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Sustainable Companies

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Commentary on the Shareholder Rights Directive

1. Executive summary and overview

The authors[1] support the objectives of the proposed revision of the Shareholder Rights Directive (Directive 2007/36/EC) (the "Proposed Directive") but are concerned that the measures being considered will not achieve their intended purpose. More worryingly, they may have unintended negative consequences. The fundamental issue is that shareholder empowerment will not, on its own, improve corporate governance or contribute to sustainable growth in the EU.

Short-termism was one of the root causes of the financial crisis. It has not been adequately addressed to promote sustainable European growth over the long-term. Despite the Commission's well-intentioned efforts, the Proposed Directive falls far short of addressing the underlying causes of short-termism so as to prevent future crises.

The current proposal relies exclusively on shareholders to drive the shift to a longer-term perspective. There is no clear reason for this exclusive 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. Their position is similar to that of bondholders, creditors and employees, all of whom have contractual relationships with companies, but do not own them. This myopic 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 Proposed Directive will further empower shareholders with a short-term orientation. For this reason, there is a need for further measures to complement the Proposed Directive and achieve the goal of a longer-term approach. Some suggestions as to further measures are set out in the final section of this commentary.

Corporate governance might be improved through a better alignment of management incentives with the long-term interests of companies, and therefore of their committed shareholders, or through a clearer specification of corporate purpose (either in the corporate constitution or in companies legislation). In contrast, transparency, disclosure of information and extending shareholder voting rights to pay will not on their own result in better governance. There is clear evidence that very few shareholders have used advisory "say on pay" votes in the UK and US to express dissatisfaction with pay policies. Nor is there any reason to believe that moving to a binding shareholder vote will suddenly result in remuneration policies that better align executive incentives with outcomes beneficial to companies, shareholders, employees and broader society. Instead, increasing shareholder empowerment will allow activist investors to place further pressure on companies to increase their short-term share price, but will not create any incentive for currently passive institutional investors to assert a more dominant voice. It is regrettable that the Proposed Directive does not create any positive incentives to promote long-

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term shareholding, nor any disincentives to portfolio turnover.

Achieving sustainability in European enterprises will require modification of the legal and regulatory framework at the national and EU levels, in addition to improvements to business education, practice and culture. We need a shift away from the current shareholder-centric approach to corporate governance and company law towards a model that prioritises the long-term interests of the company, whilst respecting the interests of shareholders and other stakeholders.

Key recommended changes:

- Addition to Preamble before current (2): Shareholders do not own publicly listed companies, which are legal entities with their own interests, but have rights to vote and attend meetings, and play an important role in the governance of these companies.

- Addition to current Preamble (2): The financial crisis has revealed that shareholders in many cases supported managers' excessive short-term risk taking. Indeed, capital market pressure on publicly listed companies to generate short-term returns often leads to measures such as financial engineering and share buy-backs. Moreover, there is clear evidence that the current level of "monitoring" of investee companies and engagement by institutional investors and asset managers is inadequate, which may lead to suboptimal corporate governance and performance of listed companies.

- Addition to Preamble (15): Since remuneration is one of the key instruments for companies to align their interests and those of their directors and in view of the crucial role of directors in companies, it is important that the remuneration policy of companies is determined in an appropriate manner. Remuneration policies should measure performance against both financial and non-financial criteria, including environmental, social and governance indicators.

- Amendment of article 1(2)(I): 'Director' means an executive director of a company;

- Amendment of article 9a: Employees should be entitled via their representatives to express a view on pay ratios.

We also recommend that the Commission consider broader initiatives which will complement the Proposed Directive, including: more stakeholder input into corporate governance; a statement of corporate purpose; and incentives to longer-term shareholding. These are set out in detail in the final section of the Commentary.

Background

In April 2014, the Commission published proposals to amend the existing Shareholder Rights Directive (2007/36/EC) in line with its 2014 Communication on the Long-Term Financing of the European Economy, its 2013 Green Paper of the same topic, and its 2012 Corporate Governance Action Plan, as well as related public consultations. The current Directive was adopted in 2007 to improve corporate governance by defining minimum rights for shareholders in listed companies across the EU.

The Commission's stated intention in introducing the amendment is to improve corporate governance of listed companies by strengthening shareholder engagement and thereby to contribute to the competitiveness and long-term sustainability of those companies.

Analysis

The Commission's shareholder-centric model

The European Commission has chosen an approach to corporate governance regulation based on shareholder empowerment. But there is no evidence that shareholder empowerment improves corporate governance by creating pressure for a longer-term perspective. This is explicitly acknowledged in the Proposed Directive.

Thus, the stated aim of the Proposed Directive is to promote "effective and sustainable shareholder engagement" (Preamble, para. 8), which it terms "one of the cornerstones of listed companies' corporate governance model". However, while the Preamble also notes that that model "depends on checks and balances between the different organs and different stakeholders", the Proposed Directive contains no provisions mandating or even facilitating input into corporate governance by those different stakeholders. Similarly, the Proposed Directive recognizes that institutional investors *can* play a role in the steering publicly listed companies towards more long-term strategies and performance, but also notes that in recent years these investors failed to engage, allowing "capital markets [to] exert pressure on companies to perform in the short term, which may lead to a suboptimal level of investments, for example in research and development to the detriment of long-term performance of both the companies and the investor' (Preamble, para. 9).

The de Larosière Report (2009, p. 29), which was requested by the European Commission, concluded that the EU's corporate governance framework was "one of the most important failures" of the financial crisis. Yet the overarching goal of that framework was to empower shareholders and to ensure that managers prioritise shareholder interests. Further, research suggests that increased shareholder power prior to the crisis would not have led to better risk management and that, in fact, "shareholder empowerment delivers management a simple and emphatic marching order: manage to maximize the market price of the stock" (Bratton & Wachter 2010, p. 653). Similarly, the Kay Report (2012 at 5.18) noted that asset managers have a "short performance horizon". This misalignment between asset managers' incentives and end beneficiaries' interests was identified officially in the UK as long ago as 2001 in the Myners Report. Millon (2013 at 930) notes that the 'substantial current obligations' of pension funds means that there can be no guarantee that these institutional investors will have the long-term

perspective expected of them. Finally, where shareholders take the lower cost route of selling in preference to engagement, this puts downwards pressure on the share price, leading executives to engage in financial engineering and buy-backs in order to drive the share price back up. Plenty of academic studies confirm that these activities, which are driven by capital market pressures, impact negatively on productive investment (Hecht 2014; Lazonick 2013; Orhangazi 2008; Stockhammer 2004).

Why focus solely on shareholders?

The logic of shareholder empowerment is frequently based on the incorrect assumption that shareholders own corporations. An example of this is to be found in the Preamble which states that 'shareholders should have the possibility to define the remuneration policy of the directors of *their* company' (Preamble, para 15, emphasis added). Corporations are, as a matter of law, legal entities that are not owned by anyone, including shareholders. Instead, shareholders own their shares, and their shares are simply a contract between them and the corporation. Through contract and legislation, shareholders receive certain voting and participation rights, as well as an economic interest in the entity. In this sense, shareholders are similar to bondholders, creditors and employees, all of which have contractual relationships with companies, but do not own them.

Looking beyond ownership, it is commonly argued that shareholders should be prioritized because they are the only residual claimant. This argument has been thoroughly rebutted. Margaret Blair has shown that employees who make investments in firm-specific human capital are also residual claimants (Blair 1995). Likewise, it is commonly argued that the directors are the agents of the shareholders; this is simply incorrect as a matter of company law in all jurisdictions (see The Modern Corporation 2014; Sjåfjell et al 2015). Moreover, many stakeholder groups are dependent upon, or affected by, corporate decisions either because their contracts are incomplete (Becht et al 2005 at p.9), or because they have no contract with the corporation at all.

Despite the absence of any compelling reason for focusing exclusively on shareholders, and despite the mounting evidence that many shareholders (ranging from pension funds to hedge funds) do not or cannot take a long-term perspective, the Proposed Directive stakes everything on shareholders alone reorienting corporate governance towards the long term. In doing so it creates a danger that the shareholders with the best incentive to take an activist approach, namely hedge funds which use leverage to build up sizeable shareholdings in companies, will use the enhanced rights in the Proposed Directive to push managers towards even more short-term decision-making.[2]

Four broader, but complementary, changes suggest themselves here, and are discussed further in the final section of this Commentary:

2 Kahan and Rock (2007) analysed the institutional framework for activist hedge funds. They argued that these funds direct activism at individual companies to make strategic and significant changes due to the incentive structures for hedge fund managers. They also noted that traditional institutional investors may face regulatory barriers or political constraints making activism less profitable than for hedge funds. The authors acknowledged that there is a risk that activist hedge funds will achieve a short-term payoff at the expense of long-term profitability.

1. Shareholders should be given incentives to hold shares for longer periods;
2. The law should enable companies to specify and lock long-term purposes into their constitutional documents to limit pressures to short term performances;
3. The law should contain a clear statement of the societal purpose of companies; and
4. Companies should be encouraged or required to seek input from a wider range of actors who have a stake in the continued success of the company over the long-term.

Recommended Changes

- The text of the Preamble should refer to the capital market pressure on publicly listed companies to generate short-term returns, which leads to financial engineering and share buy-backs.
- The Preamble should state that companies are encouraged to consult with their stakeholders, including employees, on pay, sustainability and long-term strategy.

Identification of shareholders (articles 3a & 3b)

The Proposed Directive will allow companies to demand that intermediaries such as asset managers identify the shareholders they represent. The aim here is to enable companies to communicate directly with their shareholders, and to promote participation and voting in meetings, either directly or through intermediaries. This appears to be linked to a belief that shareholders will take a longer-term view of their investments than intermediaries, who often have strong incentives to produce impressive short-term results. This, in turn, encourages low cost share sales rather than higher cost engagement. However, given the immediate pressures on many institutional investors, there is no reason, absent unacceptable short-term performance, to expect investors that have delegated investment decisions to asset managers to then incur the costs of engaging directly with companies. These improved communication channels could, however, be used to provide shareholders with the views of various stakeholders about the orientation of corporate governance.

Recommended Changes

- The Preamble should recommend that companies disseminate the views of various stakeholder groups to shareholders to give shareholders access to a longer-term perspective.

Improving institutional investor engagement (article 3f)

Institutional investors will be required, on a "comply or explain basis", to develop a policy on shareholder engagement, which must cover monitoring, dialogue, voting, use of proxy services and cooperation with other shareholders. Where the institutional investor uses an asset manager, it should publicly disclose key elements of its contract with the asset manager, including incentives and performance evaluation. The proposal aims to ensure that institutional investors engage with investee companies, either directly or through asset managers, in such a way as to influence their long-term performance. The underlying belief is that increasing the engagement of institutional investors and asset managers will yield higher returns for end-beneficiaries in the long term and reduce harmful short-term pressure on listed companies. This is presumably expected to lead to a reduction in detrimental activities such as cyclical lay-offs and financial engineering, and encourage beneficial activities like investment in long-term innovation.

While the objective is laudable, it is unclear that increasing transparency will lead to increased engagement. It seems unlikely that the end beneficiaries of pension funds, for example, will impose meaningful pressure on their funds to take a longer term approach. It is also far from clear that, to the extent that it occurs, engagement will necessarily push companies to have a more long-term horizon.

The 'institutional investor' label says little about the extent of participation or the quality of shareholder engagement. There are important differences between pension funds, insurance companies and investment funds, and even within each of those categories. The OECD (2009) has noted the rise of momentum investing by institutional investors, and the growing trend of institutional investors to invest in alternative investment funds (including hedge funds, private equity, and real estate funds), which are often opaque in terms of their strategy. Likewise there has been a marked decrease in the holding periods of institutional investors between 1991 and 2009 (De la Croce et al 2011), and increased portfolio turnover by shareholders has been shown to have a negative impact on research and development expenditure by European companies (Brossard et al 2013). These changing investment strategies may reflect a broader chase for short-term yield at a time when interest rates in many economies have been at or close to zero for several years. They certainly do not inspire confidence that requiring the production and disclosure of an engagement policy will be sufficient to reverse this trend and encourage greater engagement on the part of shareholders.

Indeed, in the UK, an engagement policy has been a soft law requirement since the introduction of the 2002 Institutional Shareholders' Committee (ISC) Principles. The requirement was endorsed by reference in the UK Corporate Governance Code in 2003, and has been a "comply or explain" obligation since the introduction of the 2009 ISC Code, which became the Stewardship Code in 2010 following a recommendation of the Walker Report. Yet there is no evidence from more than a decade of experience that these instruments have encouraged investors to call for a longer-term approach to corporate governance.

Reforms aimed at stimulating shareholder engagement need to go far beyond mere disclosure. In theory, institutional investors with long-term liabilities should purchase and hold shares for the long-term, free from short-term pressures. In practice, they do not do this. One solution would be to encourage these institutional investors to hold their shares for much longer periods.

Recommended Changes

- This provision is unlikely to achieve the goal of the Proposed Directive, but will not cause any harm (beyond increasing costs). However, it is recommended that it be complemented by other measures: introducing views of other stakeholder groups into corporate governance; allowing statements of corporate purpose to be locked-in to constitutional documents; and encouraging institutional investors to hold their shares for longer periods. These are set out in the final section of this commentary.

Improving asset manager engagement (article 3g)

Institutional investors will be required to disclose how their equity investment strategy aligns with the profile and duration of liabilities. 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, on a comply or explain basis.

Recommended Changes

It is questionable whether end beneficiaries will actually use this information to create pressure for a longer-term perspective, but the provision of this information to the public will not be unduly costly; and could be useful for NGOs and other civil society organisations.

Shareholders' "say on pay"

Right to binding vote on remuneration policy (article 9a)

This is the most important provision contained in the Proposed Directive. The proposal will not impose a cap on directors' remuneration in relation to fixed pay (the approach taken in the Capital Requirements Directive), but rather give shareholders the power to vote on remuneration policy at least once every three years (article 9a(1)). 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" (article 9(a)(3)). Notably, the policy must explain "the ratio between the average remuneration of directors and the average remuneration of full time employees of the company other than directors and why this ratio is considered appropriate". This 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.

This provision of the Proposed Directive will allow shareholders to veto a remuneration policy that they oppose. As a general principle, shareholders are unlikely to vote against a policy which uses stock options to align executive remuneration with the share price due to widespread business practice and culture. Indeed, remuneration policies will be likely to contain claims that incentives are aligned with the long-term interests of the company (for example "executive remuneration is tied to the current stock price which economic analysis shows is the best guidance available as to the future performance of the company").

Correctly aligning management incentives with the long-term interests of companies, and therefore ultimately, their committed shareholders, is crucial to improving corporate governance. From Enron to the financial crisis, poorly aligned incentives have led to corporate failure and enormous social cost. However, the evidence below shows that few shareholders used their advisory vote in the UK and US to vote against remuneration policies. It is hard to see how a binding vote will lead to remuneration policies that better align executive incentives with outcomes that will benefit companies, their shareholders, employees and wider society.

Shareholder advisory vote on remuneration report (article 9b)

In addition, the annual corporate governance statement should include a "clear and understandable remuneration report… including all benefits in whatever form, granted to individual directors" (article 9b(1)). Shareholders will be permitted to vote on the report (article 9b(3). 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. Institutional investors could 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. This opens a formal channel of communication which will supplement the informal channels intended to be opened through the policy on engagement discussed above. However, we have some reservations about whether this is likely to lead to the development of different forms of incentive which are better aligned with the long-term interests of the company. The UK's experience with an advisory vote on a remuneration report over the previous decade suggests that pay practices will not change. To the extent that shareholders expressed dissent through the advisory vote, and informally in dialogue with senior executives, there were no discernible changes in the methods used by large companies to remunerate their executives.

Evidence from the UK and the US

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". 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 (BIS 2012 at p.14). PricewaterhouseCoopers 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. PricewaterhouseCoopers ascribe this apparently a 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 (§951 Dodd-Frank Act), 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." (ProxyPulse 2014 at p.6).

Conclusion on "say on pay"

In ruling out more interventionist approaches to pay, the Commission may be relying on the widespread, but misguided, economic assumption that it is possible to draft an incentive contract that will bring the interests of executives into perfect alignment with the long-term interests of the company and its shareholders (Johnston 2014, p. 22). The search for this perfect contract has resulted in many corporate failures over the last two decades. In relying on shareholders alone to influence the design of pay policies, the Commission appears to be relying on economic arguments, which ought not to have survived the financial crisis, that executive pay is a private matter which only concerns shareholders and companies. In doing so, the Commission is missing out on other sources of influence which might steer companies away from the short-term incentives that characterise executive pay at present. Under the Proposed Directive, much will depend on institutional investors articulating a long-term view through ongoing communication with management and voting on policies and reports. As was noted above, these hopes of greater shareholder engagement may be undermined by the apparent short-term orientation of many investors at present.

Notwithstanding these concerns about the effectiveness of "say on pay" provisions, we support the detailed reporting requirements set out at article 9b(1)(b), which require companies to report on the relative change of directors' remuneration over the last three financial years, including relative to average remuneration of full-time employees. However, we recommend the following changes.

Recommended changes

- The definition of Director in article 1(l) as "any member of the administrative, management or supervisory bodies" should be changed to include only executive directors as the current wording will reduce the average ratio by including part-time non-executives (whose pay is much lower).

- Clarification may be needed regarding whether the average remuneration should be calculated on the basis of the salaries of employees across worldwide operations or restricted to employees in the EU.

- The requirement of Member States to ensure that remuneration policies are "clear, understandable, in line with the business strategy, objectives, values and long-term interests of the company" (article 9(a)(2)) should be clarified to explain whether there is an obligation on Member States to review remuneration policies, or simply to ensure that companies produce a policy that addresses these issues.

- Employees should be entitled via their representatives to express a view on pay ratios and the likely effects of the pay policy on the long-term interests of the company. These views should be disseminated to shareholders identified under articles 3a and 3b.

An alternative approach to corporate governance

An alternative to the current shareholder-centric approach to corporate governance and company law is required to ensure that companies contribute to making the European economy more socially and environmentally sustainable, and more innovative.

Companies should pursue their long-term interests, whilst respecting the interests of shareholders and other stakeholders. Steering companies toward taking account of long-term ecological and social sustainability will require numerous changes to the legal and regulatory framework at the national and EU levels, as well as improvements to business practice and culture. Broadly speaking, EU company law should encourage or require companies to take into account the long-term interests of all stakeholders, including workers, creditors, communities and shareholders, as well as broader social costs and harm to the environment arising out of their operations. This might be facilitated through provisions which allow these different stakeholder and affected groups to express their views to corporate management and shareholders.

The innovative capacity of companies should be nurtured and protected by the law. The law might, for example, encourage companies to adopt statements of long-term purposes, and protect those purposes against opportunistic change. It might also state more clearly what the societal purpose of companies is. For example, it might require directors to pursue sustainable value in their decision-making. The inclusion of long-term (social, environmental or scientific) purposes, either within the corporate constitution or in national companies legislation (as appropriate), would facilitate informed shareholder engagement. It would also prevent the reduction of corporate purpose to the shareholder interest in short-term financial returns (Segrestin and Hatchuel 2012; Sjåfjell et al 2015). Finally, it would allow enterprises to pursue long-term strategies (especially those involving R&D which entail a high degree of uncertainty), and so contribute to long-term economic, social and environmental sustainability.

The articulation of long-term purposes and the introduction of a plurality of voices into corporate governance will allow a better alignment of corporate decision-making with the common good, and operate as brake on the current systemic tendency towards short-termism.

Recommendations

The following recommendations represent potential future legislative initiatives to be reviewed by the Commission that could further its stated objective to improve corporate governance and promote long-termism:

- Voting rights might increase (either by law or by default contractual provision) for long-term shareholders, or decrease each time shares are transferred. Alternatively, changes to accounting regulation and prudential norms might be used to encourage institutional investors to hold shares for periods that match their liabilities (Auvray, Dallery & Rigot 2015).

- Restrictions might be imposed on the practice of awarding stock options (including, but not necessarily limited to, a cap relative to fixed pay in line with the approach in the Capital Requirements Directive). The Commission already canvassed this possibility for financial institutions in its 2010 Green Paper on Corporate Governance in Financial

Institutions and Remuneration Policies (at p. 18).

- Minimum standards for employee participation in corporate governance might be established as a counterbalance to capital market pressure, and a means to increasing long-termism in decision-making.
- The Commission should consider employee representation on remuneration committees as a means to better long-term alignment between directors' incentives and the long-term interests of the company.
- Companies could be encouraged to consult with affected groups with a view to minimizing the social costs of their activities.
- 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.

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