

Executive Master of European and International Business Law M.B.L.-HSG



Module 1 – Introduction to European and Business Law

Corporate governance developments

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Module 1 – Introduction to European and Business Law University of St. Gallen / Binder Rechtsanwälte



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A. Some questions ...

- Who is the owner of a corporation?
- What characterises an owner?
- How many UBS shares are there?
- Who are UBS's shareholders?
- What is the price of UBS?
- What is the price of one UBS share?
- What is the cost to buy the voting right of one share for UBS's next AGM?
- What would the takeover price of UBS be?
- How much money do the Chinese Sovereign Wealth Funds have?
- What is the average holding period of shares in listed companies?
- What happens in the shareholder base when a public takeover bid is launched?
- How do you invest your money?



B. Imperative of the time: long-termism

- Biggest economic crisis since the 1930s
- Enormous loss of confidence in enterprises and management
- Short-termism according to widespread (liberal) conviction a main cause for the crisis:
 - «*Now for the long term.*» (The Economist, The World in 2010)
 - «The economic crisis is rooted in a crisis of values: too much short-termism, insufficiently clear responsibilities, disregard for customer value, too little concern for political acceptance; *the striking loss of long-termism has fundamentally undermined our economic system.*» (G. Schwarz, NZZ, 30./31.1.2010)



B. Imperative of the time: long-termism German Corporate Governance Code

- 2008 edition: «The Code clarifies the rights of shareholders, who provide the company with the required equity capital and who carry the entrepreneurial risk.»
- 2009 edition: «The Code clarifies the obligation of the Management Board and the Supervisory Board to ensure the continued existence of the enterprise and its **sustainable creation of value** in conformity with the principles of the social market economy (interest of the enterprise).»



B. Imperative of the time: long-termism UK Corporate Governance Code

- Main principle 1 (2008 edition, Combined Code): «Every company should be headed by an effective board which is collectively responsible for the success of the company.»
- Main principle 1 (2010 edition): «Every company should be headed by an effective board which is collectively responsible for the **long-term** success of the company.»



B. Imperative of the time: long-termism

EU Commission proposal for a directive as regards the encouragement of long-term shareholder engagement (2014)*

- «The overarching objective of the current proposal to revise the Shareholder Rights Directive is to contribute to the **long-term sustainability** of EU companies.»

(* Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement of 9.4.2014)



B. Imperative of the time: long-termism

Two theses

«The system is good and needs no adjustments. It's just that some leaders have failed morally.»

«The system fosters short-termism of thought and action and must therefore be adjusted towards more long-termism.»



C. System of the corporation

Two different control systems

- Shareholder in the corporate governance system:
economic behaviour control

- Board of directors and management in the corporate governance system:
legal behaviour control



C. System of the corporation

Shareholder in the corporate governance system: economic behaviour control

- Main idea
 - Right to follow his own interests
 - No duty to act in the interest of the enterprise («lasting prosperity of the enterprise»)
 - No duty of loyalty
- Foundation of the main idea
 1. The shareholder is a long-term investor, and therefore his own interests are usually in line with the interests of all the shareholders and of the enterprise
 2. Key competencies in the corporation are assigned mandatorily to the board of directors



C. System of the corporation

Shareholder in the corporate governance system: economic behaviour control

- Mechanisms
 - Involvement through pursuance of his own interests («**voice**»): rights of participation, information and legal action; constrained because duty to pursue the interests of the enterprise is absent; the shareholder acts by means of election/dismissal of the board members
 - Market for corporate supervision (stock exchange and capital market) (market signals: «the invisible hand of the market»; «**exit**»)
 - Market for corporate control (takeover law) («**change of control**»)



C. System of the corporation

Board of directors and management in the corporate governance system: legal behaviour control

- Main idea
 - Duty to act in the interest of the enterprise («lasting prosperity of the enterprise»), not just in the interest of the shareholders
 - Duty of loyalty
- Mechanisms
 - Far-reaching direction competencies, inalienable by the AGM and non-transferable to the AGM (principle of parity)
 - Accountability to the shareholders
 - Board members can be dismissed by the AGM at any time
 - Auditors as independent control instance
 - Responsibility in case of breach of a duty



D. Corporate governance on the cusp of a paradigm shift?

Common view

Basis of the corporate governance debate: the shareholder is the owner of the enterprise



Principal-agent theory: division of ownership and direction in the enterprise



Counterweight: control and power shift

- Transparency
- Shift of power to the shareholders



Effect?

- Dependent on the shareholder structure
- Note: power shift from one control system to another!



D. Corporate governance on the cusp of a paradigm shift?

The relevance of shareholder structure

Type 1: atomised shareholder structure

- At first glance: similar to political democracy
- But: Fundamental differences exist
 - Capital democracy vs. one person, one vote
 - Shareholder indolence, rational apathy vs. political parties and decision-shaping ahead of a vote
 - Voice and/or exit vs. voice, no exit
- Possible solution: more engagement of a certain and more and more important kind of shareholders, namely institutional investors
 - (Special) rights for institutional investors
 - Tasks for institutional investors (Stewardship Codes)
 - Duties of institutional investors (duty to use its rights, e.g. duty to vote for pension funds in art. 95 para. 3 Swiss Constitution)



D. Corporate governance on the cusp of a paradigm shift?
The relevance of shareholder structure
Type 2: majority shareholder and small shareholders

- Typical structure after an IPO
- Problems
 - Dominance of AGM, dominance of board of directors
 - Problem not a principal-agent one («the [main] principal is the agent»), but one of protection of minority shareholders
 - Interests of the company vs. interests of the main shareholder
 - Information flow, confidentiality, authority to give directives
 - Who takes care of the interests of the small shareholders?
- Possible solution
 - Strengthening of independent directors
 - But: lack of legal enforcement means
 - The culture is key!



D. Corporate governance on the cusp of a paradigm shift?
The relevance of shareholder structure
Type 3: anchor shareholder(s) and small shareholders

- Typically evolving from type 1 or from type 2
- Problem and possible solution like under type 2
- Additional problem if evolving from type 1
 - The new approach to take over control without having to buy out the minority shareholders
 - Problematic as the minority shareholders have no exit choice at a fair value
 - Note: If evolving from a type 2 structure the minority shareholders can choose in an IPO whether they want to invest in the company or not



D. Corporate governance on the cusp of a paradigm shift?

New developments

Separation of economic ownership and voting power

with a lack of transparency

- ⇒ Empty voting
 - ⇒ voting power, but less/zero/negative economic ownership (through put options or securities lending)
- ⇒ Hidden ownership
 - ⇒ economic interest, no voting power, but possibility to acquire it (through call options)
- ⇒ Exaggerated ownership
 - ⇒ presentation of overstated economic ownership (through call options with high strike price)

Shareholder activism

Institutional investors and proxy advisors



D. Corporate governance on the cusp of a paradigm shift?

Empty voting – NYSE Commission Report on corporate governance (23.9.2010)

- «Another development in the last decade is the proliferation of derivative or synthetic securities and hedging transactions. Often these securities or transactions are employed for good economic reasons, but derivative positions are also used in connection with **takeover scenarios**, as well as **shareholder voting campaigns**, whereby investors gain the *ability to vote shares* while effectively having *no economic interest* in those shares.»
- «The SEC has asked for comments from interested parties on the implications of empty voting and the advisability of various proposed regulatory responses.»

D. Corporate governance on the cusp of a paradigm shift?

Empty voting – Delaware Supreme Court re Crown Emak Partners vs. Kurz (21.4.2010) / Basic concept



- «*What legitimizes the stockholder vote as a decision-making mechanism is the premise that stockholders with economic ownership are expressing their collective view as to whether a particular course of action serves the corporate goal of stockholder wealth maximization.*»
- «Policing third-party vote buying does not rest on the outdated notion that every stockholder owes every other stockholder a duty to use its best judgment while voting.»
- «Delaware law presumes that in the sale of the underlying stock, the seller sells and assigns all of its rights, title and interest.»

D. Corporate governance on the cusp of a paradigm shift?

Empty voting – Delaware Supreme Court re Crown Emak Partners vs. Kurz (21.4.2010) / Conclusion



- «This brings me to the *alignment of interests*. Although Kurz did not take title to the 150,000 shares that Boutros owned,(...) Boutros nevertheless transferred to Kurz, and *Kurz now bears, 100% of the economic risk* from the 150,000 shares.»
- «Because Kurz now holds the economic interest in the shares, Delaware law presumes that he should and will exercise the right to vote.»
- «We hold that (...) there was ***no improper vote buying***, because the economic interests and the voting interests of the shares remained aligned since both sets of interests were transferred from Boutros to Kurz by the Purchase Agreement.»



D. Corporate governance on the cusp of a paradigm shift?

Shareholder activism

Shorter share holding periods

- «The growth of institutional ownership, as well as changes in trading technology, brought a dramatic increase in trading volumes and a corresponding decline in the amount of time individual stocks are held. Annualized turnover of stocks traded on the NYSE is now estimated to be over 100%.» (NYSE Commission Report, p. 12)
- «Institutional investors have become a diverse group:
 - insurance companies and pension funds, with generally longer-term investment motivations;
 - mutual funds, with medium range investment focus but which must also look at the quarterly metrics;
 - hedge funds, with a time horizon potentially measured in minutes.» (NYSE Commission Report, p. 13)
- «The market has changed from an owners' to a traders' market.» (Peter Montagnon, UK FRC, 29.8.2011)



D. Corporate governance on the cusp of a paradigm shift?

Shareholder activism

Shorter share holding periods

- Short-termism vs. responsible and accountable owner
- Is a shareholder an owner or an investor?



D. Corporate governance on the cusp of a paradigm shift? Shareholder activism – Campaigns by activist shareholders instead of unfriendly takeover attempts

- Rise of activist shareholders such as Icahn, Ackman, Laxey, Knight Vinke, Olivant, TCI, Nelson Peltz etc.
- Typical approach
 - Sharp analysis of the company
 - Target company undervalued and unpopular with shareholders
 - Small quantity of shares in their possession
 - Open letter to the board of directors, building up of pressure, media campaigns, threat with responsibility claims, contact with other investors, typically hedge funds which start to invest



D. Corporate governance on the cusp of a paradigm shift? Shareholder activism – Campaigns by activist shareholders instead of unfriendly takeover attempts

- Aim: short-term enhancement of the share price through M&A transaction, pay-out of high cash reserves etc.
- Difference versus an unfriendly takeover attempt
 - No procedure defined by aspects of fairness
 - No rules regarding information, transparency, timeline
 - No supervisory authority
 - Typical defence measures (e.g. appealing to authorities and courts) inapplicable
- Examples Switzerland 2011
 - Actelion (Elliott Advisors)
 - Georg Fischer (Giorgio Behr)
 - Private Equity Holdings (Mantra and Guy Wyser Pratte)



D. Corporate governance on the cusp of a paradigm shift?

Collective instead of individual shareholdings

Institutional investors

- Behaviour of pension funds and insurance companies
- Importance of fund industry (equity funds etc.)
 - Swiss equity funds (UBS, CS, Swisscanto etc.) hold 15-20% of the SPI market capitalisation
 - Equity funds begin to enable investors to exercise their voting rights
- Question of corporate governance of institutional investors (pensions funds, insurance companies, funds)
 - «Institutional investors should practice what they preach.» (John Wilcox, Chairman Sodali, 29.8.2011)



D. Corporate governance on the cusp of a paradigm shift?

Collective instead of individual shareholdings

The role of proxy advisors

- Proxy advisors: a big, unregulated new power
 - ISS (Institutional Shareholder Services) has high market share and advises almost all big mutual funds in US
 - «All institutional investors say they have an independent committee which decides how to exercise the votes. In fact most of the time they follow the proxy advisors.» (Roland Abt, CFO GF, 29.8.2011)
 - If a fund manager wishes to deviate from a voting recommendation, he has to give reasons for this internally; if he wishes to follow the recommendation, then not.
 - Who in fact exercises the voting rights if institutional investors have a duty in future (e.g. pension funds acc. to art. 95 para. 3 Swiss Constitution!) to exercise them?
 - Who regulates and supervises the proxy advisors?

D. Corporate governance on the cusp of a paradigm shift?

Rising number of unfriendly takeover attempts



- Rising number of unfriendly takeover attempts
- Rising number of successful unfriendly takeover attempts
- Many unsuccessful unfriendly takeover attempts that lead to a change of control
- «The age of hostility – The new merger wave may bring more hostile takeovers than ever.» (The Economist online, 15.9.2009)

D. Corporate governance on the cusp of a paradigm shift?

Rising number of unfriendly takeover attempts



- **Saia-Burgess:** attack by Sumida, success of Johnson Electric
- **Leica Geosystems:** attack by Hexagon, white knight Danaher, success of Hexagon
- **Forbo:** attack by CVC Capital Partners, success of Mr Pieper
- **Unaxis:** attack by and success of Victory
- **Saurer:** attack by Laxey, success of Unaxis/Oerlikon
- **SIG:** attack by Ferd and CVC Capital Partners, success of Rank
- **Sulzer:** attack by Victory, success of Renova
- **Sia Abrasives:** attack by Behr, success of Bosch
- **Implenia:** attack by Laxey, repelled after fierce battle (special situation because of Lex Koller)

D. Corporate governance on the cusp of a paradigm shift? Increasing importance of regulatory framework



- **Nationalistic protection measures**
 - Laws: RUS, FRA, GER, USA
 - Political influence on M&A transactions
 - FRA: Sanofi-Aventis
 - ESP: Endesa/E.On (Gas Natural; Enel/Acciona)
 - LUX/FRA: Arcelor/Mittal
 - ITA: Autostrade/Abertis (Merger cancelled because of «insurmountable obstacles put up by the Italian government»)
 - ITA: Telecom Italia (Telefonica/Italian banks)
 - USA: Port of New York/Investors from Dubai (Congress)
- Trend to **more rigorous practice of many competition authorities** (GER: Sonova-Resound merger forbidden worldwide)
- Appraisal/behaviour **of para-governmental investors?**

D. Corporate governance on the cusp of a paradigm shift? The new shareholder in the corporate governance system



⇒ Challenging the foundation of the main idea!

- Decoupling of economic ownership and voting power: the shareholder is no longer an investor in the company
- Short-term shareholder activism: the shareholder is no longer a long-term investor
- Therefore, it is no longer valid that the shareholder's own interests usually correspond with the interests of all shareholders and with those of the enterprise

D. Corporate governance on the cusp of a paradigm shift? The new shareholder in the corporate governance system



⇒ Challenging the mechanisms?

- Voice (company law)
Thesis 1: «The worldwide trend of power shifting to the shareholder should be questioned critically.»
- Change of control (takeover law)
Thesis 2: «The board of director's strict duty of neutrality must be discussed anew.»
Thesis 3: «Granting party status to shareholders owning 3% of shares is going too far.»

D. Corporate governance on the cusp of a paradigm shift? The new shareholder in the corporate governance system



⇒ Challenging the main idea?

- Thesis 4: «New shareholder tasks are coming.»
 - UK 2010: Stewardship Code for Institutional Shareholders
 - OECD Principles of Corporate Governance 2010: 5 of 25 recommendations concern the behaviour of shareholders
 - EU Commission proposal 2014
- Thesis 5: «A discourse on the pros and cons of the introduction of new duties for shareholders is needed.»
 - Notification requirement regarding legal and economic ownership?
 - Duty to exercise the shareholder rights?
 - Duty of loyalty?

D. Corporate governance on the cusp of a paradigm shift? The new shareholder in the corporate governance system



⇒ Challenging the main idea?

- Thesis 6: «Some shareholder rights should be coupled to share holding periods.»
 - France: Optional loyalty double voting right or loyalty dividend (max. 10%) for shareholders registered more than 2 years (L'Oréal, Lafarge, Credit Agricole etc.)
 - US (SEC, 2010): Right to nominate directors simplified for shareholders who have held a minimum 3% of shares for at least 3 years
- Thesis 7: «The board of directors is the steward of the long-term interests of the company. The board must have the willingness, the means and the power to fulfil this demanding task.»

D. Corporate governance on the cusp of a paradigm shift? The new shareholder in the corporate governance system



⇒ Challenging the main idea?

«Who is the economic owner of the shares?»

Phenomenon of «separation of ownership from ownership»



⇒ Principal-agent discussion at a higher level!



D. Corporate governance on the cusp of a paradigm shift? EU Commission proposal for a directive as regards the encouragement of long-term shareholder engagement (2014)*

- Five objectives
 1. Increase the level and quality of engagement of asset owners and asset managers with their investee companies
 2. Create a better link between pay and performance of company directors
 3. Enhance transparency and shareholder oversight on related party transactions
 4. Ensure reliability and quality of advice of proxy advisors
 5. Facilitate transmission of cross-border information (including voting) across the investment chain in particular through shareholder identification

(* Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement of 9.4.2014)



D. Corporate governance on the cusp of a paradigm shift? EU Commission proposal for a directive as regards the encouragement of long-term shareholder engagement (2014)

- Intermediaries shall offer to companies the possibility to have their shareholders identified
- Intermediaries shall facilitate the exercise of the rights by the shareholder
- Companies shall confirm the votes cast in general meetings
- Institutional investors and asset managers shall develop a policy on shareholder engagement (comply or explain)
- Institutional investors shall disclose to the public how their equity investment strategy is aligned with the profile and duration of their liabilities (comply or explain)

D. Corporate governance on the cusp of a paradigm shift? Two schools of thought



Long-termists

- Differentiated view regarding the principle-agent-theory
- The shareholder is an investor, not an owner
- Problem of intermediation
- Problem of short-termism
- Robert G. Eccles, management professor, Harvard Business School: «High Sustainability companies significantly outperform Low Sustainability companies over the long-term, both in terms of stock market and accounting performance» (paper 2011)
- John Kay, economist: «The Kay review of UK equity markets and long-term decision making» (report 2012)
- Colin Mayer, economist, University of Oxford: «Firm commitment – the trust firm as a commitment device» (book 2013)

D. Corporate governance on the cusp of a paradigm shift? Seven theses



- Thesis 1: «The worldwide trend of power shifting to the shareholder should be questioned critically.»
- Thesis 2: «The board of director's strict duty of neutrality must be discussed anew.»
- Thesis 3: «Granting party status to shareholders owning 3% of shares is going too far.»
- Thesis 4: «New shareholder tasks are coming.»
- Thesis 5: «A discourse on the pros and cons of the introduction of new duties for shareholders is needed.»
- Thesis 6: «Some shareholder rights should be coupled to share holding periods.»
- Thesis 7: «The board of directors is the steward of the long-term interests of the company. The board must have the willingness, the means and the power to fulfil this demanding task.»



D. Corporate governance on the cusp of a paradigm shift?

UK: Stewardship Code for Institutional Investors 2012

- Seven principles
- Institutional investors should
 1. publicly disclose their policy on how they will discharge their stewardship responsibilities
 2. have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed
 3. monitor their investee companies
 4. establish clear guidelines on when and how they will escalate their activities
 5. be willing to act collectively with other investors where appropriate
 6. have a clear policy on voting and disclosure of voting activity
 7. report periodically on their stewardship and voting activities



D. Corporate governance on the cusp of a paradigm shift?

CH: Guidelines for institutional investors 2013

- Preamble: Institutional investors assume certain responsibilities in the exercising of their participation rights.
- Five principles:
 1. Institutional investors are to exercise their participation rights insofar as this is deemed appropriate and feasible in the interests of their clients.
 2. Institutional investors shall take due account of the interests of their clients when exercising their participation rights.
 3. Institutional investors shall assume responsibility for exercising the participation rights to which they are entitled.
 4. Institutional investors shall communicate the principles and processes involved in exercising their participation rights to their clients.
 5. Once a year, institutional investors shall disclose the manner in which they have exercised their participation rights.



E. ... and the answers

- Who is the owner of a corporation?
 - SME vs. listed corporation; in the latter depending on shareholder structure
- What characterizes an owner?
 - Rights (the full right over an object), but also duties
- How many UBS shares are there?
 - 3,842,002,069 (15.4.2014)
- Who are UBS's shareholders?
 - Chase Nominees (11.7%), GIC Private Limited (Government of Singapore) (6.4%), The Depository Trust (5.9%), Nortrust Nominees (3.8%) (31.12.2013)
 - Approx. 80% foreigners
- What is the price of UBS?
 - Market capitalisation CHF 67 bn. (15.4.2014)
- What is the price of one UBS share?
 - CHF 17.47 (15.4.2014)



E. ... and the answers

- What is the cost to buy the voting right of one share for UBS's next AGM?
 - 1/10'000-1/1'000 of CHF 17
- What would the takeover price of UBS be?
 - 20-30% of CHF 67 bn. = CHF 13-20 bn.
- How much money do the Chinese Sovereign Wealth Funds have?
 - USD 1'500 bn. (source: SWF institute, 2014)
- Which is the average holding period of shares in listed companies?
 - Some months
- What happens in the shareholder base when a public takeover bid is launched?
 - Private and institutional investors realise the profit, hedge funds step in
- How do you invest your money?
 - As an investor, not as an owner!



Questions?

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