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European Reforms In Response To "Kasino-Kapitalismus" — The Changing Landscape For Institutional Investors In Europe

By Beata Gocyk-Farber and Jeroen van Kwawegen

Now that the global financial system appears to have been stabilized, governments around the world are increasingly moving to address the underlying causes of the financial crisis through regulatory reform. Thus far, prospective reforms are largely based on the understanding that the financial crisis was caused by insufficient oversight over banks and financial institutions during a time of substantial increases in liquidity, leverage (outstanding credit) and undertaking of risk. In the words of European Central Bank President, Jean-Claude Trichet: "[i]n looking back on the years prior to the eruption of the crisis, we have to acknowledge that there was a dramatic shift in focus in large parts of the financial sector — away from facilitating trade and real investment towards unfettered speculation and financial gambling. [German economist] Hans Werner Sinn has called these deviations 'Kasino-Kapitalismus.'" Many of the proposed regulatory reforms in Europe are therefore focused on restoring or increasing oversight, both in terms of external oversight of banks and financial institutions by governments and regulatory agencies, including closer regulation of incentives and bonuses, and in terms of internal "corporate governance" oversight over management by the board of directors and, increasingly, by institutional shareholders.

"In looking back on the years prior to the eruption of the crisis…there was a dramatic shift in focus in large parts of the financial sector — away from facilitating trade and real investment towards unfettered speculation and financial gambling."

European reforms increasing external oversight over banks and financial institutions are well under way. In February 2009, a high-level group headed by former IMF Managing Director and ex-Bank of France Governor Jacques de Larosière issued a report on Financial Supervision in the EU (the "de Larosière Report") at the behest of the European Commission. The de Larosière Report included thirty-one recommendations for responding to the financial crisis

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LEGISLATIVE/REGULATORY AND JUDICIAL UPDATES AND DEVELOPMENTS OF INTEREST TO EUROPEAN INVESTORS

By Katherine Sinderson

SEC and FSA to Expand Efforts at Cooperation

The U.S. Securities and Exchange Commission and the U.K. Financial Services Authority have recently expanded efforts at cross-border cooperation. Following a meeting between the two agencies last week, SEC Chairman Mary Schapiro and FSA Chief Executive Hector Sants announced plans to collaborate on hedge fund reporting and to share data with one another. The two agencies will work together to craft "a common, coherent set of data to collect from hedge fund advisers/managers," and will share the data they collect with one another. The two regulators also said they would work to create a common approach to hedge fund regulation and would coordinate with one another. "As the regulators of two of the world's major market centers, the SEC and the FSA has a strong interest in collaborating," SEC Chairman Mary Schapiro said. "Only through strong cooperation can we achieve coherent oversight of global actors and limit opportunities for playing the regulatory seams." *http://www.sec.gov/news/press/2009/2009-198.htm*

including a call for a fundamental review of the existing rules regarding the capital requirements of financial institutions, the adoption of a common European definition of regulatory capital, and the creation of a European system of financial supervision and crisis management. In accordance with the de Larosière Report proposals, the European Commission proposed the creation of a new European financial regulatory body to oversee the European financial system called the "European Systemic Risk Council." In addition, the Commission proposed creating a "European System of Financial Supervisors" to safeguard the financial soundness of financial firms and to protect consumers of financial products. If approved by the European Council, the Commission plans to have this new regulatory framework operational in 2010.

By contrast, European reforms regarding the corporate governance rules that apply to internal oversight of management and boards of directors have been incremental and without any uniform approach or urgency to change the rules already in place. Each European country has its own corporate governance standards and rules. Because the financial crisis has impacted each country differently, there is little support for wholesale change, despite evidence that a lack of oversight by boards of directors over management at banks and financial institutions greatly contributed to the financial crisis. For example, a July 16, 2009 report on corporate governance at UK banks and other financial institutions prepared by Sir David Walker, the former Executive Director for Finance and Industry at the Bank of England (the "Walker Review") concluded that "[i]t is clear that governance failures contributed materially to excessive risk taking in the lead up to the financial crisis." The de Larosière Report similarly concluded that corporate governance was "one of the most important failures of the present crisis" and that "looking back at the causes of the crisis, it is clear that the financial system at large did not carry out its tasks with enough consideration for the long term interest of its stakeholders."

Because of the perceived failures of internal oversight by boards of directors, there is emerging consensus that institutional investors should have a more important role in overseeing and monitoring compliance with corporate governance standards. For example, the Walker Review identified a number of "key themes" for reform in the U.K., including the "need for fund managers and other major shareholders to engage more productively with their investee companies with the aim of supporting long-term improvement in performance." In this regard, the Walker Review proposes that fund managers should undertake a public "stewardship obligation," or otherwise explain their investment approach in clear terms. The stewardship obligations would include "arrangements for monitoring investee companies, for meeting as appropriate with a company's chairman, [senior independent director] or senior management, a strategy for intervention where judged appropriate, and policy on voting and voting disclosure." As described in a June 2007 International Shareholder Committee statement attached to the Walker Review, intervention may be appropriate when institutional investors have concerns about the company's strategy, operational performance, failing internal controls, or failure by independent directors to hold executives accountable. Potential intervention measures include holding meetings with management or members of the board of directors to discuss concerns, making a public statement about these concerns; and exercising their voting rights in a strategic manner. The Walker Review also suggests that "fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their websites or in other publicly accessible form."

A June 2009 report of the Organisation for Economic Co-operation and Development ("OECD") concerning corporate governance and the financial crisis similarly concludes that institutional investors should be more proactive in their oversight of investee companies, particularly through meaningful use of their voting rights. The OECD report recommends that regulators and institutions adopt measures to facilitate cross-border voting, including allowing the use of flexible voting mechanisms such as electronic voting. The OECD report also recommends that institutional investors collaborate to work together at, and in advance of, shareholders meetings, and that institutional investors acting in a fiduciary capacity adopt as "good practice" disclosure of their voting records "in order to make more transparent any conflicts of interests and how they are being managed."

If widely implemented, the current proposals in Europe to facilitate shareholder participation and require the disclosure of votes and voting policies would have important consequences for European institutional investors. While such reforms would provide greater insight and predictability to those beneficiaries and the market, without simultaneous reform of the enforcement regime, institutional investors will be hamstrung in meeting the expectations that will follow increased public shareholder oversight, particularly when confronted by a reluctant or entrenched board. Under the current legal regime in most European countries, institutional investors have only limited options to force companies in which they invest to change business strategies or enact governance reforms and risk protections. In particular, there are two main obstacles that hamper institutional investors' ability to be proactive. First, there is no clear substantive legal regime that uniformly defines the roles and authority of board of directors and institutional investors across Europe. Instead, there is a patchwork of different

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corporate governance rules that are applied to European companies depending on where they are incorporated and where they are listed on a national stock exchange. For example, some countries have incorporated corporate governance provisions into the national company code (such as Germany and the Netherlands) whereas others have incorporated such provisions in the securities listing requirements of the stock exchange (such as the United Kingdom and Sweden). As a result, companies that are for example incorporated in the Netherlands and are listed on the London Stock Exchange are subject to two different sets of corporate governance rules — the Dutch rules because that is where the company is incorporated and the British rules because of the LSE listing requirements. Conversely, and more important, companies that are incorporated in the United Kingdom or Sweden and that have a primary listing on the Deutsche Börse or NYSE-Euronext in Amsterdam may not be subject to any binding corporate governance rules at all.

Second, there are important limitations amongst the various European jurisdictions for enforcing substantive governance rules through private enforcement efforts. In the U.S., private enforcement efforts regarding the violation of director and management responsibilities are typically pursued through "derivative actions" — actions in which shareholders represent the interest of the company in disputes with the board or management. Such derivative actions are well established and widely accepted as a meaningful check on corporate wrongdoing. Although a number of European countries currently allow shareholders to bring derivative actions, the procedural hurdles for doing so are often

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much higher than in the U.S. Moreover, the absence of contingency fee arrangements, together with the various "loser pay" rules in the U.K., Germany, France and other European countries, have a particularly pernicious effect on derivative actions: after a successful derivative suit, the shareholder is reimbursed for its costs and attorneys fees to bring the action while the company and all shareholders share in the benefits; by contrast, if the derivative action is not successful, the costs and attorneys' fees of bringing the action and (all or part) of the costs and attorneys' fees of the directors and management in defending against the action are borne exclusively by the shareholder.

Because of the lack of clear, broadly-applicable corporate governance rules and the procedural hurdles and disincentives for shareholders to enforce such rules, institutional investors currently have limited options to meaningfully express their disagreement with the way entrenched management or boards of European companies fulfill their legal and fiduciary obligations. As explained by Lord Turner, the chairman of the British Financial Services Authority ("FSA"), in his March 2009 review of regulatory responses to the global banking crisis: "while it is clear in retrospect that some major corporate actions... were risky mistakes, and while several institutional shareholders expressed significant concerns at the time, they were not able or willing to force a change of strategy." Without ways to force a change in strategy or behavior, whether through cooperative measures or litigation, institutional investors in European companies either vote with their feet by selling their holdings or seek judicial relief outside Europe.

The Walker Review and the June 2009 OECD report are limited to encouraging enhanced engagement and more active voting behavior. Unfortunately, they do not include proposals for providing shareholders with additional instruments to challenge entrenched boards or management if enhanced engagement fails and the institutional investors' objections are ignored. Even if the current recommendations are widely implemented, institutional investors investing in European companies would still be left with the option of selling their holdings or seeking some form of judicial relief outside of Europe. With regard to the option of selling of holdings, the Walker Review concludes that the "signal of any associated fall in the stock price and of change in the share register is one means of transmitting a message from owner or investor to an investee company of doubts about its market valuation, strategy or leadership" but "in many cases such signal may be disregarded or will be relatively ineffective as an influence."

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With regard to seeking judicial relief, the June 2009 OECD report concludes that "[e]ffective enforcement of shareholders' rights is still an open issue both in systems with strong private litigation traditions and in systems more based on public enforcement mechanisms" and that "[s]tronger complementarity between private and public enforcement instruments could contribute to create a more favourable framework for active informed shareholders." Until the legal regimes in Europe are changed so that proactive shareholders are no longer penalized for resorting to private enforcement mechanisms, institutional investors seeking to protect the interests of their beneficiaries will in the near future continue to seek judicial relief outside traditional European courts.

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