POSITION PAPER
ENGAGED SHAREHOLDERSHIP

Adopted 12 March 2010

1. Motivation

The debate on the role of shareholders in the system of corporate governance has recently taken a new direction. Shortly after the appearance of the Dutch Corporate Governance Code in 2003 and after the legal reinforcement of the position of shareholders in 2004, the emphasis was on encouraging shareholders to make use of their new rights. The strengthening of the shareholder's position was a necessary condition at that time for improving the checks and balances at listed companies, according to the Tabaksblat Committee and the legislature. Following the actions of some reputedly activist shareholders involving a number of Dutch listed companies, the discussion is now mainly concerned with the manner in which shareholders use their rights. Shareholders are presently being increasingly reminded of their obligations. The government refers in this context to a reassessment of the position of the shareholder[1], while the Corporate Governance Code Monitoring Committee refers to the "citizenship" of the shareholder[2]. Greater responsibility is expected from institutional investors[3] in particular, on the basis of the idea that they hold the majority of the shares in the Dutch listed companies and manage other people's money.

The critical look at the role of the shareholder has been reinforced by the financial crisis. A frequently heard point of criticism by society is that shareholders sometimes used their control rights to pressurize management boards at listed companies to focus first and foremost on achieving short-term results, which interferes with the implementation of a strategy focused on the long term. At the same time, it is also asserted sometimes that shareholders did not sufficiently scrutinize decisions taken by the management board and that they did not hold the management board sufficiently to account for its performance. The business community and political parties are appealing for instruments that could induce institutional investors to keep their shares for a longer time. They believe that investors of this kind, who are characterized by their long-term investment philosophy, could

[1] 'Working on the future', a policy agreement augmenting "working together, living together', 25 March 2009.
[2] Corporate Governance Code Monitoring Committee, First Report on Compliance with the Dutch Corporate Governance Code, December 2009.
[3] Institutional investors are defined in this document as pension funds, asset managers, managers of investment institutions and insurance companies who invest "traditionally", in the sense that they do not generally go short (i.e. long only), and do not pursue an event-driven strategy.

improve the stability of the shareholder base and (partly as a consequence of this) increase the long-term ties between institutional investors and the company[4].

This position paper contains the views of Eumedion[5] on the discussion outlined above. These views are mainly, but not exclusively, based on the analysis in the research report 'Role of institutional investors in relation to management boards and supervisory directors: a triangular survey' commissioned by Eumedion from Prof. Dr. A.G.Z. Kemna and Prof. Dr. E.L.H.M. van de Loo (hereafter: Kemna and Van de Loo)[6]. The recommendations for institutional investors presented in this report are also examined.

2. Summary and recommendations

Institutional investors have a long-term investment philosophy, but this is not synonymous with keeping shares in certain companies for the long term, since institutional investors have a responsibility towards their clients and the ultimate beneficiaries. An institutional investor can come into conflict with this responsibility for example, if it continues to hold shares in a certain company while the market value of the company in question is much higher than the value of the company according to the investor, or when the company's strategy is no longer consistent with the institutional investor's investment strategy.

Eumedion endorses the conclusion reached by Kemna and Van de Loo on p. 21 of their report that "Most important of all is for long-term engaged shareholders to have confidence [...] in the following:

- the long-term strategy of the company,
- the extent to which the management board is capable of achieving this,
- the way in which and the regularity with which the management board communicates about the strategy,
- the way in which supervisory directors can support and monitor the management board in this respect,
- the involvement of institutional investors in all of this.

The potential success of long-term engaged shareholdership requires a much more intensive relationship between institutional investors, management board and supervisory directors, which means a substantial investment in time and money by all participants." In the specific case of institutional investors, Eumedion believes, therefore, that the emphasis in the social debate should not be placed so much on the encouragement of keeping shares for a *longer term*, but on the encouragement of *engaged* shareholdership on the part of institutional investors. In this paper, engaged shareholdership is held to mean (at least) the exercise of the voting rights attaching to shares during shareholders' meetings and/or engaging in a dialogue with the management of a listed company both inside and outside the shareholders' meeting, as a consequence of which the providers

[4] The supposed vulnerability of Dutch listed companies to (hostile) takeovers could also decrease as a consequence.
[5] The members of Eumedion are institutional investors as defined in footnote 3.
[6] The report is enclosed as an appendix and can also be downloaded at: http://www.eumedion.nl/page/downloads/Onderzoeksrapport_DEF_III.pdf.

of equity capital clearly demonstrate their engagement with the (financial) performance of the company.

This paper makes the following concrete recommendations to *institutional investors* to this end:

1. Substantial investments in personnel and training or to mandate – based on its own ESG policy – an external asset manager to act as an engaged shareholder;
2. Integration of ESG factors into the investment process;
3. Willingness to cooperate with other institutional investors;
4. Remuneration of fund managers that is more strongly linked to the long term and to the interests of the client and the ultimate beneficiaries;
5. A mandate to asset managers that covers a longer period and addresses engaged shareholdership;
6. The drafting of internal rules on dealing with a number of different interests;
7. The recall of lent shares when there are important matters on the agenda for the shareholders' meeting and openness on the subject of control positions during dialogue with enterprises.

The *legislature* is expected to play a facilitating role on the following specific points:

1. Retention of sufficient control rights, the exercise of which must not be made disproportionately difficult;
2. Clarification of the definition of acting in concert in the event of a mandatory offer.

An open attitude is expected first and foremost of *listed companies*:

1. Good corporate governance structure and a high degree of transparency;
2. Willingness on the part of the management board and the supervisory board to enter into dialogue with institutional investors.

Finally, *Eumedion* itself will undertake the following action to potentially stimulate engaged shareholdership:

1. Research into the increase of the involvement of major shareholders in the selection of supervisory directors;
2. Research into the added value of drafting a Dutch code for institutional investors. A working group will be formed for this purpose and will report in the autumn of 2010.

Eumedion intends to organize a number of workshops with Eumedion members and non-members in the near future to discuss the concrete recommendations.

Following on from Kemna and Van de Loo, Eumedion emphasizes in these recommendations that their main focus is not on the introduction of all kinds of new rules, legislation or compensatory options, but rather on increasing awareness of one's own role and the roles of others, and advancing effective cooperation between the parties by means including a change to one's own behaviour.

The matters outlined above will be worked out in more detail in the following paragraphs.

3. The relationship between institutional investors and their beneficiaries

Institutional investors invest directly or indirectly[7] at the expense and risk of their ultimate beneficiaries, i.e. the persons entitled to a pension, the employees who pay pension contributions, the policy-holders, the participants in investment funds, etc. These investors must deal prudently, therefore, with the financial resources entrusted to them and must render account for their dealings. In this sense, institutional investors can be compared with listed companies, since listed companies do business with other people's money and must render account for their actions. The objectives of listed companies and institutional investors also follow more or less naturally from each other. Listed companies endeavour to create shareholder value in the long term[8] and institutional investors mostly endeavour to achieve a sustainable, long-term return on their investments.

Just like listed companies, institutional investors also have a principal-agent problem, in the sense that the objectives of the fund managers (the agents) may differ from those of the ultimate beneficiaries (the principals). People who pay pension contributions have an interest, for example, in achieving an attractive return calculated over a long period. A fund manager, on the other hand, has a greater interest in achieving a high return in the short term, if a large share of his remuneration or chances of promotion depend on his investment performance calculated over a period of one year. According to the Dutch central bank (De Nederlandsche Bank; DNB) this is what has actually happened in the case of asset managers in the past few years:

> "In the case of Asset Management in particular, the risk of the activity is not sufficiently aligned with the time horizon for the determination of the variable remuneration. This would seem obvious in view of the nature of the operational activity, which is focused on long-term value development. There is a risk, in that event, that remuneration will even be paid for performance that may have a negative effect on the operating results of the enterprise. Furthermore, the tendency to focus on the short term is not corrected. The study shows, however, that the long-term remuneration is generally only a small percentage of the total bonus pool"[9].

In addition, the distance between fund managers and ultimate beneficiaries has generally become greater in the last few years. In the first quarter of 2009 for example, approximately 93 percent of Dutch pension assets was invested externally with one or more asset managers, while this percentage was still less than 50 in 2001[10]. The average duration of the mandate that a pension fund (hereafter also the "client") gives to an asset manager is three years[11] and the pension fund's decision on

[7] A direct relationship exists between a pension fund and its ultimate beneficiaries (the members) for example. There is an indirect relationship between an institutional investor and ultimate beneficiaries when a pension fund (also referred to as the client in this paper), for example, has outsourced its assets to an external asset manager.
[8] Paragraph 7 of the preamble to the Dutch Corporate Governance Code.
[9] DNB, "Principles for sound compensation policies; Report of the study of the remuneration situation at Dutch financial enterprises", September 2009 (appendix to parliamentary papers II 2009/10, 31 371, no. 254).
[10] Figures from Bureau Bosch. This can relate to both the outsourcing of part of the asset management to one or more external parties and the outsourcing of all aspects of asset management (such as the preparation of policy, the assessment of the investment policy and the risk management) to a single manager (the fiduciary manager).This fiduciary manager in his turn can subsequently outsource (part of) the asset management to one or more external asset managers. In this connection, also see the Commissie Beleggingsbeleid en Risicobeheer [Netherlands Committee on Investment Policy and Risk Management], *Pensioen: "Onzekere zekerheid" [Pension: An uncertain certainty]*, a study commissioned by the Netherlands Ministry of Social Affairs and Employment,19 January 2010, p. 44.
[11] R. van Tilburg, "Finance for Innovation; Policy options for improving the financial component of the Dutch innovation system"; Study commissioned by the Dutch Advisory Council on Science and Technology Policy, 2009.

whether to extend the mandate or not is partly based on the (financial) performance of the relevant asset manager in this period, mostly judged by market performance established by a benchmark. This settlement period can give fund managers a further incentive to pursue shorter term objectives than those of the ultimate beneficiaries. Furthermore, the increased scale of many institutional investors means that the fund manager has become increasingly distant from both the client and the ultimate beneficiaries, as well as from the company whose shares are held. Investment decisions have become impersonal or anonymous, as a result of which the fund manager is encouraged to measure his performance mainly by the performance of "his" fund in comparison with the benchmark.

The factors referred to above can contribute to an increasing incentive for fund managers to judge listed companies on their short-term performance. In addition, there can be a tendency not to allow the performance of the institutional investor to diverge too much from the benchmark (index-tracking investment), so that investment decisions are taken on the basis of the structure of a certain benchmark, instead of on the quality of the strategy or value of the underlying enterprise. These findings are in keeping with those of Kemna and Van de Loo (p. 7 and 9). Paragraph 6.1 summarizes a number of possible ways of mitigating short-term behaviour.

4. Long-term investment philosophy of institutional investors is not synonymous with long-term shareholdership

Even if the problems identified in paragraph 3 can be mitigated, having a long-term investment philosophy that is geared to achieving sustainable, long-term financial results does not mean that institutional investors will also keep the shares of a certain enterprise for the long term under all circumstances. A decision of this kind is related first and foremost to the institutional investor's ideas on investment and its investment strategy (see box 1 below for various investment strategies). If, for example, the price development of a share is such that the share is no longer undervalued, it is possible that a fund manager will sell the share in question, in the interest of safeguarding adequate results in the long term. This can also happen if the share in question is removed from the benchmark applied by the institutional investor in question. Another possibility is that the fund manager may decide to sell a share when the management board of the enterprise in question implements a change in strategy that does not inspire the trust of the relevant fund manager. There are, in short, a number of reasons for the early disposal of shares in an individual enterprise, even if an institutional investor is, in principle, investing for the long term.

Box 1: Investment strategies of institutional investors

Just like other investors, institutional investors may have different reasons for holding shares in a certain enterprise. Roughly speaking, the following considerations can be discerned among institutional investors:

- the strategy of the enterprise in question and the ensuing profitability (growth investment);
- the supposed undervaluation of the share (value investment);
- favourable growth prospects for the company (partly in view of the strategy and the quality of the management and supervisory boards), while the present valuation of the share is less than its net asset value (growth at reasonable price [GARP investment]);
- the inclusion of the share in question in a certain index (index or passive investment).

An unusual situation arises when a public offer is made for the shares of the company. If this offer has the support of the management board of the target enterprise and the takeover price reflects the net asset value of the enterprise, a shareholder with a long-term focus has little further interest in the enterprise in question, because the continuity of this enterprise has itself become uncertain. Share positions can also be quickly wound down at such times, when the enterprise concerned attracts different kinds of shareholders, such as special event-driven investors who are focused on the short term. Even if the offer does not have the cooperation of the management board of the target enterprise (a hostile situation), the investor must make its own decision on whether to keep the share, or sell it on the stock exchange or to the (hostile) bidder. If the offer is (much) higher than the net asset value of the enterprise, it is questionable whether the institutional investor is not acting contrary to its responsibility towards its ultimate beneficiaries if it does *not* offer its shares to this bidder, or does not sell its shares on the stock exchange when the share price is already reflecting the takeover price[12].

In the light of the foregoing, Eumedion believes that the emphasis in the social debate should not be placed on the encouragement of keeping shares for a *longer term*, but on the encouragement of *engaged* shareholdership on the part of institutional investors. Arguments substantiating this opinion will be provided in the following paragraph.

5. Engaged shareholdership and the responsibility of institutional investors

As remarked in paragraph 3, institutional investors have a duty to deal prudently with the resources entrusted to them – usually focused on achieving a sustainable, long-term return – and to act in accordance with the wishes of the ultimate beneficiary or the client. It is part of this responsibility to make a cost-benefit analysis of the possible use of the voting rights associated with the shares and/or whether or not to enter into dialogue with the listed companies in which shares are held. An institutional investor must judge, as it were, the extent to which engaged shareholdership may be of importance in realizing a sustainable long-term return on the investment portfolio and/or is consistent with the wishes of the clients and/or the ultimate beneficiaries[13]. Engaged shareholdership on the part of the institutional investor is stimulated in the first place, therefore, when it is clear that an approach of this kind contributes to value creation in the long term or reduction of the risk premium on shares. This will mainly be the case when an institutional investor holds a relatively large interest in an individual listed company. “Experience with investments of this kind makes it clear that having and keeping a 5% interest is so comprehensive that engagement is absolutely necessary, because too much capital is at stake,” according to Kemna and Van de Loo on page 25 of their report. In addition, larger parcels of shares are less liquid and are not easily sold without price loss, certainly in the case of smaller listed companies. Voting with your feet is not such a good option as a result and what remains is the protection of or increase in the value of the parcel of shares through engaged shareholdership. In the case of diversified shareholdings, the positive effects of engaged shareholdership will be visible first and foremost when institutional investors cooperate more. The recent past has proved that effective

[12] This does not alter the fact that the management board may be able to convince the shareholders of its possible stance that the bid price is less than the net asset value of the share.
[13] Also see Commissie Beleggingsbeleid en Risicobeheer. op. cit., p.14.

cooperation between institutional investors can lead to changes in various respects at the major listed companies.[14] In the second place, engaged shareholdership is encouraged when clients (such as pension funds) and ultimate beneficiaries attach (greater) importance to such an approach being taken by the institutional investor. A "push" like this from the clients and the ultimate beneficiaries can be influenced by social actors and political parties. A number of instruments that might also be able to stimulate engaged shareholdership are discussed in paragraph 7.

The interests of institutional investors and listed companies frequently follow on from each other in principle, since the company has to pursue the creation of shareholder value in the long term and the institutional investor generally has to pursue a sustainable long-term return. In this sense, both institutional investors and listed companies will benefit from fostering a relationship of mutual trust and cooperation, since a relationship of this kind contributes most to the achievement of shared goals. An active attitude on the part of institutional investors, focused on constructive cooperation with listed companies on a basis of mutual trust, is referred to as *stewardship*[15].

Institutional investors who practice engaged shareholdership are obviously bound by the relevant laws and regulations. In this way, shareholders - and institutional investors too therefore - have only monitoring powers within Dutch company law and no powers to decide on a change of course in relation to the company's strategy and policy, which is the task of the management board and supervisory directors. In addition, an institutional investor does not have complete freedom in all cases to determine its voting behaviour. The fact is, that the exercise of rights and powers can be assessed in the light of the standards of reasonableness and fairness (section 2:8 of the Civil Code of the Netherlands) and it generally applies in this context that the greater the interest that a shareholder holds in the enterprise, the greater its responsibility to the enterprise in question, the minority shareholders and other stakeholders in the enterprise[16].

6. Enabling conditions for engaged shareholdership by institutional investors

As is set out in paragraph 5, engaged shareholdership by institutional investors can be a corollary of their responsibility towards their ultimate beneficiaries and clients, but an institutional investor can only fulfil such a role if a number of conditions are met. A number of these conditions can be met by the institutional investor itself (also see paragraph 3); in other cases, it is dependent on the legislature and on the listed company. These enabling conditions are considered below.

[14] See also the Eumedion evaluations of the 2008 and 2009 AGM seasons (www.eumedion.nl). Eumedion disagrees, therefore, with Kemna and Van de Loo's recommendation that attention be focused in the first instance on the introduction of long-term engaged shareholdership at the smaller and medium-sized listed companies (recommendation 14).
[15] D. Walker, *A review of corporate governance in UK banks and other financial industry entities; Final recommendations*, 26 November 2009.
[16] Netherlands Supreme Court 13 February 1942 (Baus/De Koedoe), *NJ* [Dutch Law Reports] 1942, 360; Amsterdam Court of Appeal (Enterprise Section), 8 October 1998 (Zwagerman), *JOR* [Netherlands Court Rulings Online] 1998, 167; Amsterdam Court of Appeal (Enterprise Section), 30 November 2000 (Zwagerman), *JOR* 2001, 4; Amsterdam Court of Appeal (Enterprise Section), 22 March 2001 (Rodamco North America), *JOR* 2001, 130.

6.1 Characteristics of institutional investors as engaged shareholders

a. Substantial investments by the institutional investor in personnel and training

If an institutional investor wishes to interpret engaged shareholdership seriously, it is necessary, first and foremost, for this investor to invest in knowledge and personnel, in order to be able to make an effective analysis of the companies that are being invested in. Sufficient knowledge must be present to fulfil the role of a full and professional partner in discussions with the enterprises in question, certainly where the subjects of strategy, risk management, quality of management board and supervisory directors are concerned, as well as in the fields of environmental and social policy, and matters of governance (ESG). This also requires that the people who speak with the members of the management and supervisory boards of an enterprise on behalf of the institutional investors have sufficient seniority and prepare thoroughly for the discussions. Eumedion endorses, therefore, the recommendations of Kemna and Van de Loo on this point (recommendations 9 and 11). All of this does not mean, however, that an institutional investor, such as a pension fund, cannot decide for reasons of costs and capacity to mandate another institutional investor, such as an external asset manager, to act as an engaged shareholder on its behalf, on the basis of its own policy on ESG. Furthermore, some pension funds invest in investment funds alone, in which case it would be logical for a pension fund making a selection of investment funds to ascertain whether the ESG policy of these investment funds is in line with the pension fund's own ESG policy.

b. Integration of ESG factors in investment process

Analysis of an enterprise demands an integrated approach by the institutional investor. This means that, in addition to return-driven motives, fund managers also integrate relevant ESG factors into investment decisions, since factors of this kind can affect the performance/risk profile. In addition, listed companies are also required by the Dutch Corporate Governance Code to consider the relevant social aspects of entrepreneurship where the company is concerned and shareholders are expected, partly on these grounds, to start or to strengthen the dialogue on this subject with the management of the enterprise[17]. An integrated approach also has advantages for the company concerned. The report from Kemna and Van de Loo also makes it clear, in fact, that fund managers and governance teams at the same asset manager who operate independently from each other are perceived by listed companies as one of their greatest sources of irritation (explanatory notes to recommendation 8).

c. Willingness to cooperate with other institutional investors

Engaged shareholdership also implies that the institutional investor makes contact with fellow investors. Institutional investors will want to exchange views with fellow investors from time to time and will also want to decide on a common stance when appropriate, so that they can reach consensus more quickly with and form a stronger front against company management when necessary. Cooperation between institutional investors, either within a formal framework or not, can increase the effectiveness of the shareholders' monitoring function. In the case of cooperation of this kind, however, a close watch must be kept on the limits of what are known as the acting in concert rules; in the case

[17] Kamerstukken [Parliamentary Papers] II 2008/09, 31 083, no. 29. p. 14.

of acting in concert, extra statutory transparency rules may apply, or the obligation may arise to offer minority shareholders an exit option by means of issuing a public offer for the shares. See paragraph 6.2, section c.

d. The remuneration for fund managers should be more strongly linked to the long term and to the interests of the client and the ultimate beneficiaries

The incentive for a fund manager to assess listed companies on short-term performance above all, can be reduced by placing more emphasis on the long term in the remuneration structures for fund managers. In addition, the performance of fund managers should not be assessed exclusively on the basis of how the market performs in the short term, as established by a benchmark. The interests of the client and the ultimate beneficiaries should be taken explicitly into account. The creation of partnerships in which the fund manager has a more prolonged participating interest in the fund that he manages might offer a solution, since the long-term interests of a fund manager would then coincide with the long-tem goals of the client and the ultimate beneficiaries.

e. Long-term mandate for asset managers

It is important, if the short-term incentive for fund managers is to be mitigated further, that the mandates that pension fund boards give to asset managers are not too short[18]. In addition, it is advisable for a pension fund to require engaged shareholdership of its external asset manager on the basis of the fund's own ESG policies, that the asset manager reports on the implementation of this periodically and that this is included in the mandate.[19]

f. Internal rules on dealing with different interests

Engaged shareholdership can be impeded when an institutional investor has more interests (which may include conflicting ones) involving a company than its shareholder’s interest alone. This can occur, for example, in the situation in which the investor in question also offers financial products (such as insurance) to the enterprise, or when a member of the management board of the institutional investor itself also holds a management or supervisory position with the enterprise in question. It is also possible for an institutional investor to hold shares in an enterprise that sponsors the institutional investor concerned, or for the institutional investor to be affiliated with the company for which an offer has been submitted.

Different interests can also occur *within* one institutional investor. This can be the case, for example, when the investor in question holds not only shares in the company, but bonds as well, since the interests of bondholders do not necessarily always run parallel to those of shareholders. In addition, the investor may have shares in both the bidder and the target company in the case of a public offer,

[18] This does not alter the fact that pension funds subject the external asset managers to continuous monitoring on the basis of extensive and adequate reports; see Commissie Beleggingsbeleid en Risicobeheer. op. cit., p. 45

[19] The International Corporate Governance Network (ICGN) is presently preparing guidance in order to enshrine engaged shareholdership in a mandate to asset managers. This guidance is expected to be published in June 2010.

or the investor may be affiliated to a private equity fund that issues an offer for the company in which the investor is a shareholder.

It is important for institutional investors to have procedures for how to act in the event that different or conflicting interests present themselves. The clients must always be aware, as and when the situation arises, of the possible existence of interests involving the institutional investor and the company, other than the shareholder’s interest alone.

g. The recall of lent shares when there are important matters on the agenda of the shareholders' meeting and openness on control positions during a dialogue with companies

Institutional investors regularly legally transfer (a quantity of) their shares to a party which has to deliver these shares in the short term for various reasons. The borrower undertakes at the same time to return an equal number of the same shares at a later time with payment of a lending fee. Engaged shareholdership can be impeded by securities lending of this kind. The fact is that the lender, generally an institutional investor, is not the owner of the shares in a legal sense and is unable to vote the shares for as long as the shares are on loan. The shares can be held in the legal sense by a hedge fund, for example, that is pursuing a different goal with the enterprise than the institutional investor that is the beneficial owner. It is advisable, therefore, for the securities lent to have been recalled by institutional investors before the record date on which it is established which party is entitled to vote at a shareholders' meeting, certainly in a situation in which important or controversial matters have been placed on the agenda for the shareholders' meeting. Moreover, it is advisable that the agreements between lending and borrowing parties include the provision that it is not permitted for the shares to be used solely for the purpose of exercising the voting rights on these shares. In the event that an institutional investor is engaged in a dialogue with the enterprise on certain subjects, outside the context of the shareholders' meeting, it is advisable that the institutional investor's total position (the extent of its legal and economic interest) is made clear to the enterprise on its request.

h. Study of the additional value of drafting a code for engaged shareholdership

On the grounds of the Netherlands Act on Financial Supervision (Wft), Dutch pension funds, life insurers and investment institutions have a statutory obligation pursuant to what is known as the comply-or-explain principle to render account of their compliance with the two principles and six best practice provisions in the Dutch corporate governance code, which are also directed towards institutional investors. A separate code for institutional investors that has recently been drawn up in the United Kingdom (UK) includes more specific principles for engaged shareholdership,[20] enabling the ultimate beneficiary or the party that gives the mandate to the relevant institutional investor to find out whether this institutional investor is actively concerned with corporate governance and engagement. The UK code is intended to clarify the responsibilities of institutional investors and can be helpful in

[20] The UK code for institutional investors can be downloaded at: http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCCode161109.pdf. A study group led by RiskMetrics advised the European Commission in September 2009 to encourage the EU member states to draft national codes of conduct for institutional investors (RiskMetrics, *Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States*, 23 September 2009, p. 18). It is not yet known whether the European Commission will follow this recommendation.

drawing up a mandate for an asset manager. Eumedion will soon be forming a working group to study whether a specific code for engaged shareholdership on the part of institutional investors can have added value for the Netherlands as well and, if this is the case, what form a code of this kind should take. The working group will report its conclusions to the Eumedion board at the end of this year.

6.2 A facilitating role for the legislature

a. Shares with control rights

A primary enabling condition for engaged shareholdership is that the shares also actually carry proportional control rights. In this context, it is inappropriate in principle for listed companies to issue non-voting shares, non-voting depositary certificates and extraordinary control rights for certain shareholders (priority shares).

b. Sufficient control rights

If engaged shareholdership is to be interpreted effectively, a shareholder will have to have a minimum number of control rights at its disposal within the framework of the decision-making process at shareholders' meetings, including the right of:

- appointment and dismissal of members of the management board and supervisory board;
- approval of important management decisions, such as a change in the nature or identity of the company, a major takeover and/or spinoff, and the sale of practically the whole enterprise;
- approval of amendments to the articles of incorporation;
- approval of the issue of new shares and the purchase of existing shares;
- adoption of the remuneration policy for the management board and approval of share and/or option schemes;
- requesting that a general meeting/extraordinary general meeting be convened
- submission of subjects for the agenda of the shareholders' meeting.

These rights should not be curtailed. Moreover, Eumedion is of the opinion that the exercise of these rights should not be made so difficult that the rights become illusory, e.g. by specifying high voting and quorum limits (e.g. the requirement of a two-thirds majority of the votes representing half of the issued capital) for the dismissal of a member of the management board and/or supervisory director, or by specifying a high capital threshold (e.g. 3 percent of the issued capital) for requesting the management board to place an item on the agenda for a shareholders' meeting. Thresholds of this kind would have a negative effect on the required checks and balances at a listed company.

c. Being able to cooperate with (institutional) investors

Under certain circumstances (see paragraph 6.1 section c), associating with other institutional investors can give rise to the obligation to make a notification of a substantial holding in the event of a notification threshold being exceeded, or to make a public offer for the shares in the company when the parties jointly represent at least 30 percent of the voting rights. The circumstances under which consultation and cooperation between shareholders becomes acting in concert and the legal rules referred to above consequently come into force are not clear in all cases. The Netherlands Authority

for the Financial Markets (AFM) published guidelines on 20 November 2009 for submitting a (collective) notification of a substantial holding[21]. The AFM made it clear that there is no question of acting in concert when the cooperation relates to the preparation of one single general meeting or relates to the cooperation in connection with the regular points on the agenda for the general meeting. Acting in concert can only exist in the event that institutional investors cooperate for more than one general meeting, in order to change company strategy and/or to propose joint candidates for the management board and/or supervisory board. Although this has partially solved the problems identified by Kemna and Van de Loo in connection with recommendation 12, there is still some lack of clarity concerning acting in concert in relation to a mandatory bid. The legislature has announced that it will be issuing a consultation document in the first half of 2010 to clarify what is to be understood by acting in concert in relation to a mandatory bid[22]. In Eumedion's opinion, the Netherlands Ministry of Finance should then move quickly to amend the existing takeover legislation and regulations.

d. Being able to conduct a dialogue with management board and board of supervisory directors

Engaged shareholdership implies the willingness to enter into dialogue with management boards and supervisory boards. Management boards and supervisory boards can clarify their strategy and policy during this dialogue, while institutional investors can explain their views on these matters, which will lead to much more of a "real" dialogue than there is during the annual shareholders' meeting. Kemna and Van de Loo point out that statements made by the AFM in the past have made listed companies "diffident" about conducting a dialogue of this kind, so that "there is no longer any exchange of information that is needed to acquire and retain confidence." (p. 22). In an interview with one of its management board members in two daily newspapers, the AFM took the worst of the chill out of the air:

> "According to Maatman, companies have no need to be afraid of the AFM where one-on-one meetings are concerned, unless price-sensitive information is exchanged. 'You are always allowed to listen to your shareholders. And an executive is always allowed to respond.' Maatman does advise making a good report of the meeting. 'The text doesn't have to be published on the internet and there is no need for a tape either.' (Financieele Dagblad, 20 November 2009). 'This does not change the fact that executives must be very cautious about sharing price-sensitive information. You mustn't take a shareholder by surprise with things like that. And it must be necessary." (De Telegraaf, 20 November 2009).

These statements make it clear that the AFM also believes that dialogue between shareholders and enterprises can contribute to better understanding and a restoration of mutual confidence[23]. The problems identified by Kemna and Van de Loo in recommendation 11 have been solved to a large extent as a result.

6.3 An open attitude on the part of listed companies

a. Good corporate governance structure and a high degree of transparency

Engaged shareholdership is impossible without sufficient relevant information about the (financial)

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[21] http://www.afm.nl/marktpartijen/upl_documents/acting_in_concert_eng.pdf
[22] Parliamentary Papers II 2008/09, 31 083, no. 33.
[23] This does not affect the fact that an institutional investor can also decide on the basis of section 5:59 paragraph 5 Wft to enter into a confidentiality agreement with the management of the company. An institutional investor will not lightly sign an agreement of this kind, incidentally, because an institutional investor is no longer permitted then to trade in shares and other securities of the company to which the inside information refers. A trading restriction of this kind can be (very) expensive and result in conflict with the investment strategy pursued by the institutional investor (also see paragraph 4).

performance of the company, the strategy, the risk management and the corporate governance structure. Listed companies are expected, therefore, to comply with the relevant legislation and regulations and to apply the principles and best practice provisions in the Dutch Corporate Governance Code as much as possible. If a certain principle or best practice provision cannot be complied with, a listed company is expected to provide an explanation of this that is tailored to the specific situation of the enterprise.

b. Willingness on the part of the management board to enter into dialogue with institutional investors

If engaged shareholdership is to be effective, the management board must be open to taking note of and discussing the suggestions of institutional investors where company performance is concerned. Kemna and Van de Loo also refer to this in recommendation 13, specifically recommending that the chief executive officer and chief financial officer communicate more clearly on governance, risk management and strategy in their consultations with institutional investors, without infringing external supervisory requirements. In addition, Kemna and Van de Loo believe that the management board must permanently investigate the motives of shareholder groups that buy and, above all, sell shares in the company. The management board should always hold an exit interview in the case of every serious exit by a major shareholder (recommendation 4). Eumedion is in agreement with these recommendations and would also like to emphasise that the board should be open to suggestions from potential investors as a means of persuading them to buy shares in the company.

c. Willingness on the part of the supervisory board to enter into dialogue

Not only the management board, but also the supervisory board should be prepared to enter into dialogue with institutional investors. According to the jurisprudence, the supervisory board should play a mediating role in conflicts between shareholders and management board, and should adopt a position that is sufficiently independent of the management board[24]. Kemna and Van de Loo advise (recommendation 6) that the chairman of the supervisory board should be the principal focal point for institutional investors and that he should also be present at the table when the CEO is in discussion with institutional investors, in order to "enable him to sense what the concerns of these shareholders are and also to see for himself how the CEO responds" (p. 18). In the opinion of Kemna and Van de Loo, the chairman of the supervisory board should also have a separate meeting with major shareholders at least once a year, particularly with major shareholders that have sold their interest in that year (recommendation 7). Eumedion supports these recommendations and would also like to point out that there are certain situations in which institutional investors would actually like to speak with other members of the supervisory board instead of its chairman, when the discussion concerns the remuneration policy for example, or the functioning of the chairman of the supervisory board [25]. Furthermore, Eumedion believes that the chairman of a supervisory board should be independent[26] and should not limit his annual meetings to *major* shareholders, but should also speak with the most

[24] Amsterdam Court of Appeal (Enterprise Section), 17 January 2007 (Stork), *JOR* 2007, 42 and Amsterdam Court of Appeal (Enterprise Section), 5 August 2009 (ASMI), *JOR* 2009, 254.

[25] In these cases, it would seem more obvious for the chairman of the remuneration committee or the vice-chairman of the supervisory board to be the primary focal point for institutional investors.

[26] In accordance with best practice provision III.2.2 of the Dutch corporate governance code (independence criteria).

important institutional investors who have a long-term focus and/or are active with regard to ESG, regardless of the size of their relative interests. The company should place the resources required for organizing these meetings at the disposal of the supervisory board.

7. Can instruments for encouraging long-term shareholdership be helpful?

Engaged shareholdership could perhaps be stimulated if investors were partly compensated for the costs associated with engaged shareholdership. The costs, after all, are incurred at the expense of the financial return. Furthermore, the efforts of the engaged shareholders could bear fruit for the 'inactive' shareholders and this "free rider" problem can put a brake on engaged shareholdership. Comments are given below on the proposals that were also referred to in the report by Kemna and Van de Loo, with the addition of another proposal that Eumedion is presently studying.

a. Loyalty dividend and voting rights

Loyalty dividend and loyalty voting rights are often mentioned as instruments in connection with the encouragement of long-term shareholdership. The underlying idea is that the granting of extra dividend or extra voting rights is giving a bonus for long-term shareholding, and consequently for commitment to the long-term strategy of the enterprise. It is not certain, however, that these instruments will reduce the "free rider" problem identified above, since non-engaged shareholders also pocket the extra dividend or voting rights once a certain period has elapsed. In other words, loyal shareholders are not necessarily engaged shareholders. Kemna and Van de Loo justifiably remark in their report that, reasoning on the basis of the idea that it is desirable to provide some kind of compensation for engaged shareholdership, "extra dividends are a more direct advantage for the return on the portfolio than additional voting rights. Being able to exercise more power does not lead directly to a higher return, extra dividend does" (p. 24).

Both instruments have disadvantages, however. Investment decisions, for example, will no longer be taken exclusively on the basis of the strategy and value of the company in question and the efficiency of the capital market will be disrupted as a consequence. In addition, the instruments are sensitive to abuse. Another significant objection is that if the instruments actually prove a great success, the liquidity of the share will fall and its volatility will increase, which is not a favourable development for enterprise and shareholders alike. An important objection where institutional investors are concerned is the setting aside of what is known as the proportionality principle, which is the principle that the voting and dividend rights attaching to an equity interest in a listed company should be proportional to the capital contribution of the parcel of shares. Institutional investors with international share portfolios do not believe it would be beneficial to interfere with this principle.
Eumedion is consequently not in favour of the introduction of loyalty dividend or loyalty voting rights at listed companies.

b. Earning voting rights

Another possibility suggested is not to give shareholders voting rights until a certain period has elapsed. This incubation period can prevent parties that have only been shareholders for a short time from nevertheless being able to influence the long-term policy of the enterprise. After all, these parties can build up their interest shortly before the record date and sell the share again the day after that date. This instrument has significant disadvantages, however. It leads to unequal treatment for shareholders, for example; "old" shareholders *are* allowed to vote on the future of the company and "young" shareholders are not, although a resolution passed at a general meeting can also have an impact on the interests of the "young" shareholders. In addition, the instrument leads to a lot of red tape, because it requires the registration of shareholders and the monitoring of who holds the share for how long, while it does not necessarily lead institutional investors to become engaged shareholders. As a consequence, Eumedion shares Kemna and Van de Loo's objections to this instrument.

c. Voting dividend

A voting dividend is a small amount per share that is paid to shareholders if they exercise the voting rights on shares at the general meeting, either personally or through a representative. It is a clear compensation instrument for one component of engaged shareholdership, i.e. voting at the general meeting, although it has the additional advantage that the receipt of the voting dividend provides confirmation for an institutional investor that he has voted; the sum credited to the bank account is proof that the vote was also actually cast at the shareholders' meeting. This does not necessarily mean, however, that the voting dividend will encourage investors to actively seek a dialogue with the company (i.e. independently of the voting at the general meeting) and to devote time and money to analyzing the company. Furthermore, It cannot be ruled out that those shareholders who currently do not make use of their voting rights, but who will want to vote after all if a voting dividend is being paid, will choose the most cost-efficient scenario, which is buying voting recommendations from a proxy adviser and voting 'blindly' on the basis of its recommendations. As a consequence, Eumedion shares the sceptical attitude of Kemna and Van de Loo regarding this instrument for encouraging engaged shareholdership, although this does not alter the fact that the lack of clarity concerning the arrival of voting instructions should be solved as quickly as possible. Eumedion is, therefore, still in favour of European regulations for the encouragement of cross-border voting by shareholders.

d. Preferential prudential treatment for 5% interests

If institutional investors take larger interests in individual listed companies, this will increase the incentive to make in-depth analyses of the enterprises in question, to become more involved with the performance of these enterprises and to carry out more monitoring activities for disciplining the management board (also see paragraph 5). In order to encourage *pension funds* to take more 5% investments in Dutch listed companies, Kemna and Van de Loo suggest giving these investments "preferential prudential treatment, by lowering the risk for a portfolio consisting of 5% interests within

the Financial Assessment Framework (the FTK)[27] of the Dutch Central Bank (DNB), compared with the risk for shares in general". In the context of the present FTK model, retaining larger interests in individual companies actually leads to a greater concentration risk, since the share portfolio of a pension fund becomes less diversified and the investor will consequently have to hold a reserve in the shareholder's equity. Kemna and Van de Loo advise Eumedion to enter into consultations with DNB "in order to give a concrete shape to the details of preferential [prudential] treatment" (recommendation 16). Since this recommendation refers specifically to regulations for pension funds, it seems more logical to Eumedion for individual pension funds or their trade organizations to discuss this recommendation in their own circles first.

e. Involvement of major investors in the selection of supervisory directors

The organization of active, expert and professional internal supervision of the management boards of listed companies may well be even more important than engaged shareholdership. The Kemna and Van de Loo research report shows, however, that a trust gap still yawns between institutional investors and supervisory boards where the quality of the supervision is concerned. Eumedion is presently studying whether a more direct influence by major shareholders on the membership of the supervisory body could narrow this gap. In practice, the shareholders' meeting – with some exceptions – has scarcely any direct influence at present on the people who are proposed as candidates for the supervisory board (and the management board) and when this influence is actually used, the enterprise usually regards it as "hostile" action. Furthermore, the "outside world" may question the independence of supervisory directors of this kind. One element of the Eumedion study is the operation of the Swedish model, in which representatives of the two to four biggest shareholders are members of the appointment and selection committee of listed companies. What is being considered is whether this is a way to give the most important shareholders more confidence that the right people are being selected and to narrow the trust gap between shareholders and the supervisory board. The possibility of shareholders putting forward their "own" people is also treated with less hostility by the enterprise in a model of this kind, because the nominations are made jointly with the other members of the selection and appointments committee, who are sitting supervisory directors. The ex ante improvement of trust between shareholders and supervisory directors may possibly reduce the risk of prolonged conflicts between shareholders and the management of a company[28]. Eumedion hopes to complete the study in the first six months of 2010.

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[27] The statutory financial requirements for Dutch pension funds are set out in the FTK.

[28] Kemna and Van de Loo conclude in their report for example, that "The only serious contact [between supervisory boards and institutional investors] occurs in times of conflict and that does not generally lead to prolonged and sustainable relationships" (p. 9).