening a general meeting; and
- the introduction of the right to add items to the agenda of a general meeting.

We generally consider the scope of the proposed Directive as appropriate, particularly given the objective of a timely transformation into the law of the Member States. However, there are a number of articles that would benefit from some fine tuning fully to achieve the desired benefits. We consider these in detail in section 2. of this submission. Before doing so, we would like to take this opportunity to make a few comments on the wider EU corporate governance and company law reform agenda.

The wider EU corporate governance and company law reform agenda

Given that the medium and long term measures discussed in the Action Plan would involve more far reaching intervention in the regulatory framework in place in the Member States, we believe that there should be very careful consideration and analysis before any new legislative initiatives are undertaken at the EU level. Both companies and investors need time to digest the significant number of new EU rules adopted over the last few years. As such, we found the Commission's recent consultation on future priorities for the Action Plan on modernising company law and enhancing corporate governance in the European Union useful and timely. In a letter dated 28 March 2006, we set out a detailed response to each of the questions raised in the consultation (available at: www.hermes.co.uk). We also participated in the public hearing that followed the consultation. We consider the following issues raised in the consultation document as particularly important:

(i) One share-one vote

We believe that generally each ordinary share should carry one vote. The principle of 'one share-one vote' ensures proportionality between equity ownership, and thus economic risk bearing, and voting power. In our view, companies should be required to disclose and justify any divergence from the 'one share-one-vote' principle, because it concentrates voting power in the hands of certain shareholders irrespective of their equity ownership.

To produce empirical evidence that may convince companies that ultimately adherence to the 'one share-one vote' principle is in their interest, we support the Commission's proposal for an in-depth study of the efficiency effects of asymmetries between ownership and control rights. In our view, the study should cover not only the effect of shares with multiple voting rights, but all other forms of voting right distortions, including voting right limitations. It would be important that the study contains a thorough analysis of the pros and cons

of mechanisms such as double voting rights and voting right limitations which may help to identify the real issues that need to be addressed. The study should also investigate the issues that arise and the mechanisms that are used in different Member States when companies where voting right distortions exist move towards the 'one-share, one-vote' principle. Once the study is completed, there should be a consultation on the best way forward to tackle this important issue.

(ii) Nomination, election and removal of directors

The involvement of shareholders in the nomination, election and removal of directors is fundamental in holding the board of directors to account. The involvement of shareholders differs significantly between the Member States following local law and practice. We recognise that depending on the financial and legal environment different practices may be appropriate in specific Member States. However, we believe that the Commission should promote the over-riding principle of the accountability of directors to shareholders which would normally require that:

- shareholders with a certain proportion of the nominal share capital should be able to participate in the nomination of directors, for example, by proposing suitable candidates;

- directors should be elected and re-elected separately (that is, shareholders should be in a position to vote for, against or withhold their vote on each individual nominee);

- all directors should regularly stand for re-election (normally, at least some of the directors should be submitted for re-election every year);

- shareholders should be able to vote for the removal of directors (and shareholders with a certain proportion of the share capital should be able to propose the removal of individual directors);

- election, re-election and removal of directors should require a simple majority of the votes at the general meeting.

(iii) Shareholder co-operation/concert party action

We believe that shareholders should be allowed to co-operate and co-ordinate their actions without being obliged to disclose their aggregated shareholdings or to make a mandatory bid, as long as they are not seeking control of the relevant company. The law of certain Member States addresses co-operation between shareholders without clearly distinguishing between co-operation with the objective of gaining control of a company and co-operation aimed at developing and communicating a common message to a company. The legal uncertainty in respect of "concert party action" in Germany, for example, currently discourages institutional investors from communicating with each other regarding corporate governance matters and if appropriate

from getting involved, thus preventing them from meeting effectively their responsibilities as owners.

We believe that the Commission should clarify this area of the law across the EU by providing at least a common framework that provides legal certainty. In particular, we believe that there should be an explicit safe harbour for shareholders sharing information or discussing their views on corporate governance issues, particularly regarding forthcoming voting matters and subsequently acting together, including co-ordinated voting in respect of particular resolutions, provided they are not doing so with a view to gaining control. It may be that readily accessible and clear rules across the EU in this area may best be implemented by a binding instrument.

In addition to these issues, which were raised in the consultation document, we would encourage the Commission to consider in the near future the following issues, which are of great importance to companies and investors:

(a) Stock lending

There has been a growing concern regarding stock lending and its impact on the governance of companies over the past few years. We were involved in drafting the recently issued principles of the International Corporate Governance Network (ICGN) in this area, which identify best practice for the investor community, both lenders and borrowers (available at www.icgn.org). We would encourage the Commission to undertake a thorough study of the impact of stock lending on European capital markets. In particular, this study should seek to quantify the effect that the timing of dividend payments around the time of general meetings has on stock lending and consequently voting of shares. If there is sufficient evidence that the timing of dividend payments around the time of the general meeting has or may have detrimental effects regarding the governance of companies, we would encourage the Commission to consider introducing a rule requiring a clear separation of the timing of dividend payments and general meetings. The Commission should also consider mechanisms to address the problems that may arise when shares are borrowed for the purpose of voting. Although stock lending should remain the object of private contract between the parties involved, we believe the Commission should seek to establish European-wide best practice by providing some guidance or principles in the form of a Recommendation or an interpretation of the Market Abuse Directive, which might, for example, build upon the ICGN principles, which we endorse.

(b) Right to call extraordinary general meetings

The requirements attached to the right of a shareholder or a group of shareholders to call an extraordinary general meeting vary significantly between Member States. For example, in some countries a five per cent holding is sufficient to call a general meeting, whereas in other countries as much as 20 per cent is required. Such divergence in requirements creates confusion and legal uncertainty and thus disturbs the free movement of capital in the EU. We would urge the Commission to set a common standard that

would enable a shareholder or a group of shareholders holding ten per cent of a company's capital to call a general meeting, wherever it is domiciled. Member States should be able to adopt a lower share ownership threshold, if desired.

(c) Communication of information

We believe that the Commission should undertake a thorough study of the problems that the beneficial owners of companies face in exercising their rights as a result of inadequate communication of issuer information along the custodian chain where equity shares are held by an intermediary. This issue is not addressed in the proposed Directive. We understand that there is a proposal to amend article 13 of the Directive, discussed in section 2., which if taken on board would go some way to address the underlying problem. As an additional measure, we believe that setting out best practice in Europe in a Recommendation would provide useful guidance and encouragement to those Member States where the existing regulatory framework needs to be adapted to accommodate modern forms of intermediated shareholding.

2. Comments on selected articles of the proposed Shareholder Rights Directive

Our comments relate to the Commission's proposal of 5 January 2006. We have also seen an early version of the Presidency's compromise proposal and we refer to this where appropriate.

Article 2: Definition of Shareholder

We welcome the definition of "shareholder" in the Presidency's compromise proposal, which is based on the applicable law in each Member State. Harmonisation of the legal rules on share ownership applicable in the Member States requires much further thought and preparation and is clearly beyond the scope of the Directive. We look forward to the results of the ongoing work of the Legal Certainty Group and UNIDROIT on the difficult issues in this area.

Article 5 (1): Convocation of the general meeting

We were concerned about the convening notice of 30 calendar days before the meeting which the Commission proposed. In the UK, there are different notice periods for annual general meetings (21 days) and extraordinary general meetings (14 days). The latter are called at shorter notice to take decisions on important and urgent company business, such as takeovers and raising capital through share issues. A 30 day minimum notice period has at least the potential to unduly delay urgent decisions and significantly to increase the underwriting costs of share issues. For voting in the UK, the shorter notice period for extraordinary general meetings has thus proved efficient and cost effective. We value highly the right to be consulted by the management of companies on important company business. As both regulators and companies are likely to be concerned about possible delays to

and costs in respect of important and urgent company matters, a 30 day minimum notice period would potentially be counterproductive, as it may discourage systems that require the consultation of shareholders on important company business.

However, we recognise and know from our own experience that in the cross border context it would be very difficult for shareholders to obtain and process voting relevant information and communicate instructions to proxies in less than three weeks. As such, we welcome the reduction of the convening notice to 20 clear calendar days proposed in the Presidency's compromise proposal.

Article 7 (3): Admission to the general meeting

We welcome the abolition of any condition requiring shareholders to block their shares, whether or not this has an effect on the possibility of trading the shares. There is already evidence from Germany, where shareblocking was abolished last year, that this may lead to higher participation at general meetings and therefore to greater accountability of boards to shareholders. As for the record date, on balance, particularly in the interest of legal clarity, we support a single record date for each Member State rather than allowing companies to set their own. In terms of the discretion of Member States to set the record date, we strongly believe that it should be limited so as to ensure that there is a sufficient time period after the meeting is called in order to allow institutional investors to recall shares on loan.

From our experience, we would strongly recommend that there should be at least **ten** clear calendar days between the day of the convocation of the meeting and the record date. This is to allow shareholders to obtain and process relevant information and if necessary to communicate with the company before deciding whether to recall shares from loan.

To reduce the possibility that votes are exercised by a former rather than a current investor, following the sale of shares after the record date, we believe that the record date should not be set too far ahead of the meeting. However, what this means in a particular Member State may depend on local rules and practice and as such there should be flexibility on this point.

Article 9: Right to ask questions ahead of and at the general meeting

We believe that it is useful to distinguish between the right to ask questions ahead of the general meeting and the right to ask questions at the general meeting. We therefore discuss these rights separately.

<u>Right to ask questions at the general meeting</u>

The experience at general meetings in Germany, where a small number of shareholders make lengthy contributions and ask catalogues of questions – often unrelated to items on the agenda - makes it clear that both the right to speak and the right to ask questions at the general meeting need to be restricted in some way. A first step is to restrict the right to ask questions only relating to items on the agenda. Naturally, the company should be allowed to refuse answers to questions where this is necessary to protect confidentiality

or its business interests. However, there may be cases where the application of these filters does not allow an orderly conduct and finish of a general meeting.

In the UK, the chairman of the general meeting enjoys much discretion in respect of procedural aspects of the meeting. In particular, together with the shareholders present at the meeting, he may decide to restrict contributions from speakers including questions. This system has worked well in practice. Clearly, there are very different traditions and practices in Europe, but it seems to us that a system which provides the chairman of the meeting with some discretion as to the time a shareholder is allowed to speak and ask questions is the best approach to address the issue. We note that this is the approach which has recently been adopted in German law to address the potential for abuse of the right to speak and ask questions at general meetings. It will be instructive to see how the discretion will be used by chairmen going forward in cases where the right to ask questions is abused.

We believe that shareholders should have a right to speak and ask questions at the general meeting. If this right proves problematic in practice in certain Member States, as it has for example in Germany, a framework should be provided at the national level that allows the chairman at the general meeting to restrict contributions, including questions. There should be safeguards to ensure that the right to ask questions and to receive answers to them cannot be used in a way that through legal challenges may lead to unduly delay of the implementation of corporate measures. Again, we believe that the abuse of the right to ask questions, which only seems to be a problem in Germany at present, should be handled at the national and not the EU level.

Right to ask questions ahead of the general meeting

In the cross border voting context, the right to ask questions ahead of the general meeting is generally more relevant than the right to ask questions at the general meeting. However, on occasions - particularly where important issues are at stake, or a company has not satisfactorily answered questions asked ahead of a general meeting - we and other institutional investors use our right to speak and ask questions at general meetings in Member States other than the UK. Therefore, all Member States should provide shareholders with the right to speak and ask questions at general meetings.

(i) Qualifications and time frame

It is appropriate in our view to specify that questions asked ahead of the general meeting must relate to items on the agenda. We believe that the right should be understood as a means for shareholders to gather information for their voting decisions regarding the items on the agenda. If one accepts this proposition, then it follows that such a right only makes sense in a framework which ensures that shareholders receive answers to their questions before they have to submit their voting instructions. In a cross border voting context - involving a chain of intermediaries - this would generally mean that questions should be asked and answered well ahead of the date of the general meeting, probably in the period between the convocation of the general meeting and

the record date. A right framed in this way and subject to the same qualifications as the right to ask questions at the general meeting would encourage a dialogue between companies and investors on controversial issues.

(ii) Benefits and burdens

It is difficult and time consuming in a cross border voting context to gather and make sense of relevant information before the exercise of voting rights. In our experience, the information we require is not always made available in time to inform our voting decision, even though the questions we ask companies ahead of general meetings are generally on standard issues directly relating to agenda items, such as dividend policy, election of directors and executive remuneration.

As such, the right to ask questions ahead of the general meeting in respect of agenda items would greatly facilitate and improve the voting by foreign institutional investors. Moreover, much of this information should be made available to shareholders when the general meeting is called. Many of the questions that shareholders are likely to ask ahead of the general meeting could therefore be dealt with by referring investors to information that in most cases could and should be made available when the agenda is published.

We acknowledge that a right to ask questions ahead of the general meeting would put an extra burden on companies during this period. However, this would be offset at least partly by a reduction of the questions that need to be answered at general meetings, as the chairman could simply refer to answers published ahead of the general meeting. In addition, the company would generally have more time to answer questions than during a general meeting.

We would also argue that the right to ask questions ahead of the general meeting is less susceptible to abuse by frivolous shareholders than the right to ask questions at the general meeting, because they would lack a stage for their actions. If, however, the right is used extensively by shareholders, the published answers would allow the chairman to rein in investors whose main objective is to disturb the orderly conduct of general meetings by asking the same or similar questions again. As a last resort, one could consider setting a limit on the number of questions each shareholder can ask in respect of items on the agenda. However, the appropriate measures should be taken at the national level.

<u>Limitation of the right to investors with a certain shareholding</u>

We are aware of a proposal that is currently discussed which would restrict the right to ask questions outside the general meeting to investors with a certain shareholding. We understand that this right would not be limited to a period prior to the general meeting. We are deeply concerned about this proposal. To begin with, such a right may be in conflict with legal principles in certain Member States which require equal treatment of shareholders. In addition, any particular shareholding threshold would be arbitrary and may be too high or too low in the particular circumstances of a company. Moreover, there are practical difficulties in proving and verifying ownership at the

relevant time. Furthermore, the legal implications of the answers to questions asked under such rule may hamper rather than further a constructive dialogue between the company and its shareholders. From the company's perspective, it may require ad hoc announcements on a continuous basis. Most importantly, however, a right that is only available to an investor with a significant shareholding seems counterproductive, as it implicitly suggests that a company does not need to answer the questions of shareholders that do not meet the holding requirement. In our view, it is unhelpful to formalise the contact between companies and their shareholders during the year. We are thus firmly against restricting the right to ask questions ahead of the general meeting in the proposed way.

Article 13: Removal of certain impediments to the effective exercise of voting rights

We are aware and strongly supportive of the objective of a proposed amendment to article 13, which would impose an obligation on professional intermediaries to facilitate the exercise of voting rights attached to the shares held by them on behalf of the natural or legal person for the account of whom the shares are held. We would recommend some wording in the amendment which makes it clear that the decision on how to exercise the voting rights ought to vest with the natural or legal person who is the ultimate beneficiary.

We are grateful for today's opportunity to present our views on the proposed Directive to the working group of the European Parliament and remain at your disposal for further discussion of any of the points raised in this submission.

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