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EU Institutions Strike a Deal on the Shareholders Rights Directive: What's in it?

The legislative process related to the directive on shareholders' rights initiated by the European Commission in April 2014 is coming to an end.

Finally, the Council, the Commission and the Parliament reached a compromise last week under the Slovak Presidency.

The proposal was submitted in order to overcome certain corporate governance shortcomings in European listed companies and to encourage a more long-term oriented and active engagement by shareholders, including in cross-border situations. The objective is to contribute to the long-term sustainability of EU companies and to enhance the growth, job creation and competitiveness of the EU economy.

A compromise on the shareholder rights directive had been blocked for many months by the European Parliament due to its desire to include provisions on country-by-country reporting in the directive.

The European Commission presented a dedicated text on country-by-country reporting earlier this year. It was necessary for Parliament to obtain guarantees in order to be able to agree to move forward on the shareholders' rights directive.

The compromise on the shareholder rights directive will be put to the plenary vote in the European Parliament in March 2017. The Council will also need to formally approve the text; this is likely to happen in April or May 2017.

In a way, the compromise on shareholders' rights may already be out of date. It comes at a point in time when the debate on Corporate Governance is shifting to a more stakeholder-oriented approach and when there is a growing demand to balance better the interests of shareholders with the interests of other stakeholders.

What is the content of the text?

The text is somewhat less ambitious than the initial text proposed by the European Commission. This being said, it shows clearly that the European institutions are opting for harmonisation through more detailed regulations rather than by taking a principles-based approach.

1- On the identification of shareholders:

The directive requires that Member States allow companies to identify their shareholders. While the original text imposed a complete identification system, the compromise provides for the Member States to set a threshold below which shareholder anonymity is possible (this threshold cannot exceed 0.5%). There is, therefore, a risk that only a few major shareholders would then be identified.

The directive does not address the question of differences in the charges levied between domestic and cross-border exercise of rights.

2- On transactions with related parties

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 caused by a potential lack of transparency and insufficient (minority) shareholder oversight.

The Directive provides that related parties transactions are subject to vote by the shareholders or the board of directors in order to protect the interests of the company as a whole.

The original text set a threshold: only transactions that had a significant impact on turnover or which represented 5% of the company's assets were affected by the new rules.

The final text leaves it to the Member States to define which transactions are subject to this voting system. In several Member States extensive regulations already exist, sometimes with a broader scope as they cover other related party transactions involving directors (especially in the case of cross-directorships). By not defining precisely related parties transactions, the compromise allows the Member States to keep their current definitions – this is consistent with ecoDa's own position on this issue

3- **Regarding the transparency requirements of institutional investors, asset managers**, the compromise text remains in line with the initial draft.

Institutional investors and asset managers should develop and publicize their engagement policy - this policy should include how they monitor the companies in which they invest, in particular with respect to strategy, financial and non-financial performance, risk, social and environmental impact, and corporate governance. Their policy should also specify how they interact with the company, how they exercise their voting rights, communicate with other shareholders and stakeholders of the invested company.

Each year, institutional investors and asset managers must publish annually how their commitment policy has been implemented, explanations of the most important votes and their use of proxy advisors' services.

The compromise is slightly more precise than it was in the original text. The obligations to publish contractual elements will certainly impact institutional investors. It is questionable, however, whether the disclosure requirements of the directive will completely overcome the long-standing issues of investor passivity or insufficient engagement with companies.

Especially in models with dispersed shareholding, it remains to be seen whether this Directive will ultimately result in more effective shareholder monitoring. As ecoDa questioned in previous position papers, turning passive and fragmented shareholders into active monitors is a great challenge. The result could well be that it will create a much more powerful position in a very concentrated market of proxy advisors (with potentially a kind of concerted action above the 30% level). Is that what the EU wants to achieve? Should more energy, at the same time, not be devoted to further developing the professionalism of boards as the first monitor, whatever the shareholding model might be?

4- **With regard to the transparency of proxy advisors**, the compromise includes the possibility to use the comply or explain principle: proxy advisors must specify their reference code of conduct and if they do not apply it, they have to explain why.

There is already a referent code of conduct: the Best Practice Principles for Shareholder Voting Research & Analysis which were published by a group of proxy advisors in March 2014 in response to ESMA's 2013 recommendation to develop a code of conduct to improve investors' and issuers' understanding of what they can expect from proxy advisors.

Even if it is not specified in the text, the institutional investors should then monitor compliance with this code of conduct. However, the question of who should monitor the compliance of institutional shareholders with this directive and judge the quality of explanations remains open, as highlighted earlier by ecoDa.

However, the fact that proxy advisors now need to prove the reliability and quality of their advice, to give insight in their methodology, models and main information sources, to mention whether they have dialogues with the companies as well as to disclose any actual or potential conflict of interest is a step forward according to ecoDa.

5- **With regard to remuneration** (the subject that mainly attracted the attention of ecoDa at the start of the legislative process), much flexibility has been introduced on the nature of shareholder votes.

The vote on remuneration policy is binding unless the Member States decide otherwise. The say on pay on the remuneration report is an advisory vote even if the report must specify how the vote was taken into account. The Member States have the possibility to allow SMEs to make remuneration one item on the agenda of the general assembly without a formal vote. The European Council's attempt to set a specific capitalization amount for this requirement was ultimately disregarded.

ecoDa has advocated that 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. 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.

However, at least the flexibility left to the Member States is a good thing that acknowledges the different corporate governance models that prevail in differing European economies.

In fact, the European directive is less substantial than the new national developments foreseen (in the UK) and already in place (in France – Loi Sapin) where a binding ex ante and ex post vote is required.

According to the Directive, the shareholder vote on the remuneration policy must take place at least every four years (the original text provided for a vote every three years).

Companies may deviate from their remuneration policy in exceptional circumstances. The definition of exceptional circumstances has been expanded; it covers derogations taken to serve the long-term interests of the company.

It is a requirement of the Directive that the remuneration policy must contribute to the strategy, the long-term interests and the sustainability of the company. When the company awards variable remuneration, the policy shall set clear, comprehensive and varied criteria for the award of the variable remuneration. It shall indicate the financial and non-financial performance criteria including, where appropriate, criteria relating to corporate social responsibility.

Mainly due to the European Parliament's pressure, the reference to employees' remuneration has been retained. Indeed, the remuneration policy must explain how the pay and employment conditions of employees of the company were taken into account. The remuneration report itself has to include a description of the evolution of the average remuneration on a full-time equivalent basis of employees of the company other than directors. Those requirements will generate a lot of bureaucracy within companies and even more in multinationals.

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To conclude, ecoDa still has significant doubts on whether the approach prescribed will actually lead to more engagement and long-term thinking from institutional investors. It is still not clear to us what will change in the cost/benefit analysis of shareholder engagement. As stated in its title “Directive of the European parliament and of the council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement”, it might just be an “encouragement” to move towards more long-term thinking rather than marking a major turning point.

On the other hand, the EU-requirements of the shareholder directive as to governing executive remuneration might be useful for boards of directors and their remuneration committees. Directors have the duty of making sure that the remuneration policy and its application in practice answer to the conditions set out in the directive. The idea of proposing a standard template for the remuneration report is still addressed in the compromise. Even if we are speaking about non-binding guidelines, this is certainly a subject to watch closely.

Nota bene: See ecoDa initial position

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