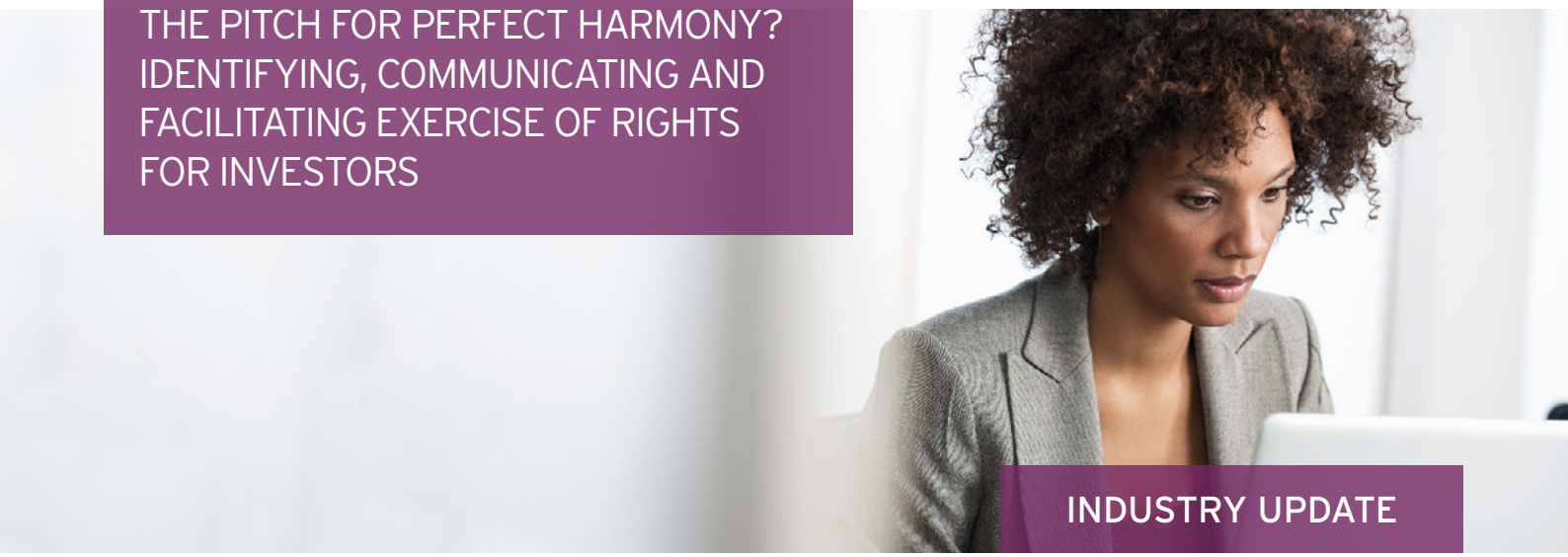
THE PITCH FOR PERFECT HARMONY? IDENTIFYING, COMMUNICATING AND FACILITATING EXERCISE OF RIGHTS FOR INVESTORS



INDUSTRY UPDATE

European Commission technical standards for implementation of the revised Shareholder Rights Directive (SRD II) with regard to shareholder identification, communications and exercise of rights are nearing finalisation. It is timely therefore to consider what this means not only in terms of the ongoing drive towards market harmonisation, but also discussions locally regarding shareholder rights.

The SRD technical standards will be a major factor in determining the future shape of processes for identification, communication and the exercise of rights for investors that hold through intermediaries across Europe. As we have advised clients previously, the terms of the revised SRD in these particular areas may have a relatively limited immediate impact for UK and Irish issuers, as current law is already broadly compliant (view our SRD Technical Standards briefing note).

However it is important that UK and Irish issuers consider these developments in light of these two broad market drivers:

- The continuing push towards increased harmonisation of post-trade processes internationally (view our October 2017 blog and briefing note); and
- Increasing investor demands for better facilitation of shareholder rights, despite holding indirectly via intermediaries.

These are likely to continue to influence our markets, and regulatory development in the medium term, beyond the specific terms of the Directive, and even despite the final outcomes of Brexit for the UK.

Discussion of the impact of SRD II often focusses on voting processes, and this is where we anticipate the more significant immediate impacts to be felt for issuers. However, it applies equally to all shareholder rights, and some changes may occur to corporate action communications and processes also.

ALL TOGETHER NOW...

Harmonisation efforts related to the operational and technical mechanics of post-trade arrangements have been underway for many years, driven by the complex 'chain' arrangements for holding securities which were largely developed during the post 'big-bang' era. The complexity of current arrangements for voting UK securities is shown in Diagram 1 .

The European Commission recently issued a consultation on the draft technical standards (view the consultation here, and our response can be viewed here), with the aim of establishing minimum standards relating to issuer and shareholder engagement in the following areas:

- Shareholder Identification
- Transmission of information
- Exercise of Rights (voting and corporate actions)
- Vote confirmations

The SRD II requirements and the technical standards form part of the Commission's Capital Markets Union project which has a core objective of removing barriers related to cross-border investment. They are set against a backdrop of the Giovannini Barriers, and the Market Standards for Corporate Actions and General Meetings which were negotiated and endorsed by key stakeholders some 10 years ago. However comprehensive application of the Market Standards has been hampered largely due to the absence of any regulatory mandate. While SRD II does not directly implement the Market Standards, it acknowledges that integration of them is a core requirement for harmonisation and they are specifically referenced in the recitals to the technical standards.

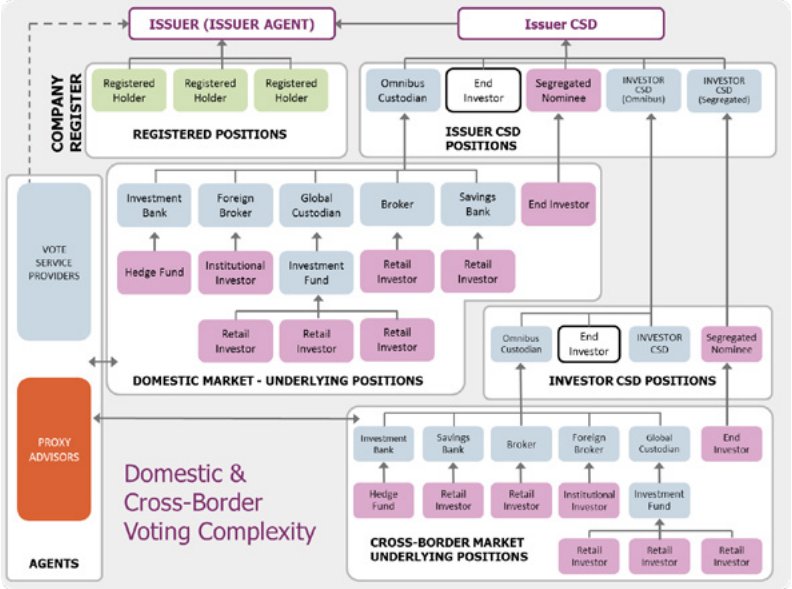


Diagram 1: UK voting structure

SHAREHOLDERS VS END INVESTORS

A central issue in SRD II is to what level of the complex ownership chain the provisions apply.
This is key to understanding the immediate impact for the UK and Ireland, compared to current requirements. SRD II is limited by application to 'shareholders', as defined under national law. The Market Standards however promote the concept of extending to all 'end investors'. It is important to realise that this was not the original intent of SRD II, and there were efforts by the Commission and members of European Parliament to have the directive apply to end investors also.

Under UK and Irish law, 'shareholders' are considered to be the persons recorded on the issuer's share register, either in certificated form or on the CREST record. By contrast, the concept of 'end investor', which of itself causes debate, is generally the person we refer to as a beneficial owner, being the individual investor who has economic rights to securities. A number of other Member States consider 'shareholder' to be the 'end investor', and thus SRD II has not in fact delivered the goal of harmonised requirements.

The SRD II requirements for shareholder identification, communication and exercise of rights therefore require limited immediate changes to UK and Irish law, unless regulators decide to take a more extensive approach. In our markets, issuers can already identify, communicate with, and receive exercise of rights from their registered shareholders. There are some specific new requirements for vote confirmations, and possibly some changes to corporate actions. However the majority of SRD II provisions are already consistent with our market rules.

A range of stakeholders are continuing to call for efforts to extend application of the SRD II principles to end investors across all Member States, including investor and some issuer associations. We are also aware that some Member States are considering extension of their definition of shareholder to include the end investor.

It is reasonable to ask though what this means for the UK and Ireland. Unless the Commission takes further legislative steps to extend SRD II to end investors, which does not appear to be on the cards at present, are these broader calls for harmonisation and further facilitation of end investors relevant? In our view, the UK & Ireland will not be immune from such calls, even if a strictly technical implementation of the SRD II is adopted in the near term and regardless of Brexit. Indeed, the recent discussion in the UK around the treatment of investor assets in the Beaufort Securities insolvency, for example, may amplify the pressure. Ultimately, the extent of extension of rights through to end investors must be an issue for our regulators to determine, in consultation with issuers and investors.

In today's digital age with so much information freely available, it is difficult to argue that (irrespective of their location) investors who have purchased securities should not automatically receive all communications from the issuer(s) and have to opportunity to exercise rights, but delivering on that requirement does not come without a debate around where the responsibility appropriately rests and who bears the costs. A few key questions need to be considered in relation to any such proposals:

- What is the requirement?
- Is it mandatory for all or are opt-outs catered for?
- How will it work in practice? What systems need to be developed/changed?
- Who will pay the costs of development and ongoing operational fees?

The last question is arguably the most fundamental. Investors holding their securities via a broker nominee will already be subject to transactional and custody fees, which are intended to cover the costs of servicing the account. Any new obligations have potential to require investment by the broker and custodian community, which in turn may lead to them looking to issuers to cover their costs. On the other hand, issuers may feel justified in refusing to meet such costs, given that communications and associated rights are already offered free of charge to shareholders who are directly registered.

FUTURE PROSPECTS?

In the context of SRD II, it seems unlikely at this stage that the technical standards can apply to end investors, despite continuing lobbying to that effect. The definitions of the first level Directive are clear. The final regulation is due to be published any day now, with a deadline of 10 September 2018. Irrespective of the ultimate outcome of the SRD standards, the issue is unlikely to go away. We can expect lobbying to continue from a varied crew of stakeholders, including the global custodian banks who have a vested interest in uniform arrangements across all markets. Institutional and some retail investor associations are also engaged to ensure that their members are fully enfranchised.

At the EU level, the Commission is keen to progress its digitalisation agenda. Separately a review of securities law has also been called for, which could contribute towards a harmonised definition of 'shareholder', potentially altering the interpretation of local obligations. While the impact of such EU developments for the UK remain unclear post-Brexit, lobbying efforts are unlikely to stop at the border. At national level, we also anticipate that various stakeholders will continue to apply pressure on regulators.

We therefore encourage issuer clients to discuss the topic internally within their own organisations, and consider their preferred policy position. It is important to share opinions collaboratively via industry associations e.g. GC100 and the ICSA company secretaries' forum. If consensus is reached and there is sufficient support, it may be appropriate to publicise or socialise with a view to influencing future policy. You are also very welcome to share views with us directly, so that we can be better informed for any ongoing dialogue with relevant stakeholders and regulators.

WHAT'S NEXT?

We will continue to monitor developments, and will be assessing the technical standards when they are published to understand the definitive impact on issuers, in relation to aspects such as 'vote confirmation'.

If after reviewing the briefing paper, you have any questions or feedback please contact

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