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## SUPRANATIONAL REGULATION OF EXERCISING SHAREHOLDERS' RIGHTS IN INDIRECT HOLDING SYSTEMS

*The author focuses exercising rights attached to indirectly held shares. The paper discusses the current state of the supranational regulation in this field and proposes some necessary improvements in order to achieve a better protection of indirect investors. It begins with a brief elaboration of the nature and structure of indirect holding systems in the cross border context. The main problems of enabling indirect investors' influence on the way shareholders' rights are exercised by the intermediary are also analysed. The author argues that these problems should be tackled on a supranational level, which has been done in the EC Shareholders' Rights Directive and the UNIDROIT Geneva Securities Convention. The core part of the paper contains a detailed analysis of the relevant provisions in these two documents and points out their limitations. It shows that the achieved level of harmonisation or unification is insufficient to protect indirect investors, which is why these issues are in need of further supranational regulatory attention.*

Key words: *Shareholders' rights. Intermediary. Indirect investor. Account holder. EC Shareholder' Rights Directive. UNIDROIT Geneva Securities Convention.*

### 1. INTRODUCTION

Investing in company shares is nowadays becoming increasingly cross-border.<sup>1</sup> For many reasons the cross-border investment is com-

<sup>1</sup> I. Gómez Sancha Trueba, "Indirect holdings of securities and exercise of share holder rights (a Spanish perspective)", *Capital Markets Law Journal* 1/2008, 33. Some research shows that 30% of shares in listed companies in the EU are held by foreign investors. See U. Noack, "Die Aktionärsrechte Richtlinie", 2008, <http://papers.ssrn.com/>

monly held indirectly, usually through a chain of two or more intermediaries.<sup>2</sup> However, indirect holding of shares means that the direct relationship between the investor and the company is lost. Instead, the status of a shareholder (as the person who has legal title to shares) belongs to the last intermediary in the chain – the one that is closest to the company and furthest from the investor. In such circumstances, the indirect investor can only influence the way in which the rights attached to shares are exercised, if the shareholder (i.e. intermediary) puts into effect his/her respective instructions, or authorises him/her to personally exercise shareholders' rights (as a proxy or a nominee).

Unfortunately, national company law can sometimes prevent the intermediary, who is acting as a shareholder on behalf of others, from enabling indirect investors to influence accordingly the way shareholders' rights are exercised. Additionally, inadequate national capital market regulation can result in lack of incentives for intermediaries to engage in exercising shareholders' rights in their clients' best interests. Hence, in order to stimulate cross-border investment there have been several supranational regulatory attempts to remove national barriers to the efficient enfranchisement of indirect investors, namely the EC Shareholders' Rights Directive and the UNIDROIT Geneva Securities Convention. Apart from that, preparations are currently under way for dealing with these issues in the forthcoming EC Securities Law Directive.

This paper discusses the current state of supranational regulation in this field and proposes some necessary improvements in order to achieve better protection of indirect investors.

## 2. INDIRECT HOLDING OF SHARES

Indirect holding systems have been developed in many countries worldwide and have become typical for cross-border investment in shares.<sup>3</sup> The expression 'indirect holding of shares' means that the inves-

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*sol3/papers.cfm?abstract\_id=1138735*, last visited 5 September 2011, 2-3; cf. D. Zetsche, "Shareholder Passivity, Cross Border Voting and the Shareholder Rights Directive", 2008, <http://ssrn.com/abstract=1120915>, last visited 10 December 2011, 2.

<sup>2</sup> See Final Report of the High Level Group of Company Law Experts, 2002, 53; M.M. Siems, "The Case against Harmonisation of Shareholder Rights", *European Business Organization Law Review* 4/2005, 541; R.C. Nolan, "Shareholder Rights in Britain", *European Business Organization Law Review* 2/2006a, 551; I. Gómez Sancha Trueba, 33.

<sup>3</sup> This development was caused by the need for proper functioning of capital markets, as well as the need for more efficient, cost effective and simplified cross border trade in shares. See M.M. Siems, *Convergence in Shareholder Law*, Cambridge University Press, Cambridge 2008, 142; E. Wymeersch, "Shareholder(s) matter(s)", *Festschrift für Klaus J. Hopt: Unternehmen, Markt und Verantwortung* (Hrsg. Stefan Grundmann et al.), Band 1, De Gruyter, Berlin New York 2010, 1567.

tor is holding shares not directly but via the intermediary who is registered as a shareholder in the shareholder register and has an obligation to safeguard and administer these shares on behalf of the investor as its client.<sup>4</sup> As a result, in the indirect holding of shares the investor stays hidden behind his intermediary and remains anonymous to the company (the issuer of shares).<sup>5</sup> Consequently, the indirect holding leads to the loss of a direct relationship between the company and the investor.<sup>6</sup>

In the simplest scenario, there are only three persons involved in the indirect holding: 1. the company (the issuer of shares), 2. the intermediary (the registered shareholder or the formal shareholder), and 3. the investor (the real shareholder or the indirect investor).<sup>7</sup> In practice, however, especially in the cross-border situations, the indirect holding structures tend to be more complicated, since intermediation is often multi-tiered, so that two or more intermediaries are interposed between the company and the indirect investor (i.e. the ultimate account holder or the underlying beneficiary).<sup>8</sup> In addition to that, indirect holding is commonly organised on a pooled basis, where one intermediary takes up the position of a formal shareholder on behalf of its many clients.<sup>9</sup> This, of course, further separates the investor from the company and makes the identification of persons on whose behalf shareholders' rights are exercised even more difficult.

### 3. EXERCISING RIGHTS ATTACHED TO INDIRECTLY HELD SHARES IDENTIFYING PROBLEMS

Indirect holding of shares induces specific problems with regard to exercising shareholders' rights. On the one hand, the intermediary as the

<sup>4</sup> Cf. F.J. Garcimartín Alférez, "The UNIDROIT Project on Intermediated Securities: Direct and Indirect Holding Systems", *InDret Revista para el análisis del derecho* 1/2006, Barcelona, <http://www.raco.cat/index.php/InDret/article/view/80981/105453>, last visited 8 July 2011, 3; cf. Er. Johansson, *Property Rights in Investment Securities and the Doctrine of Specificity*, Springer Verlag, Berlin Heidelberg 2009, 43; cf. P.E. Masouros, "Is the EU Taking Shareholder Rights Seriously?: An Essay on the Impotence of Shareholdership in Corporate Europe", *European Company Law* 5/2010, 196.

<sup>5</sup> Cf. M.M. Siems, (2008), 142; cf. I. Gómez Sancha Trueba, 39.

<sup>6</sup> E. Wymeersch, 1567; M. Ooi, *Shares and other securities in the conflict of laws*, Oxford University Press, New York 2003, 48.

<sup>7</sup> For definition of the term 'indirect investor', see R.C. Nolan, (2006a), 552.

<sup>8</sup> Cf. R.C. Nolan, (2006a), 551; cf. E. Johansson, 44; Final Report of the High Level Group of Company Law Experts, 2002, 53; Final report of the Expert Group on Cross Border Voting in Europe, August 2002, 18; P.E. Masouros, 196.

<sup>9</sup> L. Gullifer, "Ownership of Securities: The Problems Caused by Intermediation", *Intermediated Securities: Legal Problems and Practical Issues* (eds. L. Gullifer, J. Payne), Hart Publishing, Oxford Portland (Oregon) 2010, 12; cf. Final report of the Expert Group on Cross Border Voting in Europe, August 2002, 18.

registered shareholder is the only person entitled to all the powers and privileges attaching to shares, although it does not bear any economic risk regarding those shares.<sup>10</sup> Therefore, any potential damage caused by its way of exercising shareholders' rights only affects the real shareholder as the indirect stakeholder of the company. Furthermore, the intermediary does not have any economic incentives to exercise shareholders' rights responsibly or to efficiently control the management, since all the potential benefits thereof are accrued to the indirect investor.<sup>11</sup> On the other hand, the indirect investor does not appear on the shareholder register, and hence has no rights against the company,<sup>12</sup> even though he does indeed have adequate economic incentives to responsibly exercise shareholders' rights.<sup>13</sup> All this leads to the conclusion that indirect investors should be enabled to exercise shareholders' rights or at least influence the way these are exercised, whereas intermediaries should be prevented from using (or in fact, misusing) these rights in their own personal interest.<sup>14</sup>

The problem of exercising rights attached to indirectly held shares does not equally apply to all kinds of shareholders' rights. In this respect, rights attached to shares can be roughly divided into three categories:<sup>15</sup>

1. *'Mandatory' rights*: shareholders can only accept legal consequences of a certain corporate action (for example, to receive payments of declared dividends).

2. *'Discretionary' rights*: shareholders can choose whether to exercise certain rights or to take up certain obligations with regard to a specific corporate action (for example, to exercise pre-emptive rights in connection with a given share issue).

3. *'Voluntary' rights*: shareholders are free to initiate a certain corporate action (for example, to propose convening an extraordinary general meeting).

Only the last two categories are in need of specific regulation since they encompass the right to choose whether or how to exercise rights against the company. Conversely, consequences of mandatory rights

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<sup>10</sup> R.C. Nolan, (2006a), 570; R.C. Nolan, "The Continuing Evolution of Shareholder Governance", *The Cambridge Law Journal* 1/2006b, 94; R.C. Nolan, "Indirect Investors: A Greater Say in the Company?", *Journal of Corporate Law Studies* 1/2003, 75.

<sup>11</sup> Cf. R.C. Nolan, (2006a), 570; R.C. Nolan, (2006b), 94; R.C. Nolan, (2003), 75.

<sup>12</sup> M. Ooi, 94; Final report of the Expert Group on Cross Border Voting in Europe, August 2002, 19.

<sup>13</sup> Cf. R.C. Nolan, (2006a), 570.

<sup>14</sup> Final Report of the High Level Group of Company Law Experts, 2002, 54.

<sup>15</sup> Cf. J. Benjamin, M. Yates, G. Montagu, *The Law of Global Custody*, Butterworths, LexisNexis, London 2002<sup>2</sup>, 104.

should be automatically forwarded down the chain of intermediaries to the indirect investor as the beneficiary of shares and hence do not present a particular concern for legislators.

With regard to the discretionary and voluntary shareholders' rights, specific regulation should put indirect investors in a position which is in effect equal to those investing in shares directly.<sup>16</sup> Consequently, even though the intermediary is recognised as a shareholder against the company, it should only function as an 'extended arm' of the ultimate beneficiaries. However, in the absence of specific regulation to this end, the intermediary as the formal shareholder will be the only person in direct communication with the issuer of shares. In such circumstances, in order to enable the influence of indirect investors on the way shareholders' rights are exercised, the intermediary should forward any information from the company as well as authorisation forms down the chain of intermediaries to the ultimate beneficiaries.

There are, generally, two ways of enabling indirect investors to engage in exercising shareholders' rights.<sup>17</sup> Firstly, indirect investors can give instructions as to how these rights are to be exercised by the intermediary.<sup>18</sup> Secondly, the intermediary can authorise indirect investors to personally exercise shareholders' rights: either as proxies with full discretionary powers, i.e. in the name of the intermediary (the registered shareholder),<sup>19</sup> or in their own name as nominees of the registered shareholder.<sup>20</sup> Unfortunately, each of these methods can be confronted with problems regarding their application in practice.<sup>21</sup> In the cross-border context the specific problems are derived from inadequate or incomplete regulation of these issues, which is why they can be described as regulatory barriers to the efficient enfranchisement of indirect investors.

Engaging indirect investors in exercising shareholders' rights will become more difficult or even impossible if national laws, for example:

- prohibit one shareholder from exercising rights differently for different parts of his holding; or

<sup>16</sup> Cf. J. Payne, "Intermediated Securities and the Right to Vote in the UK", *Intermediated Securities: Legal Problems and Practical Issues* (eds. L. Gullifer, J. Payne), Hart Publishing, Oxford Portland (Oregon) 2010, 195.

<sup>17</sup> Cf. Final Report of the High Level Group of Company Law Experts, 2002, 54; J. Payne, 196 etc.

<sup>18</sup> R.C. Nolan, (2006a), 571; R.C. Nolan, (2003), 79.

<sup>19</sup> R.C. Nolan, (2006a), 572; R.C. Nolan, (2003), 79.

<sup>20</sup> P.L. Davies, *Gower and Davies' Principles of Modern Company Law*, Sweet & Maxwell, London 2008<sup>8</sup>, 432.

<sup>21</sup> For practical issues with regard to appointing indirect investors as proxies in the USA, see M. Kahan, E. Rock, "The Hanging Chads of Corporate Voting", *The Georgetown Law Journal* 4/2008, 1249 etc.; E. Wymeersch, 1568.

- prohibit one shareholder from granting more than one separate proxy with complete discretionary powers; or
- prohibit or leave unregulated the possibility for a shareholder to nominate another person as authorised to exercise shareholders' rights in his name; or
- impose cumbersome conditions for intermediaries when they exercise rights attached to shares on behalf of their clients; or
- allow the intermediary to exclude its obligation to exercise certain shareholders' rights in its agreement with the client; or
- do not impose adequate sanctions when the intermediary refuses to act upon instructions of indirect investors or refuses to grant them proxies or to nominate them; or
- allow the intermediary to exercise shareholders' rights even when it is not properly authorised by the indirect investor; etc.

Some of the aforementioned regulatory barriers concern the relationship between the company and its shareholder and therefore fall under company regulation, whereas others deal with the relationship between the intermediary and its client, which is traditionally within the domain of capital market regulation. However, these two 'separate' fields of law are sometimes not harmonised to the detriment of ultimate investors in indirectly held shares. In other words, protection of indirect investors provided by capital market regulation can be annulled by opposing company regulation, and vice versa.<sup>22</sup>

The growth of cross-border investment, which is more often than not based on indirect holding of shares, has made all of the above-mentioned potential problems international. Hence, the main goal of supranational regulatory instruments is to remove national regulatory barriers to the efficient enfranchisement of indirect investors.

#### 4. CURRENT STATE OF SUPRANATIONAL REGULATION

Removing regulatory barriers to exercising shareholders' rights in indirect holding systems can be achieved on a national level – through reliance on competition of legal systems, or on a supranational level – through harmonisation or even unification of the regulation.<sup>23</sup> Even

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<sup>22</sup> For example, if capital market regulation guarantees that ultimate investors have the right to instruct the intermediary on how to vote at the general meeting, company regulation can prevent them from exercising this right if it prohibits casting of votes differently with respect to different shares of one shareholder.

<sup>23</sup> Cf. L. Gullifer, "The Proprietary Protection of Investors in Intermediated Securities", *Rationality in Company Law: Essays in Honour of DD Prentice* (eds. J. Armour, J. Payne), Hart Publishing, Oxford Portland (Oregon) 2009, 225.

though fostering competition of legal systems has its many advantages,<sup>24</sup> it should still not be overestimated as a means of solving some fundamental problems of exercising rights attached to indirectly held shares. Just like purchasers of goods need some minimal protection by supranational regulatory instruments, so do purchasers of shares (i.e. investors).<sup>25</sup> Thus, there is a general consensus that at least the core problems in this field should be covered by supranational regulation, whereas regulation of issues that go beyond what may be described as minimum standards should be left to national legislators. This is why there have been up until now two attempts to harmonise or unify these issues on a supranational level. On the one hand, this was done by the European Community through the adoption of Article 13 of the Shareholders' Rights Directive, and on the other hand, by the international organisation UNIDROIT within the framework of the Geneva Securities Convention.

#### 4.1. EC Shareholders' Rights Directive

Since indirect holding of shares is typical for cross-border investments, any problems with regard to enabling indirect investors' influence on the way shareholders' rights are exercised present a potential threat to the development of the internal market of the EU. Therefore, removing national regulatory barriers in this field is an important issue on the EU level. Here, regulators can in principle focus their attention on three relationships: a) between the company and the intermediary (i.e. the formal shareholder), b) between the company and the indirect investor (i.e. the real shareholder), and c) between the intermediary and the indirect investor.<sup>26</sup> To date, the Community *acquis* has only regulated the first relationship in the EC Shareholders' Rights Directive. Conversely, the relationship between the company and the real shareholder has been completely neglected, whereas regulating the relationship between the intermediary and the indirect investor should become a part of the pending proposal for the new EC Securities Law Directive.<sup>27</sup>

Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies (hereafter, the EC Shareholders' Rights Directive or the SRD)<sup>28</sup> came into force in August 2007 and had to be im-

<sup>24</sup> Cf. M. Andenas, F. Wooldridge, *European Comparative Company Law*, Cambridge University Press, Cambridge 2009, 33.

<sup>25</sup> Cf. M.M. Siems, (2005), 544: "international investors want their... cross border exercise of rights... to have a uniform pattern."

<sup>26</sup> R.C. Nolan, (2003), 77 and 78.

<sup>27</sup> For more information about preparation of a draft *Directive on legal certainty of securities holding and transactions (Securities Law Directive)*, see [http://ec.europa.eu/internal\\_market/financial\\_markets/securities\\_law/index\\_en.htm](http://ec.europa.eu/internal_market/financial_markets/securities_law/index_en.htm), last visited 10 December 2011.

<sup>28</sup> 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, *Official Journal L 184*, 14.7.2007 (hereafter, Shareholders' Rights Directive), 17-24.

plemented by Member States until August 2009.<sup>29</sup> The main goals of enacting the SRD were: to strengthen certain rights of shareholders in connection with voting at the general meeting;<sup>30</sup> to remove the barriers to exercising those rights in the cross-border context;<sup>31</sup> to facilitate exercising rights attached to shares held indirectly via intermediaries<sup>32</sup> and thereby facilitate the engagement of beneficiaries in the corporate governance process.<sup>33</sup>

Unfortunately, the very notion of a shareholder is not harmonised by the SRD, leaving it to the national laws of Member States to provide a precise definition of this term.<sup>34</sup> Hence, in the indirect holding system the SRD provisions on exercising shareholders' rights will apply exclusively to the formal shareholder and will protect his position as against the company. Conversely, under the SRD the real shareholders (i.e. the indirect investors) are not given any directly enforceable rights against the company or the formal shareholder (i.e. the intermediary).<sup>35</sup> Indeed, many provisions of the SRD indirectly affect the position of ultimate beneficiaries, by protecting the formal shareholder who holds shares on their behalf and enables their influence on corporate governance. Still, only one provision, namely Article 13 of the SRD directly addresses the problem of enfranchising indirect investors in the company.

<sup>29</sup> Shareholders' Rights Directive, Article 15 (1 2). The only exception to this general rule is Article 10 (3), which has to be implemented until August 2012. See F. Ochmann, *Die Aktionärsrechte Richtlinie: Auswirkungen auf das deutsche und europäische Recht*, Schriften zum Europäischen und Internationalen Privat-, Bank- und Wirtschaftsrecht, Band 35, De Gruyter Recht, Berlin 2009, 7; S. Pluskat, "Auswirkungen der Aktionärsrichtlinie auf das deutsche Aktienrecht", *Wertpapiermitteilungen Zeitschrift für Wirtschafts- und Bankrecht* 46/2007, 2135; J.C. Kunz, *Das Recht der Hauptversammlung unter Berücksichtigung der RL 2007/36/EG*, Dissertation, Universität Wien, Wien 2008, [http://othes.univie.ac.at/3232/1/2008\\_10\\_28\\_0104881.pdf](http://othes.univie.ac.at/3232/1/2008_10_28_0104881.pdf), last visited 5 September 2011, 7; Eckart Ratschow, "Die Aktionärsrechte Richtlinie – neue Regeln für börsennotierte Gesellschaften", *Deutsches Steuerrecht* 2007, 1402; P.E. Masouros, 196.

<sup>30</sup> J. Payne, 213; D. Zetzsche, (2008), 34.

<sup>31</sup> F. Ochmann, 13; S. Pluskat, 2136; S. Grundmann, N. Winkler, "Das Aktionärsstimmrecht in Europa und der Kommissionsvorschlag zur Stimmrechtsausübung in börsennotierten Gesellschaften", *Zeitschrift für Wirtschaftsrecht* 31/2006, 1424; D. Zetzsche, (2008), 34.

<sup>32</sup> J. Payne, 213.

<sup>33</sup> A. Hainsworth, "The Shareholder Rights Directive and the challenge of re-enfranchising beneficial shareholders", *Law and Financial Markets Review* 1/2007, 11; cf. U. Noack, M. Beurskens, "Einheitliche "Europa Hauptversammlung"? Vorschlag für eine Richtlinie über die (Stimm-)Rechte von Aktionären", *Zeitschrift für Gemeinschaftsprivatrecht* 2006, 88.

<sup>34</sup> E. Ratschow, 1402; D. Zetzsche, "Die neue Aktionärsrechte Richtlinie: Auf dem Weg zur Virtuellen Hauptversammlung", *Neue Zeitschrift für Gesellschaftsrecht* 2007, 686; F. Ochmann, 192; J. Payne, 214; U. Noack, (2008), 15; I. Gómez Sancha Trueba, 52.

<sup>35</sup> J. Payne, 214.

#### 4.1.1. Narrow Scope of Application

One of the reasons why the SRD offers only insufficient protection of indirect investors stems from its narrow scope of application. The SRD applies only to companies (i.e. issuers of shares) “which have their registered office in a Member State and whose shares are admitted to trading on a regulated market situated or operating within a Member State”.<sup>36</sup> Thus, this Directive only deals with exercising certain shareholders’ rights in listed companies<sup>37</sup> whose shareholders are usually widely dispersed, often in two or more states.<sup>38</sup> Consequently, the cross-border issues of exercising rights attached to indirectly held shares are considered inherent in listed companies, which led to the adoption of specific European harmonisation rules that are confined to tackling precisely these problems.<sup>39</sup>

With regard to enabling indirect investors’ influence on the way shareholders’ rights are exercised, the SRD only harmonises certain problems in connection with voting at the general meeting. Hence, its rules apply exclusively to voting shares<sup>40</sup> and not to preferential shares<sup>41</sup> even though these can also be indirectly held via intermediary. Moreover, the SRD completely neglects harmonisation of rules which protect indirect investors when it comes to exercising other shareholders’ rights, except voting rights (e.g. the right to ask questions, the right to add items to the agenda of the general meeting, the right to table draft resolutions, the right to convene an extraordinary general meeting, etc.).<sup>42</sup> Of course, one must acknowledge that voting right is an extremely important shareholders’ right,<sup>43</sup> especially from the corporate governance perspective, but still it is only one of numerous rights with regard to which indirect investors require protection. Bearing in mind that indirect investors’ involvement in exercising other shareholders’ rights is an important (although not the most important) problem of indirect holding of shares, the achieved level of harmonisation can only be assessed as insufficient and therefore incomplete.

<sup>36</sup> Shareholders’ Rights Directive, Article 1 (1); F. Ochmann, 17; S. Pluskat, 2135; S. Grundmann, N. Winkler, 1424; U. Noack, (2008), 3; U. Noack, “Der Vorschlag für eine Richtlinie über Rechte von Aktionären börsennotierter Gesellschaften”, *Neue Zeitschrift für Gesellschaftsrecht* 2006, 322; E. Ratschow, 1403; D. Zetzsche, (2007), 686.

<sup>37</sup> J. C. Kunz, 13; U. Noack, M. Beurskens, 88.

<sup>38</sup> S. Pluskat, 2135; cf. S. Grundmann, N. Winkler, 1424; cf. U. Noack, M. Beurskens, 88.

<sup>39</sup> S. Pluskat, 2135.

<sup>40</sup> F. Ochmann, 17; E. Ratschow, 1403.

<sup>41</sup> J.C. Kunz, 14.

<sup>42</sup> D. Zetzsche, (2008), 38.

<sup>43</sup> M. Kahan, E. Rock, 1229: “Never has voting been more important in corporate law.”

However, the described downsides of the determined scope of application of the SRD are diminished by the fact that this Directive only contains minimal harmonisation.<sup>44</sup> Consequently, in the implementation process Member States can enhance the level of protection of indirect investors, so that the harmonised rules equally apply to other (non-listed) companies,<sup>45</sup> other shareholders' rights (except voting rights), preferential shares, etc. Apart from that, Member States can provide additional mechanisms for the protection of indirect investors besides those harmonised by the SRD.<sup>46</sup>

#### 4.1.2. *Harmonisation of exercising shareholders' rights in indirect holding systems*

Article 13 of the SRD deals with exercising rights attached to shares held indirectly via intermediary.<sup>47</sup> The first paragraph of this article states that its provisions apply to a person who is recognised as a shareholder by the applicable law and acts in the course of a business on behalf of another natural or legal person (the client).<sup>48</sup> This clearly encompasses financial intermediaries who, in the course of their business, provide services of safeguarding and administering shares for others, by taking up the position of a formal shareholder against the company.<sup>49</sup> On the other hand, the SRD neither defines nor uses the term "indirect investors" or any other equivalent, but only refers to the "clients" of the formal shareholder.<sup>50</sup>

Indirect protection of intermediary's clients in the SRD consists of harmonising the following legal provisions of the Member States.

1. Member States shall allow the intermediary as the formal shareholder to cast votes differently with regard to different parts of his holding on behalf of clients.<sup>51</sup> In this way, the intermediary will be able to respect the instructions and act in the best interest of each client.<sup>52</sup>

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<sup>44</sup> S. Pluskat, 2136; S. Grundmann, N. Winkler, 1424, J. C. Kunz, 23; U. Noack, (2008), 6; U. Noack, M. Beurskens, 88; E. Ratschow, 1403; D. Zetsche, (2007), 691.

<sup>45</sup> U. Noack, (2006), 322.

<sup>46</sup> S. Pluskat, 2136; U. Noack, M. Beurskens, 88; E. Ratschow, 1403.

<sup>47</sup> F. Ochmann, 174.

<sup>48</sup> Shareholders' Rights Directive, Article 13 (1); D. Zetsche, (2007), 687. Whether a person is acting as a shareholder in the course of a business on behalf of another natural or legal person, is determined by *legis societatis*. See F. Ochmann, 175.

<sup>49</sup> J.C. Kunz, 140; U. Noack, (2006), 324.

<sup>50</sup> J.C. Kunz, 141.

<sup>51</sup> Shareholders' Rights Directive, Article 13 (4); A. Hainsworth, 16; D. Zetsche, (2007), 687; J.C. Kunz, 144; U. Noack, M. Beurskens, 90; J. Payne, 213; R.C. Nolan, (2006a), 582.

<sup>52</sup> R.C. Nolan, (2006a), 582; F. Ochmann, 177; D. Zetsche, (2008), 38.

2. Even when the national law of the Member State limits the number of proxies that one shareholder can appoint to vote at the general meeting, Member States shall make an exception to this rule when a formal shareholder is in fact an intermediary acting on behalf of others. Namely, the intermediary should be able to give a voting proxy to each client or another person designated by the client.<sup>53</sup> This rule enables the intermediary's client to exercise voting rights personally or through a third party of his choice, notwithstanding the fact that he is not recognised as a shareholder by the company.
3. The SRD allows Member States to prescribe certain conditions for exercising voting rights by the intermediary on behalf of its clients, with a view to increasing transparency of the indirect holding system. However, these conditions cannot go beyond revealing the identity of each client and the number of shares safeguarded and administered on his behalf.<sup>54</sup>
4. Finally, the SRD aims to protect the intermediary's clients from unnecessary formalities regarding voting authorisations and instructions. In this regard, national laws of the Member States shall not impose formal requirements that go beyond what is necessary to ensure the identification of the client, or the possibility of verifying the content of his instructions, and is proportionate to achieving those objectives.<sup>55</sup>

#### *4.1.3. Limitations of the Achieved Level of Harmonisation*

Closer analysis shows that the achieved level of harmonisation in Article 13 of the SRD is incomplete and therefore insufficient for the protection of indirect investors. Firstly, the SRD neither determines how the intermediary is going to prove to the company that it is holding shares as a registered shareholder on behalf of its clients, nor does it regulate whether the company can or should require such confirmatory evidence.<sup>56</sup> Unless it is closed by national laws of the Member States, this regulatory gap can lead to *fraus legis* by shareholders who want to make use of exceptions to the general company law with regard to exercising shareholders' rights by the intermediary on behalf of clients.

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<sup>53</sup> Shareholders' Rights Directive, Article 13 (5); cf. U. Noack, (2008), 11; U. Noack, M. Beurskens, 90; D. Zetzsche, (2007), 687; S. Grundmann, N. Winkler, 1427; J.C. Kunz, 144.

<sup>54</sup> Shareholders' Rights Directive, Article 13 (2); J.C. Kunz, 142; U. Noack, (2008), 14; E. Ratschow, 1408; D. Zetzsche, (2007), 687; cf. F. Ochmann, 176; D. Zetzsche, (2008), 38.

<sup>55</sup> Shareholders' Rights Directive, Article 13 (3); F. Ochmann, 176; A. Hainsworth, 16; J.C. Kunz, 143; E. Ratschow, 1408.

<sup>56</sup> J. Payne, 198.

The SRD enhances the transparency of the indirect holding of shares by allowing Member States to require the disclosure of clients' identities as a precondition for exercising voting rights by the intermediary. However, this rule refers solely to clients of the intermediary who is a registered shareholder, whereas it completely neglects the fact that indirect holding systems (especially in cross-border context) are often multi-tiered and organised on a pooled basis. Therefore, clients of the formal shareholder will usually be other intermediaries acting on behalf of their respective clients, and so on until the ultimate beneficiaries (who are the indirect investors). In such a scenario, the formal shareholder will not know the identities of indirect investors. Nevertheless, the SRD does not oblige him to gather such information or to reveal it to the company.

The fact that the protection of Article 13 only encompasses clients of the intermediary who is a registered shareholder shows that the SRD is turning a blind eye to the problem of multi-tiered structure of holding intermediated shares.<sup>57</sup> Bearing in mind that clients of the formal shareholder are often other intermediaries who safeguard and administer shares for their clients, the Directive fails to provide rules that would enable indirect investors as ultimate beneficiaries to effectively engage in exercising shareholders' rights. Consequently, the SRD does not contain any rules that would apply to sub-custodians in the potential chain of intermediaries.<sup>58</sup>

Furthermore, Article 13 only regulates certain aspects of the relationship between the company and the intermediary (i.e. the formal shareholder), whereas it completely leaves out the relationship between the intermediary and its clients, as well as the relationship between the company and indirect investors.<sup>59</sup> This is why Article 13 does not grant indirect investors any directly enforceable rights against the company or against the intermediary. In addition to that, the SRD does not prescribe an obligation of the intermediary to enable indirect investors' influence on exercising shareholders' rights, or its obligation to distribute information from the company to the account-holders,<sup>60</sup> but leaves these issues to national laws of the Member States or to the agreement between the intermediary and its client. In this respect the SRD does not achieve the necessary level of harmonisation, since there is no guarantee that the intermediary will facilitate the engagement of indirect investors in exercising shareholders' rights.<sup>61</sup>

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<sup>57</sup> Cf. F. Ochmann, 177.

<sup>58</sup> J. Payne, 213; F. Ochmann, 176; D. Zetzsche, (2008), 37.

<sup>59</sup> Cf. U. Noack, (2008), 6.

<sup>60</sup> F. Ochmann, 177.

<sup>61</sup> Cf. R.C. Nolan, (2006a), 574: "...the mere existence of... possibilities may not be adequate to enfranchise indirect investors in shares. It may well be necessary to put

Not only does the SRD avoid regulating intermediary's obligations towards its clients, but it also contains no rules regarding the right of the intermediary to vote at the general meeting on behalf of clients. As a consequence, Article 13 does not specify whether the intermediary has the right to vote in any case, or only if it is properly authorised or explicitly instructed by the indirect investor.<sup>62</sup> Therefore, the conditions under which the intermediary as the formal shareholder can exercise shareholders' rights are left to national laws of the Member States.

It can be concluded that the protection of indirect investors under the SRD is inadequate and incomplete. This Directive only deals with some company law issues, although company regulation can only enable indirect investors to exert influence on the way shareholders' rights are exercised, while it does not force the intermediary to acknowledge their influence. For that reason, focusing exclusively on company law aspects of the problem proves to be insufficient for the protection of indirect investors.

Company regulation has to be coupled with capital market regulation in order to achieve the optimal level of protection of indirect investors.<sup>63</sup> This means concentrating on the relationship between the intermediary and its client, that is, on the rules under which the service called "safeguarding and administering shares" is provided. Of course, the European Commission is well aware of this, which is why these issues were planned to become a part of the new Securities Law Directive. In the meantime, under the auspices of UNIDROIT, 37 states as well as the European Community have adopted the international Convention on Substantive Rules for Intermediated Securities (shortly called "the Geneva Securities Convention").<sup>64</sup>

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further pressure on intermediaries to realise those possibilities to enfranchise indirect investors in the company." Cf. D. Zetsche, (2008), 49–50.

<sup>62</sup> S. Grundmann, N. Winkler, 1427.

<sup>63</sup> Cf. M.M. Siems, (2008), 44: "...shareholder protections through company law and through securities law have differing orientations: securities law serves to protect the assets of the investor, while company law has its focus on shareholder participation in the firm and on the share as an investment."

<sup>64</sup> Final Act of the final session of the diplomatic conference to Adopt a Convention on Substantive Rules Regarding Intermediated Securities, UNIDROIT 2009, CONF 11/2 Doc 41, Appendix, Convention on Substantive Rules for Intermediated Securities & Resolutions No 1, 2, 3, <http://www.unidroit.org/english/conventions/2009intermediatedsecurities/finalact.pdf>, last visited 14 December 2011; J. Than, "Der funktionale Ansatz in der UNIDROIT Geneva Securities Convention vom 9. Oktober 2009", *Festschrift für Klaus J. Hopt: Unternehmen, Markt und Verantwortung* (Hrsg. S. Grundmann, et al.), Band 1, De Gruyter, Berlin–New York 2010, 231.

## 4.2. UNIDROIT Geneva Securities Convention

The Geneva Securities Convention (hereafter, ‘the GSC’ or ‘the Convention’) was adopted on 9 October 2009.<sup>65</sup> However, it still has not come into force due to the fact that the requirement of at least three ratifications has not yet been met.<sup>66</sup> Instead of specifically dealing with problems of exercising shareholders’ rights in indirect holding systems, the main purpose of adopting the GSC was to achieve general unification of rules that govern holding securities via intermediaries (which comprise indirect as well as direct holding structures). Still, this Convention is relevant to exercising shareholders’ rights by an intermediary on behalf of indirect investors since its general rules on rights of ultimate account holders also apply to investors in indirectly held shares.

### 4.2.1. Scope of Application

The very definition of ‘securities’ in the GSC shows that shares are one type of financial instruments typically covered by this term.<sup>67</sup> Furthermore, the Convention applies to ‘intermediated’ shares, which is an expression used to describe shares credited to a securities account or rights or interests in shares resulting from the credit of shares to a securities account.<sup>68</sup> This means that the rules of the Convention encompass not only the relationship between the intermediary, who is the registered shareholder, and his client (where shares are being credited to a securities account) but also the relationships between lower-tier intermediaries (i.e. sub-custodians) and their respective clients (where, in the indirect holding system, the assets credited to a securities account are not shares, but rather rights or interests in shares).<sup>69</sup> Therefore, the GSC clearly respects the fact that holding systems are usually multi-tiered, so that (interests in) shares are held through a chain of two or more intermediaries. In this respect, the scope of application of the GSC is wider than that of the SRD which only regulates certain rights of the intermediary acting as a registered shareholder on behalf of its immediate clients.

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<sup>65</sup> For more details, see C.W. Mooney, H. Kanda, “Core Issues under the UNIDROIT (Geneva) Convention on Intermediated Securities: Views from the United States and Japan”, *Intermediated Securities: Legal Problems and Practical Issues* (eds. L. Gulifer and J. Payne), Hart Publishing, Oxford–Portland (Oregon) 2010, 70–71.

<sup>66</sup> For the status of the UNIDROIT Convention on Substantive Rules for Intermediated Securities (hereafter, Geneva Securities Convention), see [http://www.unidroit.org/english/implementation/2009\\_intermediatedsecurities.pdf](http://www.unidroit.org/english/implementation/2009_intermediatedsecurities.pdf), last visited 11 December 2011; J. Than, 233.

<sup>67</sup> Geneva Securities Convention, Article 1 (a).

<sup>68</sup> Geneva Securities Convention, Article 1 (b); cf. J. Than, 234.

<sup>69</sup> For detailed explanation of interests in securities, see J. Benjamin, *Interests in Securities: A Proprietary Law Analysis of the International Securities Markets*, Oxford University Press, New York 2000, 28 etc.

In addition to that, unlike the SRD, which covers different types of relationships between the registered shareholder and his client that can lead to exercising shareholders' rights by the former on behalf of the latter, the GSC only applies to relationships arising from account agreements where clients of the intermediary are qualified as account holders. Therefore, the rules of this Convention do not protect indirect investors who are holders of depository receipts or holders of shares (or units) in a collective investment scheme.<sup>70</sup>

The GSC primarily regulates the relationship between the so-called 'relevant intermediary' and its immediate client (the account holder), which is traditionally considered to be the subject of capital market law.<sup>71</sup> In this respect, it sets out rights of an account holder and corresponding obligations of the intermediary, some of which directly refer to exercising rights attached to intermediated securities. Conversely, the relationship between the company (i.e. issuer of shares) and ultimate account holders (i.e. indirect investors) is completely left to non-Convention law. Finally, the relationship between the company (i.e. issuer of shares) and its shareholders is generally outside the scope of this Convention, since it endorses the principle of neutrality with respect to company law.<sup>72</sup> However, one important exception to this principle was made in Article 29 subparagraph 2, precisely concerning exercise of shareholders' rights via the intermediary in indirect holding systems. Hence, unlike the SRD, which exclusively focuses on company law issues, the GSC combines detailed regulation of capital market law issues with some rudimentary regulation of company law problems.

Finally, the rules of the GSC are intended to cover all situations where the law of a Contracting State is the applicable law, whether as a result of the conflict of law rules or because the circumstances of a particular case are purely domestic (with no foreign element).<sup>73</sup> This provision enhances the importance of GSC as a unification instrument, which should help minimise difficulties arising out of holding shares through intermediaries in cross-border as well as exclusively national contexts.

#### *4.2.2. Specific Regulation Relevant to Exercising Shareholders' Rights*

There are several provisions of the GSC that are particularly relevant to exercising shareholders' rights in indirect holding systems. On the one hand, the Convention clarifies that the person entitled to all the benefits stemming from intermediated shares is the ultimate account holder

<sup>70</sup> Unlike the Convention, Article 13 of the Directive also applies to holders of depository receipts. See F. Ochmann, 179.

<sup>71</sup> Cf. P. Keijser, "Die Verabschiedung der Genfer Wertpapierkonvention (Bericht von der Diplomatischen Konferenz)", *BKR Zeitschrift für Bank und Kapitalmarktrecht* 2010, 152.

<sup>72</sup> Cf. C.W. Mooney, H. Kanda, 80.

<sup>73</sup> Geneva Securities Convention, Article 2; C.W. Mooney, H. Kanda, 80.

– that is, the account holder who is not an intermediary or is an intermediary acting for its own account.<sup>74</sup> Therefore, the intermediary is under obligation to regularly pass on to its account holders any distributions (e.g. dividends) received in connection with intermediated shares.<sup>75</sup> Moreover, in the indirect holding system the ultimate account holder has the right against his relevant intermediary to exercise any rights attached to intermediated shares.<sup>76</sup> In effect, such a provision empowers indirect investors to influence the way shareholders' rights are exercised by the intermediary against the issuer. Hence, the GSC explicitly obliges the intermediary to respect and to give effect to account holder's instructions in this regard.<sup>77</sup> In addition to that, the Convention prescribes certain obligations of the intermediary whose main purpose is to aid indirect investors in making an informed decision about the way shareholders' rights are to be exercised. For example, according to the Convention the intermediary has to regularly forward information regarding intermediated shares from the company to its account holders.<sup>78</sup>

In principle, the GSC does not deal with the relationship between the formal shareholder and the company or that between the company and the ultimate account holder.<sup>79</sup> However, Article 29 subparagraph 2 of the Convention prescribes that Contracting States must allow an intermediary to exercise not only the voting rights but also other shareholders' rights differently in relation to different parts of a holding of shares. In other words, this rule introduces not only split voting but also split exercise of other shareholders' rights, and thereby goes beyond the requirements of the SRD. This particular exception to the general principle of neutrality with respect to company law was considered a necessary minimum provision, without which the functioning of cross-border indirect holdings could be seriously hindered. Apart from that, the GSC contains no further regulation of exercising shareholders' rights against the company on behalf of indirect investors.<sup>80</sup>

Like the SRD, the GSC sets only minimal standards with a goal to achieve compatibility of different legal systems.<sup>81</sup> For that reason, all of

<sup>74</sup> Geneva Securities Convention, Article 9 (1) (a) (i); cf. C.W. Mooney, H. Kanda, 84 fn. 66.

<sup>75</sup> Geneva Securities Convention, Article 10 (2) (f); P. Keijser, 157.

<sup>76</sup> Geneva Securities Convention, Article 9 (1) (a).

<sup>77</sup> Geneva Securities Convention, Article 10 (2) (c); P. Keijser, 157.

<sup>78</sup> Geneva Securities Convention, Article 10 (2) (e); P. Keijser, 157.

<sup>79</sup> Geneva Securities Convention, Article 8.

<sup>80</sup> Therefore, conditions under which the intermediary is authorised to exercise these rights against the company are not specified in the Convention.

<sup>81</sup> P. Keijser, 153; H. Kronke, "Das Gesellschaftsrecht im Genfer UNIDROIT Abkommen über intermediär verwahrte Effekten", *Wertpapiermitteilungen Zeitschrift für Wirtschafts- und Bankrecht* 43/2010, 2009; H. Kronke, "Remarks on the Geneva Securities Convention's Development and its Future", *Intermediated Securities: Legal Prob*

the above-mentioned obligations of the intermediary as well as rudimentary company regulation can and should be further specified by non-Convention law.

#### 4.2.3. *Limitations of the Attempted Unification*

When focusing exclusively on its regulation relevant to exercising shareholders' rights in indirect holding systems, it can be concluded that the GSC has its limitations, which brings into question its overall ability to completely protect ultimate account holders as indirect investors in intermediated shares. Namely, in this Convention many important issues are left unregulated, such as: the account holder's authorisation of the intermediary for exercising shareholders' rights; the consequences of exercising shareholders' rights by the intermediary who is not properly authorised by its client; the formalities with regard to authorisation and instructions; the conditions for exercising rights attached to intermediated shares on behalf of account holders (for example, revealing the identity of indirect investors to the company); intermediary's obligation to enable indirect investor to personally engage in exercising shareholders' rights (e.g. through appointing him as a proxy, or through empowering him as a nominee); the right of the intermediary as the formal shareholder to grant more than one separate proxy with complete discretionary powers; etc. Additionally, intermediary's obligations that are explicitly regulated by the Convention are only sketched out abstractly, so that their elaboration is left to non-Convention law or the account agreement.

### 5. COMPARISON AND COMPATIBILITY OF THE TWO SUPRANATIONAL REGULATORY INSTRUMENTS

The previous analysis has shown that the two current supranational regulatory instruments offer only partial solutions to the identified problems of exercising shareholders' rights in the cross-border context. However, their approach to dealing with specific regulatory issues in this regard is substantially different. While the SRD contains only company regulation and leaves out all questions that fall within capital market regulation, the GSC has in principle adopted the opposite approach. Another important distinction between these two documents lies in the fact that the GSC treats the ultimate account holder (i.e. the indirect investor) as the sole beneficiary of intermediated shares, while the SRD only recognises the need for (indirect) protection of intermediary's immediate clients, without taking into account the prevailing multi-tiered structure of cross-border holdings.

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*lems and Practical Issues* (eds. L. Gullifer and J. Payne), Hart Publishing, Oxford Portland (Oregon) 2010, 247; L. Gullifer, (2009), 226.

Bearing in mind the divergent ways of tackling problems in connection with exercising shareholders' rights in indirect holding systems in the SRD and the GSC, the question is whether these two regulatory instruments are complementary, so that they can build a complete set of supranational rules in this field. In other words, could the ratification of the GSC, coupled with the implementation of the SRD, suffice to fully protect indirect investors? On the basis of the analysis conducted in this paper the resulting answer to the posed question is negative, because a lot of important gaps would remain, especially in company regulation, which is incomplete in the Directive and completely marginalised in the Convention. Admittedly, if the GSC was ratified by the European Community, the regulation of many issues planned for the Securities Law Directive would become superfluous. However, since this Convention has not yet come into force, it remains to be seen whether and to what extent it will actually influence the cross-border problems with regard to exercising rights attached to indirectly held shares.

## 6. CONCLUSION

When shares are held indirectly via intermediary, exercising shareholders' rights poses specific problems, especially in the cross-border context. However, indirect investors cannot rely upon the protection provided by divergent national rules, as some of them completely ignore these problems. For this reason, there is a strong need for supranational regulation in this field, which has up until now resulted in adopting the EC Shareholders' Rights Directive and the UNIDROIT Geneva Securities Convention. Unfortunately, a closer analysis has shown that each of these regulatory instruments is in itself incomplete and hence incapable of offering full protection of indirect investors. Additionally, the combination of these two documents would not lead to the desired result either, since a lot of important issues would still be left unresolved (primarily in the field of company law). Therefore, as long as indirect holding systems are common for cross-border investments, further supranational regulatory activity in this regard will remain necessary.