

Proportionality

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Opening remarks from Iain Richards, Aviva Group - Morley Fund Management

Good afternoon.

After the almost comic tragedy of the Takeover Directive, there is a grim sense of déjà vu in being here to talk about proportionality.

Let me start by saying that we should not be mistaken into thinking that this debate is just about looking into how particular groups of vested interests seek to maintain special privileges or to disadvantage the EU's broader base of equity risk capital providers, or whether some few have a rational, limited purpose and effect.

At a policy level the issue is far more significant than is often credited in the entrenched discussions on this topic. In the spotlight should be some of the key principles that underpin our European ambitions and the benefits that are on offer.

The principle that Control Enhancing Mechanisms can frustrate the objectives of the EU Treaties has already been established in the European Court of Justice (ECJ), in its deliberations and rulings in relation to Golden Shares.

Not least, these mechanisms create exceptions to the principles of free movement of capital and consequently the principle of freedom of establishment.

While the ECJ rulings have dealt with actions taken at Member State level, the effects of many CEMs and related structures are little different in practice.

Clearly given the precedent set by the ECJ and the fact that European Treaties can, in certain circumstances, have horizontal direct effect, there may well be some distant, theoretical possibility of challenging some of the more extreme CEMs.

I doubt though that any of us will be holding our breaths waiting to see that happen.

That is not to say the problem is remote or unimportant. I expect many of the investors here today share the scars received as a result of CEMs and their like.

Indeed, at a policy level the issues at stake here are too important to ignore. In particular, I have in mind the efficiency and competitiveness of the EU capital markets.

Ultimately, this debate must be set against the growing challenges and opportunities the EU faces from globalisation and competition from the developing powerhouse economies in the East.

To any thoughtful reader, the survey of investors carried out in the EU study makes clear that CEMs are an issue and do have an effect on the willingness to commit capital.

"So what" some will say "there is plenty of capital to go around' and in some respects that rather narrow and short-sighted view is sometimes true, at least in the current benign environment we have had.

The reality is that CEMs are reflected to a greater or lesser extent, depending on their nature and the prevailing situation, in, amongst other things, the discounts that will be applied to the valuation of a company.

The result and effect of that should be obvious - it increases the cost of capital and as the cost of capital increases the competitiveness of our companies on the global stage, is effected.

That is not however, the only issue. Linked to the effect on valuations, CEMs distort and undermine the proper and efficient operation of the market for corporate control and foster inefficiencies. They are key tools of entrenchment.

I doubt any of us today need a lesson in agency theory, so let me just say CEMs are characteristics of both a market failure and, in evolutionary terms, a damaging dead end, rather like ancient concept of the 'droit de seigneur'.

They do hinder or prohibit market forces from achieving EU treaty objectives and can stifle efficiency, competitive innovation, interaction, diversity and selection.

The comparison I used to the 'droit de seigneur' is not intended to be facetious. Just as Marie-Antoinette once said "let them eat cake", so the vested interests expropriating value and control through CEMs will say if you don't like it, tough, sell the shares.

If nothing else that suggests a marked degree of ignorance or perhaps opportunistic spin about the reality of modern capital markets.

Maybe the investment industry should be restructured so that we all operate as Hedge Funds willing and able to dip in and out of stocks with ease, but I doubt that is what most people want or what the capital markets and our economies need.

Indeed, Hedge Funds often find companies with CEMs of particular interest for three reasons:

- the first is the valuation discount applied to them;
- the second is that they can and do foster the inefficiencies academic literature point to; and
- the third is that the broader often disenfranchised and marginalized providers of equity risk capital are increasingly willing to listen to them out of frustration.

The reality is that providers of equity risk capital do not opt to be disenfranchised or marginalized in the ways that they are. Any more than those having to deal with

Cartels do. Comply or explain is hollow and ineffective in a context where shareholders are disenfranchised.

Where there are problems and the opportunity arises it is very clear that we will opt-out of such servitude.

That choice can be seen where negotiating ability becomes available, such as in IPOs or when companies require additional or new capital.

In extremis, thanks to the French association ADAM (l'Association de défense des actionnaire minoritaires), we now also have the precedent set in the French Court of Appeal that legal action is possible to gain protection and redress for minorities. I am thinking of the Schneider Legrand case.

In that case shareholders with voting control, sought to siphon off the value for themselves at the expense of the disenfranchised minority.

So what needs to be done?

Having been a policymaker, I have to admit that any rash wholesale move to prohibit CEMs would be both unwise and possibly ineffective.

Even leaving aside the technical challenges of intervention, we need to recognise not only that not all CEMs are necessarily a problem, but also that this issue sits in a wider context.

In terms of the market for corporate control in Europe, poison pills, other board entrenchment mechanisms, the abusive termination or break fees we are seeing in acquisitions, amongst other things, are also relevant.

Ultimately, any intervention needs, itself, to be proportionate and based on solid foundations with clear objectives.

It must also recognise that, as has been seen in the tax avoidance industry, there is an army of well paid lawyers and bankers who will be ready to swing into action and design mechanisms to circumvent any attempted intervention.

That is not to say that nothing should be done or that this study is not useful. What the study has provided us with is two things:

- The first is a better understanding of the complexity of this issue and of market practice.
- The second is further evidence of the fact that there is a problem.

So what should be done?

- The importance and relevance of some of the outstanding recommendations of the High Level Group of Company Law Experts on takeovers remains and these need to be pursued.

- As a first step, we need to ensure the EU Directives deliver full and meaningful disclosure about capital and control or control distorting structures, conflicts and related party benefits.
- Those disclosures must be kept up to date and reflect and appropriately encompass the mixture of insider and outside parties involved. They need to provide clarity about the nature, purpose and rationale of such distortions, as well as their limits and the safeguards that exist.
- Alongside that, policymakers at both EU and Member State level should look to extend the program of research that has been started by this study, looking further at the characteristics of 'problem' cases, the effects on and of the cost of capital and distortions in the market for corporate control, including breakdowns between risk-bearing capital, economic interest and control.
- In addition, consideration should be given to the experiences of markets which have put restrictions or safeguards in place or which have undergone a transition away from CEMs such as unequal voting rights.

Looking ahead the agenda should include:

- Consideration of the possibility of requiring sunset clauses that would require selected CEMs and other entrenchment mechanisms to be subject to a regular, fair and proportionate vote by the providers of the company's equity risk capital. If the market is really to have the ability to decide, this is essential.
- Reflecting the experience of the Schneider Legrand case, consideration should be given to introducing a coherent and consistent framework to enable minority shareholders to seek effective redress or intervention where their economic interests are being expropriated.
- While this may make those still nursing the wounds from last time around, groan, consideration should also be given to revisiting and re-asserting the break through provision of the Takeover Directive.

There will be other steps and options that I have not mentioned, but I hope what I have said has given you food for thought and an insight into some of the issues that are important to us as long-term shareholders and providers of equity risk capital.

Thank you.