Shareholder Rights Directive

Policy Brief[1]

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In April 2014, the European Commission proposed to amend the Shareholder Rights Directive[2] with the aim of improving corporate governance and promoting long-term shareholder engagement.

The Commission's proposal was later extensively amended by the European Parliament's Committee on Legal Affairs (JURI).

A compromise text was adopted during the Parliament's plenary vote of July 2015[3] but is now blocked in protracted trilogue negotiations between the Commission, Council and Parliament.[4]

This brief analyses the evolution of the text up to the current version and draws tentative conclusions about remaining gaps that will need to be addressed to drive Europe towards a more sustainable corporate governance model that takes into account the long-term interests of the company and its impact on all relevant stakeholders.

A. Where are we now?

A.1. Shareholders do not own the corporation and stakeholders' voices matter

In the current version of the draft Directive, as adopted by Parliament, the recitals clarify that shareholders do not own corporations, which are 'separate legal entities beyond their full control'. This accurately captures the state of the law in Europe, and indeed all known jurisdictions.[5]

The recitals were also amended to acknowledge that the interests of stakeholders such as employees may be more important as a factor of corporate governance than those of shareholders.[6]

Although recitals are not binding, they reflect Parliament's commitment to depart from the initial version of the text of the Directive, which was extremely protective of shareholders whereas their interests sometimes conflict with those of other shareholders.

A.2. Improving institutional investor engagement

Institutional investors will be required to develop a policy on shareholder engagement, which must cover monitoring (including of the investee company's non financial performance and reduction of social and environmental risks) dialogue, voting, use of proxy services and cooperation with other shareholders.[7] The information must be publicly available, at a minimum on the company's website, along with information about how votes were cast.

Where the institutional investor uses an asset manager, the investor should publicly disclose key elements of its contract with the asset manager, including incentives and performance evaluations.

The draft Directive aims to ensure that institutional investors engage with investee companies, either directly or through asset managers, in order to influence their long-term performance. The underlying belief is that increasing the engagement of institutional investors and asset managers 'contributes to a more long-term perspective of shareholders which ensures better operating conditions for listed companies'[8]. The draft Directive does not specify what constitutes 'better operating conditions'. The Commission's Action Plan: European company law and corporate governance - a modern legal framework for more engaged shareholders and sustainable companies, which outlines the Commission's strategy in this area, elaborates that improve transparency to increase dialogue between shareholders and companies, promote accountability to civil society and ensure there are proper checks and balances on (supervisory) board oversight[9].

While the objective is laudable, it is unclear that increasing transparency on its own will lead to increased engagement by institutional investors or that end beneficiaries of pension funds, for example, will pressure their fund administrators to take a more active role.

Furthermore the obligation to disclose both the engagement policy and its implementation applies on a comply-or-explain basis[10], which means that investors have the option to opt not to comply provided that they explain this omission. An earlier version of the draft Directive would have made it mandatory to have and disclose an engagement policy.

A.3. Improving asset manager engagement

Institutional investors will be required to disclose how their equity investment strategy aligns with the profile and duration of liabilities[11]. This will involve disclosure of attempts to align manager incentives with institutional investor liabilities, as well as incentives for asset managers to make decisions based on "medium to long-term company performance", and other factors.

It is questionable whether end beneficiaries will actually use this information to create pressure for a longer-term perspective, however the requirement to develop a policy may encourage investors to give more consideration to the appropriateness of their investment strategy.

Furthermore it may begin to address the disparity between the portfolio a long-term investor aspires to hold and that which it actually holds, which may differ significantly due to over-reliance on short-term asset managers[12]. This provision may also be useful for stakeholder groups, such as civil society organisations seeking to engage with businesses.

This requirement applies on a comply-or-explain basis[13].

A.4. Directors' remuneration

The proposal[14] does not impose a cap on directors' remuneration in relation to fixed pay (which was the approach taken in the Capital Requirements Directive)[15], but rather gives shareholders the power to vote on remuneration policy at least once every three years[16] and potentially veto a remuneration policy that they oppose. The policy must "explain how it contributes to the long-term interests and sustainability of the company", and give full details of fixed and variable pay.[17] Notably, shares must not be the most significant part of variable pay and financial performance must not be the most important criteria for deciding pay.[18]

This provision is very similar to the requirements of the UK's Enterprise and Regulatory Act 2013, which amended the Companies Act 2006, although the requirement to explain the pay gap between directors and employees goes beyond the UK's current approach.

Studies on the effectiveness of "say on pay" requirements in the UK and the US suggest that few shareholders vote against pay policies. Before 2013, few shareholders used the advisory vote to vote against the remuneration report, and "most remuneration reports in the FTSE 350 receive backing from around 90% of shareholders".[19]

In FTSE 100 companies, around 3% of shareholders dissented in 2008, but levels of dissent have been considerably higher since the financial crisis, and in 2009, around one fifth of FTSE 100 companies had more than 20% of their shareholders dissent.[20]

PricewaterhouseCoopers (PwC) reported in July 2014 that in 2013, only one in four CEOs received a pay increase, and of those, many only saw pay increases matching inflation. In addition, remuneration committees did not award the whole of the bonus maximum for CEOs or CFOs.[21] PwC ascribes this apparently more cautious approach to new disclosure requirements, which allow shareholders to subject companies to greater scrutiny.

There may also be other reasons behind this but it is certainly not a result of shareholders' right to a binding "say on pay" in the UK, since this only came into force on 1st October 2013.

In the US, where it is mandatory to hold a shareholder advisory vote on executive compensation at least every three years,[22] a survey across all publicly listed companies found that only 2% of pay plans (123 out of 4,113) considered in 2014 failed to receive majority shareholder support. On average, pay plans received 89% support from shareholders in the advisory vote, with small- and mid-cap companies more likely to see their play plans rejected. The same survey reports that "two thirds of directors don't believe that 'say-on-pay' has effected a 'right-sizing' of CEO compensation".[23]

Correctly aligning management incentives with the long-term interests of companies, and therefore ultimately, their committed shareholders, is crucial to improve corporate governance. From Enron to the financial crisis, poorly aligned incentives have led to corporate failure and enormous social cost.

Despite the above-noted skepticism about whether the proposal is likely to lead to different forms of incentives better aligned with the long-term interests of the company, it is a step in the right direction.

The provision opens a formal channel of communication that will supplement the informal channels intended to be opened through the policy on engagement[24] and foster executive remuneration that aligns with the long-term health of the company (not short-term stock price).

Furthermore, engaged institutional investors will be able to express dissatisfaction and demand changes to incentives that better align directors' remuneration with the long-term interests of the company, its shareholders and other stakeholders.

A.5. Shareholder advisory vote on remuneration report (Article 9b)

The annual corporate governance statement should include a remuneration report outlining all benefits in whatever form granted to individual directors.[25] Shareholders will be permitted to vote on the report.[26] The vote is merely advisory but the company is expected to disclose the outcome of the vote in the next year's remuneration report, and explain whether the vote was taken into account, and if so, how.

A.6. Companies' ability to identify their shareholders and shareholders' rights to be informed by the company (Articles 3a-c)

The draft Directive provides for exchange of information between shareholders and companies through both intermediaries and online disclosure, as a way to facilitate 'the exercise of the rights of shareholders, of engagement and dialogue between the shareholders and the company on company-related matters'.[27] The requirements in that regard are increased in the latest version of the Directive proposal.

A.7 Transparency on related party transactions (Article 9c)

The draft Directive requires the company to inform (under the form of a report drafted by an independent of supervisory body) shareholders, especially minority shareholders, of any foreseen material transaction with related parties.[28]

Material transactions shall then be 'approved by the shareholders or by the administrative or supervisory body of the companies, in accordance with procedures which prevent a related party from taking advantage of its position and provide adequate protection for the interests of the company and of shareholders which are not related parties, including minority shareholders'.[29]

The increased requirements relating to material transactions of related parties aim to protect the rights of minority shareholders as well as the company's interests against those of majority shareholders who pursue short-term financial objectives.

B. Provisions deleted from the draft Directive

B.1 Incentives for long-term shareholding (Article 3ea)

JURI proposed to require Member States to choose between several means to promote long-term shareholding, whether it be additional voting rights, tax incentives, loyalty dividends or loyalty shares.[30]

There has been a marked decrease in the holding periods of institutional investors between 1991 and 2009 (De la Croce et al 2011). Increased portfolio turnover by shareholders has been shown to have a negative impact on research and development expenditure by European companies.[31] The deletion of that provision is therefore regrettable.

France has adopted the so-called *Loi Florange*,[32] which allows shareholders to automatically acquire double voting rights after two years unless two thirds of shareholders vote to overturn it.[33] Italy has also approved a law that allows companies to give double voting rights to shareholders that own shares for at least two years.[34]

In the investment world, BlackRock CEO Larry Fink has called for capital gains regimes that reward long-term investment with long-term treatment only after three years, and a decreasing tax rate for each year of ownership beyond that.[35] Advantageous tax treatment, in particular, would be an interesting option to explore in future regulatory interventions as it promotes long-term shareholding while still respecting the principle of one share, one vote.

B.2. Employees' right to give advisory opinion on remuneration (Articles 9a, para. 3 (4b) and 9b, para. 3)

JURI's version of the draft Directive provided for an employee right to express a view (through their representatives) on the company's remuneration policy and on the remuneration report before its submission to shareholders. This would have been an opportunity to promote employee's engagement, which tends to foster the company's long-term good health.[36]

C. Beyond the Directive

In spite of Recital 8 that expresses the crucial role of stakeholders such as employees in the corporate governance model that the EU is seeking to develop, European corporate governance tends to rely on shareholders to drive the shift to a longer-term perspective. There is no clear reason for this reliance on shareholders. Although shareholders have and should have specific rights in corporate governance, it is important to clarify that, contrary to the popular conception, shareholders do not own companies (which is recognised in Recital 2 of the draft Directive). Their position is similar to that of bondholders, creditors and employees, all of whom have contractual relationships with companies, but do not own them.

The focus on shareholders neglects potentially valuable input from other stakeholder groups, such as employees.

Moreover, shareholders differ considerably in their time frames and approaches. Some shareholders are committed to holding for the long-term, whilst others only hold for the short-term. It is important that the former group become more engaged; however, there is a danger that the draft Directive will further empower shareholders with a short-term orientation.

For this reason, there is a need for further measures to complement the draft Directive and achieve the goal of sustainable companies, such as:

- EU company law could require all Member States to allow companies to specify long-term purposes in their constitutional documents. These statements of purpose might cover environmental, social or scientific goals. In addition, EU company law could require that companies be able to lock-in those purposes against opportunistic change by short-term shareholders (perhaps by requiring a supermajority to amend the purpose clause).
- EU company law could specify more clearly the societal purpose of companies generally, creating an explicit duty for directors to pursue sustainable value.

At present, the societal purpose of companies is not explicit in law and this has created space for short-termism to flourish. A clear statement of purpose would: introduce legal clarity; complement many of the other suggestions set out above; and create a level playing field for companies that wish to contribute to a sustainable and innovative economy.

However, while specifying corporate purpose would be useful it must be supported by changes to the surrounding rules of corporate governance, including:

- Clarifying or expanding the (fiduciary) duties of directors and institutional investors;
- Requiring companies to take into account the long-term interests of all relevant stakeholders.
- Reviewing executive pay rules to promote the integration of ESG factors and the long-term interests of the company.

An explanation and analysis of these policy recommendations is available in our briefing "Implementing sustainable corporate governance in Europe: a new vision of corporate purpose".

Footnotes

1. This briefing note is current as of July 2016 and has been prepared partly on the basis of an earlier paper written by Prof. Andrew Johnston and Paige Morrow available at SSRN (Johnston, A., and Morrow, P. Commentary on the Shareholder Rights Directive (University of Oslo Faculty of Law Research Paper No. 2014-41; Nordic & European Company Law Working Paper No. 15-13). Retrieved from SSRN : ssrn.com/abstract=2535274). It was drafted by Paige Morrow and updated with the assistance of Sandrine Brachotte.
2. See Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, COM/2014/0213 final (the 'draft Directive').
3. (the 'draft Directive').
4. EU ordinary legislation is adopted as a result of a co-decision process between the European Commission (that makes the initial Proposal), the European Council, and the European Parliament (that must both agree on the final content of the law). The trilogue negotiations step comes as pre-final step to the adoption of a EU act. Representatives of the Commission, the Council and the Parliament meet informally in order to obtain agreement on a package of amendments acceptable to both the Council and the European Parliament (on the ordinary legislative procedure, see Directorate General for Internal Policies of the Union and Directorate for Legislative Coordination and Conciliations Conciliations and Codecision Unit (2014). Codecision and Consiliation. A guide to how the European Parliament co-legislates under the ordinary legislative procedure. Brussels: European Parliament (European Union).
5. See The Modern Corporation Project (2014). Statement on Company Law Available at https://themoderncorporation.wordpress.com/company-law-memo/ 18 July 2016.
6. Recital 8 now states: 'Effective and sustainable shareholder engagement is a relevant element of listed companies' corporate governance model, which depends on checks and balances between the different organs and different stakeholders. Proper involvement of stakeholders, in particular employees, should be considered *an element of utmost importance* in developing a balanced European framework on corporate governance' (emphasis added).
7. Article 3f
8. COM(2014) 213: 2.
9. COM(2012) 740 final
10. Article 3f4
11. Article 3g
12. Clark and Monk 2012
13. Article 3g2
14. Articles 9a and 9b
15. 2013/36/EU
16. Article 9a(1)
17. Article 9(a)(3)
18. Article 9a(3)
19. BIS 2012 at para. 47
20. BIS 2012 at para. 48
21. PricewaterhouseCooper 2014
22. Dodd-Frank Wall Street Reform and Consumer Protection Act, §951
23. ProxyPulse 2014, at p.6
24. Articles 3f and 3g
25. Article 9b(1)
26. Article 9b(3)
27. Articles 3a, 3b and 3c

28. Article 9c(1)
29. Article 9c(2)
30. Article 3ea
31. Brossard et al 2013
32. Loi n° 2014-384 du 29 mars 2014 visant à reconquérir l'économie réelle (1), JORF n°0077 du 1 avril 2014, p. 6227
33. Article 7.I.2°, amending Art. L. 225-123 of the commercial code
34. Euractiv, 8 May 2015
35. Turner 2016. In his annual letter, Fink also affirms the commitment of BlackRock, which is the world's largest investor, to invest in companies where CEOs lay out for shareholders each year a strategic framework for long-term value creation and explicitly affirm that their boards have reviewed those plans.
36. See e.g. Harter, Schmidt and Hayes 2002

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