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Confédération Européenne des Associations d'Administrateurs
European Confederation of Directors' Associations

ecoDa's reaction to the 'Proposal for a Shareholder directive'

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Our main concerns:

- The European Institutions should not jeopardize Corporate Governance structures in companies. It is essential to keep boards of directors as the central actors and not to overhaul the delicate equilibrium between the respective roles and duties of a shareholders' meeting versus a board of directors, while not curing the intrinsic problem of accountability of the board towards shareholders.
- It is important that boards keep the leadership in defining the level and the structure of the management remuneration while the remuneration of directors has to be decided by the shareholders.
- It is not realistic to turn inactive shareholders into micro-managers. ecoDa is doubtful whether the directive will lead to more engagement and long-term thinking from institutional investors.
- In order not to create more risk-averse listed companies, society should not impose strategic choices on the owners of privately held companies.

I. Some general observations

ecoDa highly appreciates the intention of the European institutions to foster a competitive business world in general and good governance more specifically. However, ecoDa is convinced that **a thorough reflection** is necessary to **question the approach used up till now**.

Notwithstanding the gradual evolution towards a more harmonised European Market, corporate law and corporate governance remain diversified throughout Europe. These differences are embedded in a long history of specific societal and economic approaches towards the organisation of the business world (governance being aligned with the quite different societal priorities). Consequently ecoDa would like the EU to opt more for a principles-based approach, focusing on the broad routes towards achieving a level playing field, rather than opting for (full) harmonisation through more detailed regulations. In this respect, the route followed by the OECD might inspire in setting out broad guidelines while investing most of the time and effort in following-up the translations of these broad guidelines into national governance recommendations. While discussing with national authorities about the compliance with the general principles, the Commission could refer to best practices in other Member States (gathered through the regular update of governance practices). Of course, the need for building/ensuring a single market will oblige the Commission to review whether the translation of these European principles into national recommendations is able to guarantee the necessary level playing field.

A second point of attention that concerns ecoDa is that "good governance" is increasingly being defined in terms of shifting key decision-making powers from the board to shareholders or other stakeholders (e.g. in respect of the "say on pay" or related party transactions). We perceive that this approach may be underpinned by an implicit mistrust of boards by policy makers and wider society. However, ecoDa would like to point out that an independently-minded board is uniquely well-placed to oversee the best interests of the organisation. The board is the body where the company's interest is considered (directors have the duty to focus on the corporate interest (only)) while at the General Meeting the opinion and individual interests of shareholders may/will prevail. Moreover, unlike most external stakeholders (including shareholders), the board has unrestricted access to the company's management, information and resources. Furthermore, an effective and well-balanced board contains individuals with a significant amount of relevant experience, expertise and business acumen.

ecoDa recognises that the reputation of boards has taken a battering as a result of the financial crisis and other corporate failures. However, rather than shift powers away from boards towards less well-positioned governance actors, ecoDa believes that the perception problem of boards should be addressed head-on. The effectiveness and objectivity of boards should be developed by things such as improved training and professional development of directors, encouragement of greater boardroom diversity, and use of board evaluation techniques. Most importantly, a key means of rebuilding trust in boards will be the development of a more transparent and professional approach to the appointment of directors.

Although ecoDa is fully supportive of encouraging shareholders and other stakeholders to take a more active role in the stewardship of corporations, it should not be forgotten that boards of directors are the central actors in any system of corporate governance. Ultimately, the key to a more effective governance system will be the emergence of more competent and legitimate boards. This is an objective to which ecoDa is fully committed.

II. General comments on the shareholder directive

ecoDa appreciates that this directive further builds on previous consultations and impact assessment. Moreover, the European Commission clearly understands the **complexity of the investment chain** in listed companies and translates this into specific requirements (such as for institutional investors (including also branches of third country intermediaries), asset managers and proxy advisors). At the same time, the directive proves that the European Commission is well aware that a one-size-fits-all approach is not a feasible solution and explicitly tackles the **potential weaknesses of the two shareholder models prevailing throughout Europe**: at the one hand insufficient engagement of institutional investors and at the other hand the risk of private benefits and abuse of controlling position (at the detriment of minority shareholders) in the blockholder model. ecoDa also applauds relying again on the **Comply or Explain** approach (if no engagement, or no voting by institutional investors and/or their intermediaries, an explanation has to be given).

However ecoDa also has a number of critical remarks. **We question whether the approach prescribed will actually lead to the envisaged outcome**. Several assumptions need far more reflection and should be part of an in-depth critical cost-benefit analysis (more generally speaking, the condition of an objective and critical cost-benefit analysis needs to be more thoroughly taken care of, when introducing new EU directives).

- In the draft directive, the European Commission justifies its action by the fact that *"the EU equity market has to a very large extent become a European/international market (…). Action from Member States would only cover some of the institutions concerned and would most likely lead to different requirements, which could lead to an uneven level playing field on the internal market*". However given the international dimension of the equity market, the EU parties in the equity market are certainly not always the most prominent shareholders any longer. To some extent the EU tries to cope with this internationality by introducing comparable obligations for 'branches' of non-EU financial intermediaries and shareholders. It is however to be seen whether the EU will be more efficient than the Member States in regulating all these shareholders. In addition, the European Commission does not seem to take into account the existing national regulations (which might already cover all the items addressed in the draft directive, may be from a different angle). There is a risk of overregulation and adding administrative burdens to companies which have to adjust to continuing legal changes.
- Will this directive **really lead to more engagement and long-term thinking from institutional investors**? The question is: what will change in the cost/benefit analysis of shareholder engagement? If there are no incentives, what will stimulate them to interfere? What will change the attitude of institutional investors to become more long-term oriented?
- Giving shareholders sufficient say in corporate decision-making and allowing them to really monitor the investee company and its board deserves all support. Indeed, building sufficient countervailing power is essential for securing good governance. However the detailed requirements of this directive go counter to the observation that shareholder engagement is lacking in many Member States. **It is not realistic to turn inactive shareholders into micro-managers.** Ages ago it was already observed that in larger companies, shareholders were unable to monitor the companies, leading to the creation of an interface, the board of directors. **If the board is not performing its duties the shareholders should dismiss the board, not take over the management of the company**. It is this point that seems so crucial to ecoDa, and which the EU proposals are totally ignoring. ecoDa therefore proposes to **further reflect on ways to really make boards accountable to shareholders**, rather than to make them decide on all kinds of issues, that traditionally belong to the board (for more details see point 3 on say-on-pay).
- The assumptions on monitoring compliance with this Directive certainly need further reflection. Institutional investors have to monitor compliance of asset managers; but **who will monitor the compliance of institutional shareholders with this directiv**e and judge (stimulate) the quality of explanations? It will probably not be their clients/beneficiaries that will do so! Moreover, this leaves monitoring of compliance and eventual penalties again at the discretion of the Member States (which is contrary to the intention of the Directive to regulate institutional investors and their intermediaries at EU level).

The Commission narrowly defines the notion of institutional investors by excluding mutual funds. Mutual funds are often short-term investors. Given that the Commission has also privileged the CoE approach for these regulations of the Shareholder Directive, ecoDa does not see the reason for not including them.

III. Detailed analysis of the Proposal

We have grouped our reactions under the 5 major aspects integrated in this Directive Proposal.

1. **Level & quality of (institutional) SHAREHOLDER engagement:** The EU correctly points to the insufficient and inadequate engagement of institutional investors & asset managers and the risk of excessive short-term thinking. Today, there is increased attention for favoring the long term. However, we may not ignore that short-term success is a prerequisite for having any long-term prospects. In order not to create more risk-averse listed companies, society should not impose strategic choices on the owners of privately held companies. Otherwise, even long-term owners could abdicate from their ownership role. Moreover, it is **questionable whether the disclosure requirements of the directive[1] will effectively solve the downside risks of such passive shareholder model**. It is clear that such transparency will probably not fundamentally change their business model, nor bend the cost-benefit balance of engagement in favour of a more active attitude.
   The only incentive might be the accountability to prove how the investment strategy contributes to the medium to long-term performance, including non-financial performance of their assets.

   Promoting activism from a long term perspective through additional incentives might be a better solution. Again, we might refer here to our previous proposal for additional rights (dividend, voting) for active and long-term shareholders that might deserve some more reflection. Also promoting specific guarantees for a say of minority shareholders might be a solution, even in models with dispersed shareholding (see point 3).

   On top of that, we fear that the directive will imply a considerable growth in the administrative cost on institutional investors and even more so on asset managers. We would like to question why there is a difference in disclosure requirement (and periodicity) between institutional investors and asset managers, on points such as (b) changes in portfolio, (c) level of portfolio turnover, (d) portfolio turnover costs, (e) securities lending.

   ecoDa is supportive of the Commission's request for more accountability but considers that it might be a bit too bureaucratic for institutional investors.

2. **Say on pay:** ecoDa has the impression that the **proposal reflects much more a socio-political agenda than a business or economic reflection**. This is clear when it comes to setting a maximum to executive pay as well as the obligation to publish the ratio of executive pay to average employee remuneration. It is questionable whether it is a duty of the EU to oblige Member States to set maximum remuneration levels to director remuneration! On this point ecoDa would like to refer to the reaction of European Issuers, which she completely supports on this point (20.5.2014, p3-4).

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[1] We refer here to art 3f (mandatory transparency of institutional investors & asset managers on voting & engagement; development and annual disclosure of a policy on shareholder engagement and its implementation; per investee company explanation of voting behaviour) and to art 3g (institutional investors have to disclose how their investment strategy is (directly or through asset managers) aligned with the profile and duration of their liabilities and how it contributes to the medium to long-term performance (including non-financial performance) of their assets). To complete the information cycle parallel obligations are laid down for asset managers (with half-yearly information to the institutional investor on how the investment strategy and the medium to long-term perspective are complied with).

The key challenge for executive remuneration is to develop a sufficient link between pay & performance and develop **a remuneration policy that fosters the long-term interests and sustainability of the company**. ecoDa **doubts whether the proposed directive will really cure this challenge**. The demand for ex ante as well as ex post voting by shareholders of respectively the remuneration policy and its application, is too far reaching (what if the two outcomes differ as European Issuers highlight in their reaction to this proposed directive?). But more importantly, it will overhaul the delicate equilibrium between the respective roles and duties of a shareholders' meeting versus a board of directors, while not curing the intrinsic problem of accountability of the board towards shareholders. What really matters is to enable shareholders to exercise their control and to enable them to dismiss the board if they are not acting properly also when setting executives' remuneration. ecoDa therefore would like to make a plea for **changing the approach by finding routes to ensure that the shareholders really have a say on the nomination and dismissal of directors and on the obligation of directors to be accountable towards shareholders**[2]. Such a system will correctly position the governance bodies in their respective duties. Placing more power with shareholders on executive remuneration will not guarantee that long-term and corporate interests are given sufficient priority. As said in the introduction, the board is the body where the company's interest is considered while at the General Meeting the opinion and individual interests of shareholders can prevail. ecoDa would like to stress that it is important that boards keep the leadership in defining the level and the structure of the management remuneration while the remuneration of directors has to be decided by the shareholders (see Position Paper of ecoDa 1.10.2009 http://ecoda.org/uploads/media/PP_-_2009_10_01_Directors_remuneration_in_listed_companies.pdf).
Furthermore the role of boards might be quite different in one-tier and two-tier models, justifying that specific regulation on this theme should be taken at the national level.

On the other hand, **the EU-requirements** of the shareholder directive as to governing executive remuneration **might be very useful for boards of directors and their remuneration committee**. Directors (should) have the duty of making sure that the remuneration policy and its application in practice answer to the conditions set out in the directive. Such in-depth analysis and accountability makes much more sense in a context of a board than in the public forum of a general assembly. The complementary duty towards shareholders could be limited to providing insight in the decision-making process and explaining how the board monitors executive remuneration, proving that the process is free of conflicts-of-interests. If the shareholders have their doubts on executive remuneration, they can and should question the directors and eventually dismiss them. It's up to the board to make sure that executive pay is really in line with corporate performance (to what extent performance criteria have been fulfilled; explaining how the total remuneration is linked to long-term performance and value creation over the last 3 years). Additional attention should also be paid to making sure sufficient control systems are in place, in order to overcome excessive risk taking. To this end, the financial sector may be an interesting reference how boards can be made more accountable, rather than shareholders.

As to transparency on executive remuneration, the proposed directive is well aware of the downside privacy risk (article 9b/2), but how this aligns with the full disclosure on individual remuneration (9b/1) is an open question for ecoDa.

[2] It is important that even dispersed shareholders use their voting rights to dismiss, if needed, the board and that the GM has enough power to form coalitions to make the necessary changes. In the UK minority shareholders can exercise their rights through the nomination of independent directors since they have just been allocated a separate vote on independent directors.

3. **Related party transactions:** With the proposed new legislation on related party transactions, the EU Commission tries to deal with a risk affecting listed companies when transacting business with controlling shareholders, a risk due to the lack of transparency and (minority) shareholder oversight.
   Understandably, the EU wants to install a level playing field, but in that effort **ignores regulatory efficiency as well as business efficiency**. In several Member States extensive regulations already exist, sometimes with a broader scope as it covers other related party transactions involving directors (especially in the case of cross-directorships). Consequently Member States will be faced with either dismantling their current procedures or piling up inconsistent regulations. For important transactions (more than 5% of assets (cumulative) or significant impact on profit or turnover) the transparency requirements (and independent opinion for transactions above 1% of assets) are complemented with an a-priori approval by the non-involved (minority) shareholders. This raises the question of business efficiency.
   The proposal for a-priori approval of the non-involved minority shareholders creates the necessity for either a costly additional extra-ordinary meeting, or the need for postponing the transaction until after the next annual general assembly. **Moreover this proposal neglects the potential of abusing minority positions (by giving (small) minorities a veto right in business decisions).** An a-posteriori ratification may provide an efficient safeguard, if the transaction is considered by the shareholders to be harmful for the company, triggering the board's liability.
   Finally, an additional question that ecoDa would like to put forward in this respect is, **how such regulation fits with the lack of a group governance approach throughout Europe**?

4. **Proxy advisors**: As to the requirements for proxy advisors, **ecoDa fully supports** the requirements to solve the inadequate transparency & the potential conflicts of interest. The fact that proxy advisors need to prove the reliability & quality of their advice, to give insight in their methodology, models and main information sources as well as to disclose any actual or potential Conflict of Interest (3i) is a step forward.

5. **Shareholder info & (cross-border) voting**: As has already been highlighted in the general remarks (point 2), **ecoDa understands the objectives** of this shareholder directive **but doubts whether the method chosen** (more information on shareholding and facilitating shareholder voting) **will really trigger** more shareholder engagement and long-term.

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About ecoDa:

The European Confederation of Directors' Associations (ecoDa) is a not-for-profit association founded in December 2004 under the laws of Belgium. Its objective is to represent the views of company directors from EU member states to corporate governance policy-makers at EU level. ecoDa, the European Confederation of Directors' Associations, is a not-for-profit association acting as the "European voice of board directors".
Through its 16 national institutes of directors, ecoDa represents around sixty-five thousand board members from across the EU, ensuring that their views on Corporate Governance are clearly communicated to policymakers in the EU institutions. ecoDa's member organisations represent board directors from the largest public companies to the smallest private firms, both listed and unlisted.

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