EU Amendment Directive

CONSIDERATION OF LONG-TERM INTERESTS OF SHAREHOLDERS

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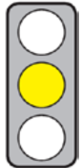
Centrum für Europäische Politik

KEY ISSUES

Objective of the Directive: The long-term interests of shareholders should be given greater consideration by stock companies when making decisions.

Affected parties: Shareholders, stock companies, intermediaries, investors, institutional investors, asset managers, proxy advisors.



Pro: Obligations to obtain the approval of shareholders for decisions on remuneration of the management and on related-party transactions allow shareholders to assert their interests more easily.

Contra: (1) Obligations to obtain the approval of shareholders for decisions on remuneration of the management and on related-party transactions threaten to encroach on entrepreneurial flexibility.

(2) The duty for proxy advisors to guarantee that their recommendations are "accurate and reliable" may result in their making only vague recommendations or even none at all.

CONTENT

Title

Proposal COM(2014) 213 of 9 April 2014 for a **Directive** 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

Brief Summary

Note: Article numbers refer to Directive 2007/36/EC as amended by the proposal.

- **Context and objective**
  – The Shareholder Rights Directive (2007/36/EC) defines the voting rights and other rights held by the shareholders of listed stock companies established in the EU in relation to general meetings.
  – The Commission wants decisions by stock companies to be based to a greater extent on their long-term performance and less on short-term share price fluctuations. It therefore proposes measures aiming to ensure that decisions by stock companies take more account of shareholders' interests. In particular, it supplements the Shareholder Rights Directive by providing for
    - voting rights for shareholders at the general meeting in relation to
      - remuneration of the management and supervisory boards as well as
      - transactions with persons and companies which are related to the stock company,
    - obligations on intermediaries such as depositary banks to facilitate the exercise of shareholder rights,
    - obligations on institutional investors and asset managers when acting as shareholders as well as
    - obligations on proxy advisors who give voting recommendations to shareholders.
- **Remuneration of the management and supervisory boards**
  – Shareholder supervision of the remuneration of members of the management and supervisory boards will bring the interests of directors into line with those of shareholders [Recital 15, Art. 2 (l)].
  – The shareholders must agree at least every three years on the criteria whereby the remuneration is determined (hereinafter: remuneration policy). The stock company cannot deviate from this. [Art. 9a (1)]. In particular, shareholders must decide on [Art. 9a (3)]
    - a maximum amount of remuneration for members of the management and supervisory boards,
    - criteria for determining the fixed and variable components of the remuneration as well as for granting benefits in whatever form,
    - the "main terms" of the contracts with members of the management and supervisory boards as well as
    - the ratio between the average remuneration of members of the management and supervisory boards, on the one hand, and that of the other employees, on the other hand.
  – The stock company must make the remuneration policy public [Art. 9a (4)].
  – When recruiting new members of the management and supervisory boards, the stock company can deviate from the remuneration policy. Remuneration must, in this case, be paid provisionally pending approval by the shareholders. [Art. 9a (1)]
  – After each financial year, shareholders must vote on a remuneration report which must be made public by the stock company [Art. 9b (3), new Art. 20 (1) (h) Directive 2013/34/EU].

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- This contains detailed information about how the remuneration policy is implemented, e.g. the actual remuneration paid out to each member of the management and supervisory boards and its components [Art. 9b (1)].
- Where the shareholders vote against the remuneration report, the stock company must explain, in the next remuneration report, whether and how this vote has been taken into account [Art. 9b (3)].

► **Transactions with persons and companies which are related to the stock company**
– Shareholder supervision of transactions with parties which are related to the stock company will prevent the stock company from concluding transactions which are not in the interests of the shareholders (Recital 19, p. 5 et seq.).
– A person is related to the stock company if he/she can exercise influence over the decisions of the stock company, or is a family member of a related person [Art. 2 (j) in conjunction with Regulation (EC) No. 1606/2002 in conjunction with IAS (International Accounting Standards) 24.9].
– A company is related to the stock company particularly if it belongs to the same group of companies or is run by a related person [Art. 2 (j) in conjunction with Regulation (EC) No. 1606/2002 in conjunction with IAS 24.9]. The Member States can exclude from these rules transactions with wholly-owned subsidiaries of the stock company [Art. 9c (4)].
– Transactions with a related party are subject to shareholder approval if the transaction [Art. 9c (2), (3)]
  - may have a "significant" impact on the profits or turnover of the stock company or
  - has the result that the volume of all transactions of the stock company with this party, within the last 12 months, exceeds 5% of the company's assets.

  Prior thereto, the stock company can only conclude the transaction pending approval.
– The stock company must publish a transaction with a related party which exceeds 1% of the company's assets. The announcement must be attached by a report from an independent third party assessing whether the transaction is on market terms and whether it is "fair and reasonable" from the perspective of the shareholders. [Art. 9c (1)]
– The shareholders can give 12 months' advance approval for clearly defined, recurrent transactions with a related party or allow the stock company for such transactions a 12-month exemption from the duty to attach the report [Art. 9c (1) and (2)].

► **Obligations on intermediaries**
– As many shareholders are not permitted to operate directly on the stock exchange, they hold securities accounts with intermediaries such as banks through which they buy and sell shares.
– Intermediaries have to make it easier for shareholders to exercise their rights
  - either by exercising the shareholders' rights for them after their approval and in accordance with their instructions, or by making the "necessary arrangements" for shareholders to exercise their rights themselves [Art. 3c (1)],
  - by transmitting, to the other respective party, the information received from the stock company or from the shareholder which is important for exercising shareholders' rights [Art. 3b (1) - (3)] as well as
  - by communicating the name and contact details of shareholders to the stock company on request [Art. 3a (1) - (3)].

  This also applies to EU branches of intermediaries established outside the EU (Art. 3e).
– Prices which the intermediaries charge for their services must be "non-discriminatory and proportional" as well as published [Art. 3d (1) and (2)]. The ban on discrimination aims to prevent price differentiation between domestic and cross-border shareholdings (Recital 7).

► **Obligations on institutional investors and asset managers acting as shareholders**
– Institutional investors such as life insurance companies and asset managers invest as shareholders in stock companies [Art. 2 (f) and (g)]. The Commission wants them to have greater influence on the decisions of stock companies (Recitals 8 - 12).
– Institutional investors and asset managers must develop and publish a "policy on shareholder engagement". This determines inter alia how they engage in the stock company, exercise their voting rights and manage conflicts of interest such as a business relationship with the stock company. A waiver of this obligation is possible subject to reasoned explanation. [Art. 3f (1)-(4)]
– Institutional investors and asset managers must publish their investment strategy [Art. 3g (1)].
– Where an asset manager acquires shares for an institutional investor [Art. 3g (2), Art. 3h],
  - the asset manager must provide the institutional investor with details of the implementation of its investment strategy on a half-yearly basis and
  - the institutional investor must publish the main elements of the agreement between the two of them.

► **Obligations on proxy advisors**
Proxy advisors provide shareholders with recommendations for exercising their voting rights at the general meeting [Art. 2 (i)]. In this regard they must [Art. 3i (1) - (3)]
– guarantee that their voting recommendations are "accurate and reliable",
– notify the shareholder and stock company without delay about any conflicts of interest such as business relationships which may influence the voting recommendation, and
– publish details such as the methods they use and their main sources of information.

Main Changes to the Status Quo

- New is the obligation to obtain approval for the remuneration of the management and supervisory boards, for the remuneration report and for transactions with related parties.
- New is that intermediaries must provide the stock company with the name and contact details of shareholders on request. Currently, shareholders only have to give their name to the stock company if they hold at least 5% of the voting rights [Art. 9 (1), Art. 12 (1) Directive 2004/109/EC].
- New are also the additional obligations imposed on intermediaries, institutional investors, asset managers and proxy advisors.

Statement on Subsidiarity by the Commission

Due to the international nature of the equity market, the objectives of the Directive can be better achieved at EU level (Recital 23).

Policy Context

In April 2014, the Commission submitted a package of measures on company law and corporate governance which, in addition to this Directive, also contains a Directive on single-member limited liability companies [COM(2014) 212] and a recommendation on the quality of corporate governance reporting (2014/208/EU). In 2010 and 2011, in preparation for this Directive, the Commission surveyed stakeholders in connection with the Green Papers "Corporate Governance in Financial Institutions" [COM(2010) 284] and "Corporate Governance Framework" [COM(2011) 164, see cep**PolicyBrief**)] and issued an Action Plan "Company Law and Corporate Governance" [COM(2012) 740, see cep**PolicyBrief**].

Legislative Procedure

09 April 2014	Adoption by the Commission
Open	1st Reading in European Parliament
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Directorates General:	DG Internal Market and Services (leading)
Committees of the European Parliament:	Employment (leading), Rapporteur TBA
Federal Ministries:	Justice and Consumer Protection (leading)
Committees of the German Bundestag:	Legal Affairs and Consumer Protection (leading); Finance; Economic Affairs and Energy; Affairs of the European Union
Decision-making mode in the Council:	Qualified majority (Adoption by a majority of the Member States and with 260 of 352 votes; Germany: 29 votes)

Formalities

Legislative competence:	Art. 50 TFEU (Attaining Freedom of Establishment) and Art. 114 TFEU (Internal Market)
Form of legislative competence:	Shared competence [Art. 4 (2) TFEU]
Legislative procedure:	Art. 294 TFEU (Ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

Stock companies compete with one another for shareholders' capital so only those companies which take account of shareholders' interests will remain on the market in the long term. However, **the management boards of stock companies do not always act in the interests of the shareholders in the short term** because they are not generally substantial owners of the stock company themselves and pursue their own interests, e.g. the highest possible salary. **To prevent this, shareholders should exercise extensive supervision of management. Many shareholders**, with only a small number of shares, **refrain from this because their vote has very little influence and their information costs are therefore too high (rational apathy).**

In some Member States, in order to overcome the problem of rational apathy, shareholders elect the supervisory board to monitor management on their behalf. Monitoring is insufficient for several reasons however: The management board, which would prefer less stringent monitoring, is often involved in electing the supervisory board members for example. Statutory provisions in Germany stipulate that representatives of the employees, whose interests are different to those of the shareholders, also have to be included on the supervisory board.

The proposed **obligations to obtain the approval of shareholders for decisions on remuneration of the management and on related-party transactions, on the one hand, allow shareholders to assert their interests more easily. On the other hand, this threatens to encroach on entrepreneurial flexibility. In addition, there is a risk that, due to rational apathy, shareholders will** not be sufficiently informed and therefore **make decisions that are not in their own interest.** To be specific:

As a result of the obligation to obtain approval for remuneration of the management, shareholders may, on the one hand, influence management performance incentives, included in the remuneration, in a way that the management takes account of their interests. For example, remuneration may be arranged in order to deter management from basing its decisions only on short-term company gains. On the other hand, for example, imposing a mandatory maximum amount of remuneration undermines the company's ability to react flexibly to new situations because convening an extraordinary general meeting is too expensive. For this reason, a non-binding agreement on remuneration policy - as currently proposed in Germany - is appropriate. Even with a non-binding agreement, stock companies cannot, without sufficient reason, act in breach of the voting result as this would clearly be acting against the interests of the shareholders, as a result of which they could lose their good reputation in the eyes of both shareholders and the public.

It is far from certain that the obligation to obtain approval for remuneration of the management will achieve the Commission's objective of increasing the focus on the long-term performance of the stock company because shareholders themselves do not always think long term. In addition it will not necessarily lead (where intended) to a noticeable cap on remuneration of the management since shareholders have an interest in ensuring that the remuneration structure remains attractive to good managers.

The obligation to obtain approval for large transactions with related parties, on the one hand, reduces the risk of the stock company being intentionally exploited by way of such transactions. On the other hand, lucrative transactions may be delayed or lost if they are subject to approval because the management or the other contracting party shies away from the risk involved. Since the provision also applies to transactions between groups of companies, this risk may exist for a large number of transactions. It is unclear how the obligation to obtain approval can be put into practice. This is likely to be difficult. Approval by way of an extraordinary general meeting is generally impracticable.

Due to rational apathy, shareholders may refrain from voting. Proxy advisors overcome this problem by casting votes for a large number of shareholders. This reduces the information costs to the individual shareholder. In addition, voting behaviour is coordinated by the proxy advisors so that individual votes gain more influence. Where proxy advisors make recommendations which are not in the interests of the shareholders, they will not remain on the market in the long term. The activity of proxy advisors becomes problematical however when they are subject to conflicts of interest, e.g. where they are also advising the management of the stock company. By disclosing such conflicts of interest, shareholders are better able to assess whether proxy advisors are acting in their interest and, if not, can change their advisor. Rather than imposing a statutory duty of disclosure, however, an examination should be carried out as to whether self-regulation by the industry using a voluntary code of conduct, as has already been started (see Link), would be sufficient. Proxy advisors would have to comply with it in order to avoid losing their customers.

The duty for proxy advisors to guarantee that their recommendations are "accurate and reliable" may result in their making only vague recommendations or even none at all, if it is impossible to give a guarantee of "accuracy". In this case, shareholders may fall back into rational apathy and refrain from voting.

Legal Assessment

Legislative Competency

Unproblematic. In order to ensure the functioning of the internal market in general, the EU can adopt measures for the approximation of national legal or administrative provisions (Art. 114 TFEU). It can also approximate the national company law provisions which companies must comply with in order to protect the interests of members and third parties such as investors [Art. 50 (2) (g) TFEU].

Subsidiarity

Unproblematic. Provisions concerning the consideration of shareholders' interests can only take place effectively at EU level because the equity market is an international market.

Conclusion

The management boards of stock companies do not always act in the interests of the shareholders in the short term. To prevent this, shareholders should exercise extensive supervision of management. Many shareholders refrain from this because their vote has very little influence and their information costs are therefore too high (rational apathy). Obligations to obtain the approval of shareholders for decisions on remuneration of the management and on related-party transactions, on the one hand, allow shareholders to assert their interests more easily. On the other hand, this threatens to encroach on entrepreneurial flexibility. In addition, there is a risk that, due to rational apathy, shareholders will make decisions that are not in their own interest. The duty for proxy advisors to guarantee that their recommendations are "accurate and reliable" may result in their making only vague recommendations or even none at all.

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