



Brussels, 9.4.2014
SWD(2014) 126 final

COMMISSION STAFF WORKING DOCUMENT
EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

Accompanying the document

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL
on 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

and

COMMISSION RECOMMENDATION
on the quality of corporate governance reporting ('comply or explain')

{COM(2014) 213 final}
{C(2014) 2165 final}
{SWD(2014) 127 final}

1. INTRODUCTION

The past years have highlighted certain corporate governance shortcomings of European listed companies. These shortcomings relate to different corporate governance actors: directors, shareholders (institutional investors and asset managers) and proxy advisors.

Only a number of key aspects of corporate governance have been harmonised at EU level, in particular through Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies. This Directive contains rules on the participation in general meetings. The need to enhance the current framework has been highlighted in the Commission Action Plan on European company law and corporate governance.¹ This impact assessment considers possible ways to achieve the objectives of the Action Plan.

2. PROBLEM DEFINITION

This impact assessment analyses a number of problems in the area of corporate governance. One of the key issues in corporate governance is the separation between ownership and control and the resulting principal-agent relationship between shareholders and directors. The delegation of management of the company by shareholders (“principals”) to directors (“agents”) leaves room for directors to act more in their own self-interest than in the interest of the shareholders. This could lead to suboptimal corporate governance and performance of companies. Today, institutional investors and asset managers are an important force in equity markets and intermediation within the investment chain (delegation of the day-to-day management of the investment to asset managers) has increased substantially. Increased intermediation has led to the emergence of incentives within the investment chain that often focus on short-term performance and do not sufficiently exploit the benefits of shareholder engagement. Institutional investors and asset managers are therefore often absent and do not take an interest in the governance of companies. This exacerbates the agency problem between shareholders and company directors and leads to suboptimal performance of listed companies. Studies demonstrate that long-term shareholder engagement not only leads to better performance of investors but contributes also to enhancing the competitiveness and performance of companies.

2.1. Insufficient engagement of institutional investors and asset managers

The financial crisis has revealed that shareholder control did not function properly in the financial sector. Rather than containing excessive short-term risk taking by managers, shareholders, in many cases, supported it. Listed companies in general do not have markedly different shareholders than financial institutions and there is clear evidence that the current level of “monitoring” of investee companies and engagement by institutional investors and asset managers is sub-optimal. Research demonstrates that institutional investors and their asset managers do not sufficiently focus on the long-term performance of companies, but on share-price movements and the structure of capital market indexes, which may not lead to an optimal return for the end beneficiaries (for example future pensioners) and puts short-term pressure on companies.

This short-termism appears to be rooted in a misalignment of interests between asset owners and asset managers. Large asset owners, such as pension funds and insurers have long-term

¹ COM/2012/0740 final

interests as their liabilities are long-term. However, for the selection and evaluation of asset managers they often rely on benchmarks, such as market indexes, and the performance of the asset manager is often evaluated on a quarterly basis. In case of underperformance, the asset manager may lose the mandate. As a result many asset managers' main concern has become their short term performance relative to a benchmark or to other asset managers, although the end beneficiaries have an interest in the long-term absolute performance of the investment. Short-term incentives turn focus and resources away from making investments based on the fundamentals and longer term perspectives, from increasing long-term value through shareholder engagement and result in short-term pressure on companies creating disincentives for competitiveness-enhancing investments.

Albeit still relatively limited, there is a growing number of investors which aim to combine financial outperformance with long-term value creation and their investment strategies also involve engagement with investee companies.

2.2. Insufficient link between pay and performance of directors

Shareholder oversight on directors' remuneration has also shown to be insufficient. Directors' remuneration plays a key role in aligning the interests of directors and shareholders and ensuring that the directors act in the best interest of the company. Where shareholders do not oversee directors' pay, there is a risk that directors will apply a strategy which rewards them personally, but that may not contribute to the long-term performance of the company. Several shortcomings have been detected in the current framework. First, the information disclosed by companies is not comprehensive, clear nor comparable. Secondly, shareholders often do not have sufficient tools to express their opinion on directors' remuneration.

2.3. Lack of shareholder oversight on related party transactions

Related party transactions (RPTs), i.e. transactions between a company and its management, directors, controlling entities or shareholders, create the opportunity to expropriate value belonging to the company to the detriment of (minority) shareholders. In most cases shareholders do not have access to sufficient information ahead of the planned transaction and do not have adequate tools to oppose to abusive transactions. As institutional investors and asset managers are in most cases minority shareholders, more control rights over RPTs would improve their ability to protect their investments.

2.4. Inadequate transparency of proxy advisors

Proxy advisors provide recommendations to investors on how to vote in general meetings of listed companies. The large number of (cross-border) holdings by many institutional investors and asset managers and the complexity of the issues to be considered make the use of proxy advisors in many cases inevitable and thus proxy advisors have considerable influence on the voting behaviour of these investors. In particular, shortcomings concerning the quality of advice as well as conflicts of interest have been observed.

2.5. Difficult and costly exercise of rights flowing from shares

Investors face difficulties in exercising the rights flowing from their shares, especially if these are held cross-border. In intermediated holding chains, especially when they involve many intermediaries administering securities accounts, information is not passed to shareholders from companies or shareholders' votes get lost. There is also a greater likelihood of misuse of

the voting rights by intermediaries. Three main causes affect the systems: the lack of possibility for the company to identify investors, a lack of timely transmission of information and rights in the investment chain and price discriminations of cross-border holdings.

2.6. Insufficient quality of corporate governance information

Shortcomings have been observed as regards the quality of corporate governance reports prepared by listed companies in the EU, in particular as regards the explanations for deviations from corporate governance codes’ recommendations. In over 60% of cases where companies chose not to apply recommendations, they did not provide sufficient explanations. Inappropriate reporting makes it more difficult for shareholders to take informed investment decisions and engage with the company.

2.7 Subsidiarity

The competence for action is based on Article 50(2)(g) of the TFEU. The growing importance of cross-border equity investments (some 44% of the total market capitalisation of EU listed companies is held by foreign investors) and the changes in the equity investment chain justify certain targeted measures at EU level in order to ensure the protection of the interests of shareholders and other stakeholders. Only a limited number of Member States has undertaken action or is considering doing so to tackle the problems, and these actions cannot bring effective solutions to these problems. Action from Member States alone is likely to result in different sets of rules creating an uneven level playing field, which may undermine or create new obstacles to the good functioning of the internal market.

3. POLICY OPTIONS, IMPACT ANALYSIS AND CHOICE OF PREFERRED OPTION

3.1. Increase the level of engagement of institutional investors and asset managers

Policy options
1 No policy change
2 Recommendation on transparency of institutional investors and asset managers on their voting and engagement and certain aspects of asset management mandates
3 Mandatory transparency of institutional investors and asset managers on their voting and engagement and certain aspects of asset management mandates

Assessment of policy options			
	Effectiveness	Efficiency	Coherence
Option 1: no policy change	0	0	0
Option 2: recommendation on transparency of institutional investors and asset managers	+	+	+
Option 3: binding rules on transparency of institutional investors and asset managers	++	+	+

Option 3 is the preferred option:

This option would increase transparency on how asset owners incentivise their asset managers to act in the best long-term interest of their beneficiaries and to pursue investment strategies involving shareholder engagement. Asset managers would be required to be transparent about their engagement policies, the benefits of these and how they discharge their policies mandated. Substantial and relevant information would enable asset owners to make better informed decisions about their investment policies. It would stimulate them to engage more with investee companies. Transparency on the costs of frequent portfolio turnover by asset managers may reduce the magnitude of such transactions, contributing to a better focus on the fundamental value of companies and increasing this value through shareholder engagement. These measures may ultimately result in cost savings and better return for asset owners and ultimate beneficiaries. A better focus on the fundamentals and the real value-creative capacity of companies could in particular be beneficial for listed SMEs. More engagement and a longer-term perspective could also contribute to higher investments by companies into research and competitiveness and thus more employment.

Binding rules on transparency would provide the highest likelihood to trigger a positive change with limited cost.

3.2. Create a better link between pay and performance

Policy options
1 No policy change
2 Binding rules on transparency of remuneration
3 Shareholder vote on remuneration

Assessment of policy options			
	Effectiveness	Efficiency	Coherence
Option 1: no policy change	0	0	0
Option 2: binding rules on transparency of remuneration	+	+	+
Option 3: shareholder vote on remuneration	+	++	+

Options 2 and 3 are the preferred options: Providing shareholders with clear, comprehensive and comparable information on remuneration policies and individual remuneration of directors would help them in exercising effective oversight. Harmonisation of disclosure requirements at EU level would be a remedy to asymmetry of information and, therefore, minimise agency costs. It would be beneficial for cross-border investment, since it would facilitate comparison of information and make engagement easier and thus less costly. Moreover, it would make companies more accountable to other stakeholders.

Granting shareholders a vote on pay would give them an effective tool to oversee directors' remuneration and engage with companies while also strengthening the link between pay and performance.

3.3. Transparency and oversight on related party transactions

Policy options
1 No policy change
2 Soft-law providing guidance
3 Improving transparency requirements for related party transactions
4 Shareholder vote on the most important transactions

Assessment of policy options			
	Effectiveness	Efficiency	Coherence
Option 1: no policy change	0	0	0
Option 2: soft-law providing guidance	≈	≈	+
Option 3: improving transparency requirements for related party transactions	+	+	+
Option 4: shareholders vote on the most important transactions	++	++	+

Options 3 and 4 are the preferred options: providing investors with ex ante information on most important transactions would allow them (in particular minority shareholders) to act against unjustified transactions and to engage more with the company, while the vote would allow them to reject abusive transactions. A shareholder vote would also stimulate reflection of companies on RPTs. This combination could have a positive impact on competitiveness and sustainability of companies and cross-border investment.

Binding rules are likely to be more effective than soft-law guidance.

3.4. Transparency of proxy advisors

Policy options
1 No policy change
2 Recommendation on transparency on methodology and conflicts of interests
3 Binding disclosure requirements on methodology and conflicts of interests
4 Detailed regulatory framework

Assessment of policy options			
	Effectiveness	Efficiency	Coherence
Option 1: no policy change	0	0	0
Option 2: recommendation on transparency	≈	+	++
Option 3: binding rules on transparency	+	++	+
Option 4: detailed regulatory framework	++	-	-

Option 3 is the preferred option: requiring disclosure on the two main areas of concern (methodology and management of potential conflicts of interest) would put additional pressure on proxy advisors to establish adequate procedures on these crucial aspects. Binding transparency requirements would be more effective than soft law, while avoiding inflexible and disproportionate charges linked to a detailed regulatory framework.

3.5. Shareholder identification and facilitation of the exercise of shareholder rights by securities account providers

Policy options
1 No policy change
2 Minimum EU rules
3 Detailed requirements regarding the possibility of shareholder identification and obligations for the facilitation of the exercise of shareholder rights by intermediaries

Assessment of policy options			
	Effectiveness	Efficiency	Coherence
Option 1: no policy change	0	0	0
Option 2: minimum EU rules	+	++	+
Option 3: shareholder identification mechanism obligations for intermediaries	++	++	+

Option 3 is the preferred option: An obligation for intermediaries providing securities accounts to offer the service of shareholder identification to the company will facilitate a direct contact between the shareholder and the company. The obligation for these intermediaries to transmit information related to the share, facilitate the exercise of shareholder rights and justify price differences for these services if the rights are exercised across the borders will ensure that shareholder votes do not get lost and shareholders are able to engage more efficiently across the borders.

3.6. Improving the quality of corporate governance reporting

Policy options
1 No policy change
2 Recommendation providing guidance
3 Detailed requirements regarding corporate governance reporting

Assessment of policy options			
	Effectiveness	Efficiency	Coherence
Option 1: no policy change	0	0	0
Option 2: recommendation providing guidelines	+	++	++
Option 3: detailed rules	++	+	+

Option 2 is the preferred option: Providing guidelines on the explanations for deviations from codes is likely to give companies more certainty in preparing such reports and improve their quality. It would incentivise them to reflect more thoroughly about their corporate governance arrangements and improve them, if necessary, which could contribute to better

performance. It could also contribute to cross-border investment, due to increased transparency and comparability of reports.

4. OVERALL IMPACTS OF THE PACKAGE

The proposed approach constitutes a package of complementary actions. The package is part of the Commission's work on the long-term financing of the European economy: it contributes to a more long-term perspective of shareholders which ensures better operating conditions for listed companies.

The objective of the preferred options is to ensure that investors have clear, comprehensive and comparable information at their disposal, which removes, in particular for cross-border investors, barriers to engagement. Creating more transparency on the impact of the investment policies will result in more informed decisions of investors and final beneficiaries, but will also incentivise investors to become more engaged with their investee companies. Any increase in shareholder engagement is likely to have a positive effect on both shareholder value and the efficiency, competitiveness and performance of the target company.²

The proposed package could therefore positively impact the long-term sustainability of listed companies, including SMEs, which are likely to benefit from a better access to capital markets. Some positive social impacts could also be expected, since long-term oriented companies could create more employment. No specific environmental impact is foreseen.

The package would result in an increase in administrative burden, including for listed SMEs. However, these costs would be limited considering that mostly transparency and publication measures are foreseen and that some degree of transparency is already imposed or applied on voluntary basis. Additionally, costs will be distributed evenly between the different stakeholder groups.

5. EVALUATION

An evaluation of the impact of the package shall be carried out five years after the transposition deadline, and the appropriateness of eventual amendments may be considered on basis of the results of the evaluation.

² Shareholder engagement on corporate governance, with remuneration being one of the key issues, may generate an average of 7-8% abnormal cumulative and buy and hold stock return over a year, lower the cost of capital for companies and significantly improve their governance and profitability.