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Shareholder Rights Directive II:

Improving Corporate Governance of Listed Shares in the EU

With less than a year to go before the September 2020 deadline for Shareholder Rights Directive II (SRD II) implementation, industry participants such as intermediaries, asset managers, brokers, and financial institutions are asking "How do I prepare?"

SRD Timeline and Development

The original Shareholder Rights Directive (SRD I) was implemented in 2007 and sought merely to regularize basic corporate governance in companies which have their registered office in the EU and whose shares are admitted to trading on EU regulated markets. Like SRD II, it focused on the exercise of voting rights and the cross-border availability of corporate governance information to shareholders.

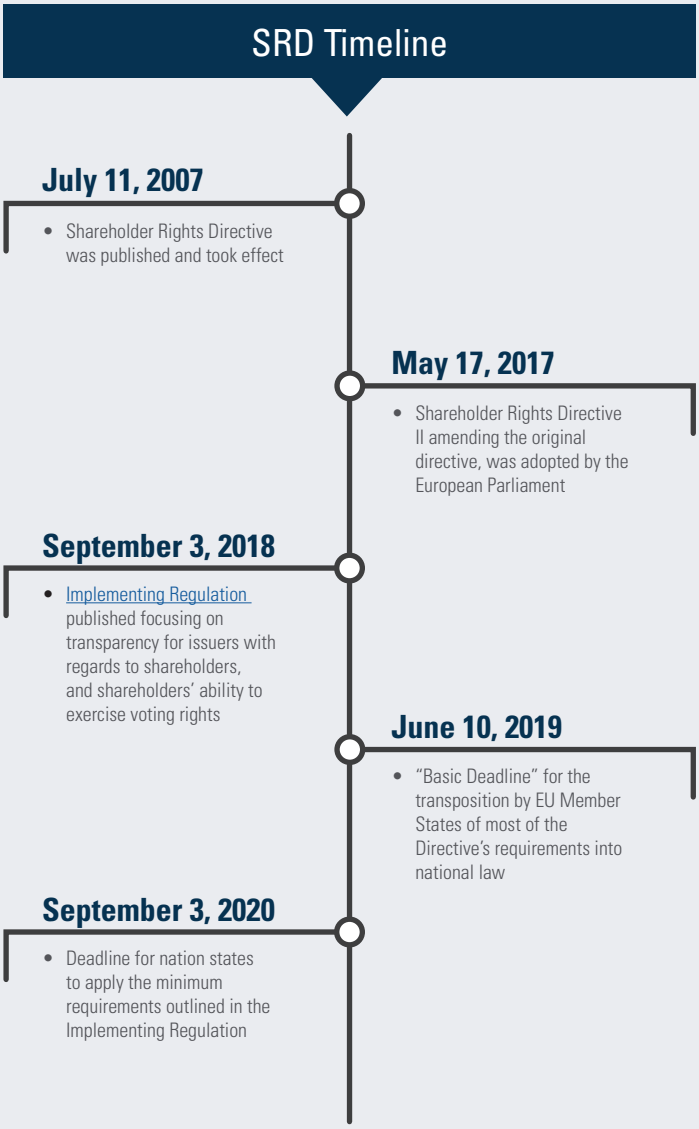
SRD I dealt with high level and foundational principles, and these fundamentals remain in place. The original directive established:

- Standards for provision of information before a general shareholders meeting
- The principle of equal treatment of all shareholders
- Basic rules applicable to general meetings of shareholders, including that shareholders:
  - Should be given the right to put items on the agenda to table resolutions at meetings
  - Should be able to ask questions at general meetings
  - May vote by proxy
  - Have access to voting results via publication

These basic parameters were necessary given that before SRD I, shareholder rights were determined under divergent local laws in 28 member states and were an important part of creating an integrated EU securities market.

However, in the wake of the financial crisis, public authorities concluded more needed to be done based on a view that:

1. Shareholders' inaction or inattention seemed to encourage excessive short-term risk-taking by investment managers
2. Complex chains of intermediaries made the exercise of shareholder rights more difficult, which could obstruct shareholder engagement
3. Companies were unable to adequately identify their shareholders



By contrast, SRD II – published by the EU commission in June 2017 – aims to encourage active engagement of shareholders in corporate governance, and to impose much more specific rules on intermediaries and issuers to facilitate and record the content and processing of instructions and information relative to shareholders and the exercise of shareholder rights. It does this by imposing:

- Specific rules governing minimum content of corporate information
- Specific rules governing the handling, transmission, and recording of shareholder right activity
- A requirement that asset managers establish and publish a policy of engagement with companies in which they invest or to explain why they do not do so

Additionally, SRD II could also be called in part the "Corporate Rights Directive" in that it establishes the right of corporations to request information as to ultimate shareholding of intermediaries that hold shares for their underlying clients.

While *our earlier publication* looked at the aims of the directive, this paper will answer some frequently asked questions and explore the operational aspects of the amended directive that will affect custodians and their underlying clients, such as asset managers and financial intermediaries. We will also address certain points that have been discussed within industry working groups and task forces with great fluidity.

Frequently Asked Questions

What is the status of transposition of the directive into local law?

While some countries have met the June 2019 timeframe for transposition, many have missed the deadline, instead aiming for full operational readiness and transposition by September 2020. A number of countries have also indicated transposition readiness in 2019, yet also indicate that any custody-related obligations will only take effect from September 3, 2020.

An additional challenge to cross-border operational implementation may arise from national transpositions that are applied in a manner from the SRD general provisions.

Who is impacted by SRD II?

Asset managers, intermediaries, and institutional investors holding shares with voting rights of companies that have their registered office in the EU and their shares listed on a regulated market in the EU.

Intermediaries will need to:

- Receive and pass on general meeting notifications
- Facilitate an end investor's voting for the general meeting
- Receive and pass on requests for shareholder identification to intermediary clients
- Respond to such a request directly to the issuer or the issuer's appointed third party the day after record date or the date of receipt of the request, whichever comes later
- Differentiate at a securities account level end shareholder or intermediary status
- Transmit notifications relating to general meetings and corporate events the same day it was received (unless if received after 16:00 CET, in which case by 10:00 CET the following business day) provided it had been received in electronic and machine-readable formats

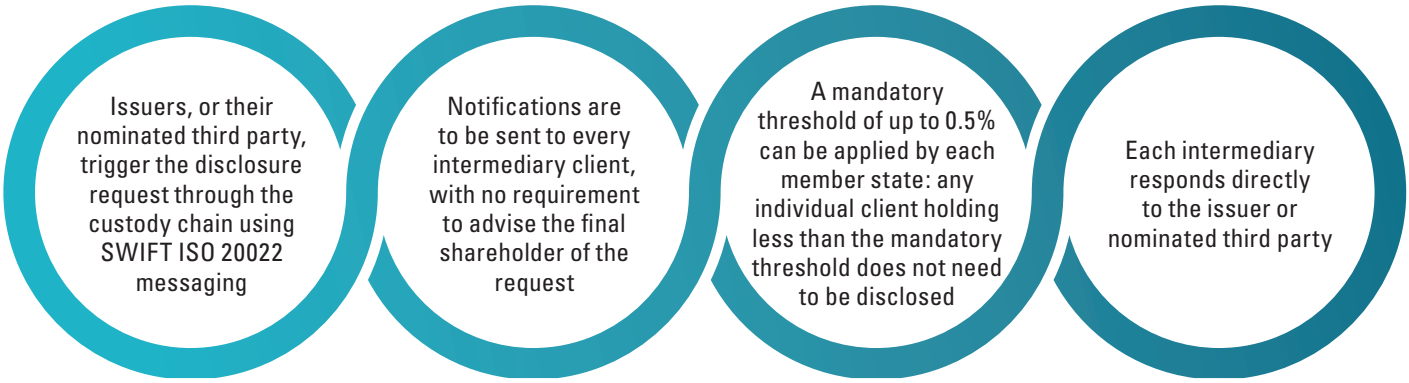
Final intermediaries (the intermediary in the chain that holds the shares for the entity ultimately empowered to vote them in) will need to:

- Process the items described above
- Provide the shareholder with confirmation of entitlement to participate
- Ensure that the number of units voted by the client is consistent with the shareholder's entitled position

Ultimate shareholders will have the right to receive general meeting notifications and exercise their right to vote. Intermediaries are required to provide a service to facilitate this.

Asset managers will have to establish and publish policies related to their active engagement with companies in which they invest.

What is the expected flow of information for a shareholder ID request?



Responses to shareholder disclosure requests will be provided the same day they were received (unless if received after 16:00 CET, in which case will be provided by 10:00 CET the following business day) provided they have been received in electronic and machine-readable formats.

Will there be updated messaging standards, in line with ISITC to process these new information flows?

All of these requirements will entail the development of standardized and automated means of transmitting and processing information. Industry discussions aim towards the ISO 20022 standard of SWIFT messaging which will enable more standardization of messages and responses. Efforts are also underway to define industry-wide templates that can be applied for shareholder identification and disclosure requests. This allows for machine readable requests, acknowledgements and responses to be harmonized.

What will general meeting/proxy notification messaging entail?

New ISITC standard confirmation messages will be created for:

- *Confirmation of entitlement* where the service provider will confirm the client's entitlement to vote
- *Confirmation of voting receipt* where the service provider will confirm receipt of voting response
- *Confirmation of recording* to the votes where the Issuer will confirm receipt of the final shareholder vote
- *Confirmation of counting* of the votes where the issuer will confirm vote has been counted and cast

Identifiers for the final shareholder information (such as name and identifier) is mandatory information along with the proxy advisor (if known) and is required for any vote.

Notifications of general meeting should be transmitted the same day it was received (unless if received after 16:00 CET, in which case by 10:00 CET the following business day), provided they have been received in electronic and machine-readable formats.

What volume of shareholder disclosure to issuer requests can be expected?

SRD II establishes a new information flow to deal with issuer requests for information as to their shareholders. Estimates by the European issuer community suggest that shareholder requests by issuers could be allowed to happen twice per year. There are approximately 7,500 issuers registered in EU locations: it can therefore be assumed that a volume of 30,000 shareholder identification requests would need to be handled per year.

Issuers may also request information relative to confirmation of receipt of information and the exercise of shareholder rights. This information will also have to be processed through the chains of intermediation.

Is there clarity on the definition of a shareholder?

EU member states will determine the definition of a shareholder under their own national laws when transposing the directive. It therefore remains an open question the extent to which custodians or sub-custodians might be recognized as "shareholders," or whether recognition of the underlying beneficial owner will be required on shareholder identification requests. An example from Luxembourg transposing the directive into national law indicates that ...

> "The shareholder is defined as any natural or legal persons owning shares, from the first share owned. Hence, the person recorded as the owner of the shares in the shareholders register is the deemed owner of the shares"

We expect that the ultimate shareholder will be the person or entity entitled to exercise the particular shareholder right.

How does SRD II address data privacy aspects?

SRD II establishes the threshold of shareholder identification as 0.5% to facilitate more transparency on shareholdings. This is viewed as a minimum threshold requirement: member states in the EU were given the opportunity to opt-out of this threshold requirement and apply their own standards. To do this, they needed to inform European regulators by June 2019 if they intended to apply a different threshold.

SRD II will align with existing data privacy regulation such as *GDPR* in ensuring that individuals are only identified for verified requests and the data maintained on them will be retained only within relevant data retention timeframes.

What are the impacts of engagement policy on asset managers?

Regulated asset managers will need to develop and publicly disclose their shareholder engagement and proxy voting policies when it comes to shares traded on a regulated market. The policy would cover how the asset manager communicates with investee companies, as well as how it monitors investee companies' strategies, performance, capital structure, social and environmental impact, and corporate governance.

Asset managers have the option not to disclose, but then would need to explain the rationale for not doing so.

What are the required components of an asset manager engagement policy?

A shareholder engagement policy should describe how an asset manager:

- integrates shareholder engagement in its investment strategy
- monitors companies in which they invest, which should include:
  - issuer management and market strategy
  - financial and non-financial performance and risk
  - capital structure
  - social and environmental impact
  - corporate governance
- conducts dialogue with investee companies
- exercises voting rights and other rights attached to shares
- cooperates with other shareholders
- communicates with relevant stakeholders of the investee companies
- manages actual and potential conflicts of interest in relation to the firm's engagement

This all works toward the SRD II goal of encouraging active shareholder engagement in corporate governance, but it represents a significant new imposition on asset managers. We should emphasize that the directive imposes these requirements unless the asset manager indicates in a clear and reasoned way why one or more of these aspects is not part of their asset management regime. To the extent that asset manager's policy does not fully conform to one or more of these requirements, the reasoning for non-compliance must be disclosed and, in some cases, reported annually to certain institutional investors. Annual public disclosures will be required including a general description of the asset manager's voting behavior, an explanation of the most significant votes, and reporting on the use of the services of proxy advisers.

What impact will this have on the use of global proxy notification services?

The industry anticipates that in order to meet the regulatory requirements, in particular to handle requests "without delay," notifications of global proxy voting events will need to be generally provided on the same business day. In order to support this, use of a global proxy notification service that provides a shared and standardized framework for proxy processing will be virtually necessary.

What will this mean for the costs associated with being compliant?

With the need to build solutions and services for transmitting information regarding shareholders, general meetings and other SRD II requirements, intermediaries may charge fees associated with this service. This will be determined depending on national transposition.

For more information on SRD II, please contact your relationship manager.

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