Corporate governance: long-term shareholder engagement

Impact Assessment (SWD (2014) 127, SWD (2014) 126 (summary)) of a Commission proposal for a Directive of the European Parliament and of the Council 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 (COM (2014) 213), and of a Commission Recommendation on the quality of corporate governance reporting ('comply or explain') (C(2014) 2165)

Background

This note seeks to provide an initial analysis of the strengths and weaknesses of the European Commission's Impact Assessment (IA) accompanying the above proposal for a Directive, which has been referred to the Legal Affairs Committee. The legislative proposal amends Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies and the Accounting Directive 2013/34/EU on annual financial statements, consolidated financial statements and related reports of certain types of undertakings. The IA also accompanies a Recommendation providing guidance aimed at improving the overall quality of corporate governance statements published by companies in accordance with the quoted Accounting Directive.

Following the financial crisis, the Commission has undertaken a thorough review of the current corporate governance framework. This has resulted in a 2010 Green Paper on Corporate Governance in financial institutions and remuneration policies, discussing the lack of shareholder engagement, and a 2011 Green Paper on an EU corporate governance framework, which contained a chapter focused on the role of shareholders (IA, p. 7). This sparked an EP resolution on the subject[1]. The proposal would apply to 10 400 listed companies in the EU that contribute to a total market capitalisation of over 8 trillion euros. The size of the market in Member States varies significantly. The largest markets are (in descending order) the UK, France, Germany and Spain. These Member States account for over two thirds of the total market capitalisation in the EU (IA, p. 9).

Problem definition

The Commission argues that there are shortcomings in relation to long-term shareholder engagement and corporate governance within listed companies. Shareholders are not provided with enough accurate information to be able to engage sufficiently with the listed companies in which they are shareholders. Listed companies and their boards have remunerated directors disproportionately in relation to their performance and have conducted related party transactions (RPT)[2] that do not sufficiently consider the long-term interests of the company. The advice provided by proxy advisors[3] to institutional investors and asset managers can be questioned regarding its quality, reliability and transparency. Finally, intermediaries struggle to enable shareholders to exercise their rights, particularly in cross border contexts.

[1] EP resolution of 29 March 2012 on a corporate governance framework for European companies, P7_TA(2012)0118.
[2] Related party transactions are transactions between a company and its management, directors, controlling entities or shareholders. For example, a company may sell a subsidiary to its chief executive officer.
[3] Proxy advisors are defined as firms providing voting services to investors, including voting advice.

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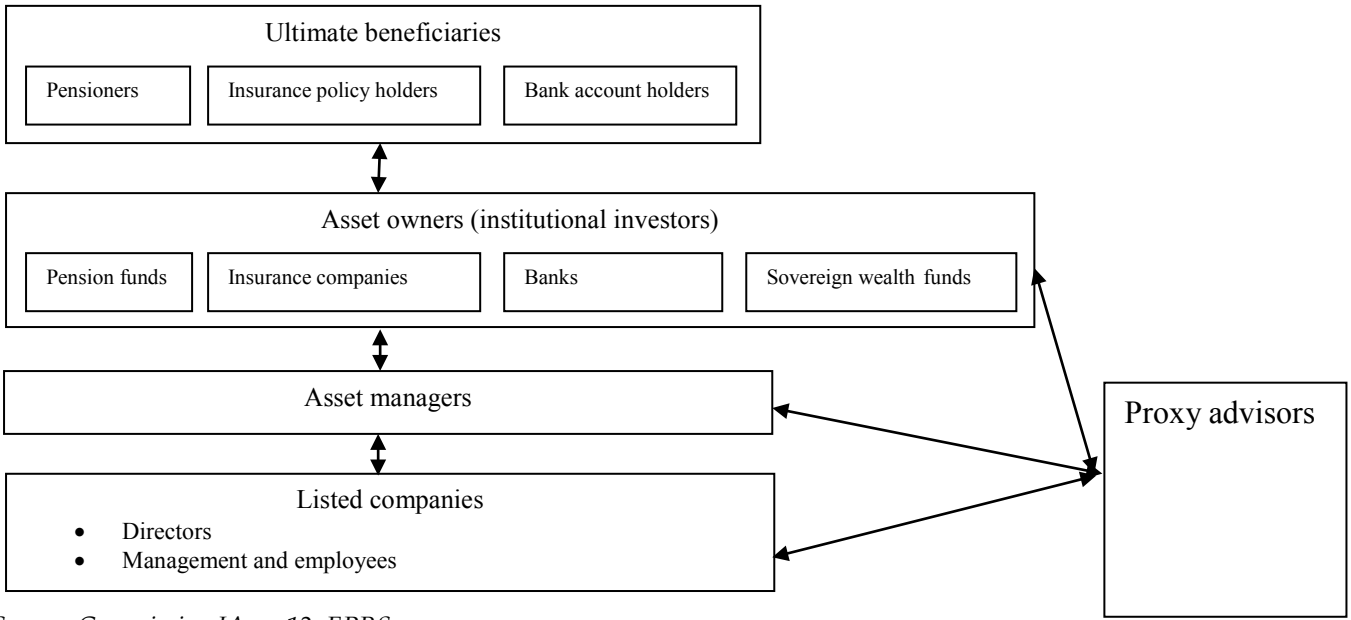
The IA identifies 6 key problems regarding the longevity of shareholder engagement and the quality of corporate governance within European listed companies. These are: 1) Insufficient shareholder engagement; 2) Insufficient link between pay and performance of directors; 3) Lack of shareholder oversight on related party transactions; 4) Doubts on the reliability of the advice of proxy advisors; 5) Difficult and costly exercise of rights flowing from shares; 6) Insufficient quality of corporate governance information.

The IA highlights the lack of engagement of institutional investors and asset managers, which it considers leads to sub-optimal corporate governance of listed companies through short-term-focused strategic decisions. This results in lost potential for better financial performance. The IA establishes the link between pay and performance of directors and a lack of transparency concerning RPTs as being two of the six overall major problems identified. However, the possible linkages between those two problems, both of which may subtract value from a company, are not elaborated upon.

The IA expressly highlights that constraints are placed on the analysis of the problem due to the 'scarcity of the statistical data and the confidential nature of some of the evidence available to the Commission' (IA, p. 16). Against this background, the quantitative evidence provided in reference to the problem of insufficient engagement of institutional investors and asset managers is rather thorough. For instance, according to a study quoted in the IA, 20 per cent of fund managers had a one-year investment horizon and only less than 10 per had a three year investment horizon. In comparison, however, constraints appear particularly relevant in relation to the definition of the problem of proxy advisors. The discussion around this issue only provides quantifiable evidence regarding who the proxy advisors are and why they are used with regard to the specific cases of the Netherlands and Germany, rather than addressing the quantifiable scale of the problem across the EU. It is nevertheless established that ten proxy advisor firms are active in the EU, including the two biggest players (IA. p. 32). Despite the admission of 'limited competition', this potential issue is not developed. According to the Commission's IA Guidelines, weak markets, or markets lacking competition, should be explored within the problem definition. Broadly speaking, the analysis of the causes for most problems especially develops the principal-agent relationship between the shareholders (the principals), who delegate the management of the company to the directors (the agents). This creates information asymmetries at various levels of the investment chain. High costs of intermediation and conflicts of interest are also mentioned, but they are not explored in the same depth. The figure below completes the schema of the equity investment chain provided in the IA with additional information drawn from the IA itself.

Figure 1: schema of the equity investment chain



Source: Commission IA, p. 12; EPRS.

Objectives of the legislative proposal

The objectives of the legislative proposal correspond to the identified problems. Three *general* objectives are identified as being: to improve the governance and (financial) performance of EU listed companies; to contribute to enhancing the long-term financing of companies through equity markets, and to improve the conditions for cross-border equity investments.

To achieve the general objectives requires the realisation of more *specific* objectives that are identified as being: to increase the level of engagement of asset owners and asset managers with their investee companies; to create a better link between pay and performance of company directors; to enhance transparency and shareholder oversight on RPTs; to ensure the reliability and quality of the advice provided by proxy advisors; to facilitate the exercise of rights by shareholders, and to improve the quality of information on corporate governance provided by listed companies (IA, p. 45).

Range of options considered

A range of options are considered in the IA in order to work towards the objectives of the legislative proposal. These are illustrated in the table below. The options retained by the Commission are highlighted.

Figure 2: overview of options

Increase engagement of institutional investors and asset managers	**Better link between pay & performance of Directors**	**Related-party transactions**	**Reliability of proxy advisors' advice**	**Facilitate the exercise of rights**	**Improve the quality of information**
1) No policy change					
2) Transparency - recommendation	~~Transparency - recommendation*~~	2) Soft law guidance for Member States	2) Transparency - recommendation	2) Non-legislative mutual recognition	2) Recommendation
3) Mandatory transparency	2) Mandatory transparency of remuneration	3) Mandatory transparency for RPTs	3) Mandatory transparency	3) Intermediaries are obliged to transmit information through the holding chain	
	3) Shareholder vote on remuneration	4) Shareholder vote on RPTs	4) Detailed mandatory transparency	4) Detailed requirements	3) Detailed rules

Source: Commission IA; EPRS.

***** This option was discarded upfront, as it had proven ineffective.

As the table above shows, firstly, most options relate essentially to transparency and little consideration is given to possible additional ways to achieve the objectives identified, which are quite broad. Secondly, beyond no policy change, and with the exception of the shareholder vote, the IA essentially considers three approaches revolving around the legislative instrument to be used and its nature: recommendations/soft law options; binding rules/mandatory requirements; and detailed requirements. Therefore, even within a rather restricted frame, political decision-makers are not given a sufficiently complete choice of strategic scenarios and options, in terms of content. For instance, which strategic options are available to introduce mandatory transparency of institutional investors and asset managers? Finally, the presentation of the analysis results is sometimes repetitive, as options are discarded for similar reasons, because the instrument is either too weak or too inflexible.

In attempting to engage institutional investors and asset managers the IA identifies option 3 - binding rules on transparency - as the most appropriate option. This option would introduce the same transparency measures as discussed in option 2, but these would be in binding form as opposed to recommendations. The binding rules would require asset owners to publish the extent to which their investment strategies are in accordance with the foremost long-term interests of the beneficiaries (IA, p. 46). Option 3 also binds asset owners to publish information on shareholder engagement and corporate governance issues. Asset managers would also be required to disclose information concerning portfolio turnover (IA, p. 46). The Commission advocates option 3 as the preferred option to create a level playing field across the EU (IA, p. 49).

Concerning the objective of creating a better link between the pay and performance of directors, the IA highlights option 3, a mandatory shareholder vote on remuneration, as the preferred option. The shareholder vote on this issue will either be advisory (not obliging boards to follow it) or binding (meaning boards cannot derogate from it) (IA, p. 52). The IA surmises that the difference between the two in practice may not be overtly stark, as even an advisory shareholder vote can send a strong message to a board. Yet despite this, the IA later illustrates the greater impact a binding vote can have on the connection between pay and performance, which is the chosen practice in a number of Member States (IA, p. 55). It is not expressly mentioned in the IA what the process would be to decide if a shareholder vote on remuneration policy will be advisory or binding.

In relation to transparency and oversight of RPTs, the IA identifies option 3, a binding legal framework requiring a public announcement of RPTs over 1 per cent of the assets and the provision of a fairness opinion from an independent advisor, as one of the preferred options. Option 3, in combination with option 4, a shareholder vote on RPTs over 5 per cent of assets, is advocated as the most appropriate route forward (IA, p. 62). The announcement of RPTs over 1 per cent is already required by EU law: they must be reported in the annual report. Option 3 would require the announcement to be made already at the completion of the transaction. It is also highlighted that an independent advisor will, on average, take between five and ten hours to be able to offer a fairness opinion on transactions (IA, p. 59). However, the basis for this conclusion is unclear. It is felt that providing shareholders with a right to vote on RPTs over 5 per cent will result in boards being less inclined to engage in problematic RPTs (IA, p. 60). The 1 per cent and 5 per cent thresholds were recommended by the European Corporate Governance Forum, a group of fifteen experts in the field. However, the IA does not mention whether different thresholds could be envisaged as strategic options.

Concerning the transparency of proxy advisors, option 2 (recommendations on disclosure requirements) and option 3 (binding transparency requirements) are given the majority of the focus. In contrast, the potential negative impacts of a detailed regulatory framework (option 4) are not explored or explained in a thorough manner, yet it is concluded that option 3 is the most likely to trigger a positive change. Option 3 requires compulsory disclosure from proxy advisors regarding their treatment of conflict of interests and their methodology in preparing advice (IA, p. 62).

Shareholder identification, transmission of information and instructions by intermediaries is the most thoroughly analysed area in the IA in considering the potential options available. Option 3, the creation of an EU shareholder identification instrument and obligations for intermediaries to transmit information through the holding chain, is advocated as the optimum policy direction in this area (IA, p. 73). Option 3 will see an EU mechanism developed to help issuers identify their shareholders if they so wish. This received a high level (81 per cent) of support from issuers who responded to a public consultation (IA, p. 69). This is in comparison with Option 2, which would define minimum EU rules through promoting the existing market standards as developed by the industry. The issue highlighted regarding the minimum EU rules is that without a legal requirement for compliance to the market standards, little effort will be made to comply (IA, p. 67).

The options relating to the improvement of corporate governance reporting are the least thoroughly assessed in the IA. Option 2, a Recommendation providing guidelines on corporate governance reports and the application of the 'comply or explain' approach, is chosen as the most appropriate option (IA, p. 76). According to this approach, a company 'choosing to depart from a corporate governance code has to explain which parts of the corporate governance code it has departed from and the reasons for doing so' (IA, p. 80).

It is established that while option 3, introducing detailed requirements on corporate governance reporting, would have a globally positive impact economically, it is less flexible than option 2 in enabling competent national bodies to adapt the guidelines to national specificities (IA, pp. 74-75).

Scope of the Impact Assessment

Economic

A general theme of the IA is that long-term shareholder engagement and greater transparency in corporate governance can contribute to overall sustainable economic growth in the EU. The Commission states that improving transparency and oversight of RPTs can have a positive influence on economic growth and employment (IA, p. 58), although no details or quantitative estimations are provided.

Social

It is established within the IA that '23% of the value of shares is owned by institutional investors such as pension funds' (IA, p. 9) and that pension funds represent '3.5 trillion in assets' (IA, pp. 10-11). It is also acknowledged and that there is a lost potential of improved corporate governance contributing to better investment results and that the problems identified have an impact on EU citizens, who are future pensioners and who are currently employees (IA, p. 41). For instance, the cost of intermediation 'reduces the end-value of a pension fund by around 30 per cent' (IA, p. 41). Yet, it is not discussed in any specific detail what positive or negative social impacts, e.g. on the health of ultimate beneficiaries of pension funds, could result from the potential changes made by this legislative proposal.

Short- and long-term cost-benefit analysis

The requirement of institutional investors and asset managers to produce publications in reference to their investment strategies receives particular attention in relation to the costing of the requirement. It is established that the cost of publishing engagement and voting policies will range between 600 to 1 000 euros per year. Significant costs for a detailed disclosure on voting records could cost between 15 000 and 20 000 euros (IA, p. 48). However, the source of the first estimate is a calculation performed for an IA on a different banking topic (the Capital Requirements Directive (CRD) IV IA), and the source for the second estimate is unclear.

Focus is given to the beneficial effect on costs relating to the remuneration policy of directors by reducing the amount of time shareholders will have to put aside to review pay policy statements (IA, p. 53). A table highlighting the cost implications of binding rules on transparency and a mandatory shareholder vote illustrates costs of approximately 500 to 1 000 euros to disclose the remuneration policy and between 600 and 1 000 euros for a remuneration report (IA, p. 54). The source of the latter estimation is again the CRD IV IA, and the Commission states that these are 'comparable disclosures', but this point is not elaborated upon. In relation to the cost implications of improving transparency requirements and shareholders vote on the most important related party transactions, it is illustrated that obtaining a fairness opinion from an auditor will take between 5 and 10 hours and will cost between 2 500 and 5 000 euros for companies (IA, p. 59). This estimation seems to be based on industry-specific rates for auditors (i.e. 500 euros per hour, IA p. 111). With reference to the costs that will arise from the preferred option 3 of binding transparency requirements on proxy advisors, it is established that preparing and publishing information on their practices will take between 20 and 50 hours and will cost between 1 000 and 2 500 euros for 10 proxy advisory firms (IA, p. 63). Unlike the estimate for auditors, the quantification for proxy advisors is based on the average hourly wage of senior officials and managers (50 euros per hour), highlighting the limited data available regarding this niche market.

Establishing an EU shareholder identification instrument would entail certain costs. However, it is difficult to analyse the actual level of fees due to the national discrepancies. It is also acknowledged that, as intermediaries would be required to transmit information needed to exercise shareholder rights anyway, it does not add any additional costs (IA, pp. 69-70). There may be one-off costs for intermediaries to adjust current IT infrastructure and ongoing costs for the distribution of letters to clients, for example. However,

there will be savings made through a harmonised system limiting the current need to comply with differing standards when transmitting information in a cross-border context (IA, pp. 70-71).

European Economic and Social Committee

The European Economic and Social Committee, in its opinion of 9 July 2014 on this proposal, supported its overall aims and states that the Commission is moving in the right direction, 'insofar as... a culture change [away from short-term performance towards a more sustainable long-term investment perspective] can be achieved through regulation'. However, the advisory committee suggested that the Commission should reflect on how better to involve employees in the building of long-term value.

Subsidiarity / proportionality

The IA checks the regulatory options in the light of the principle of subsidiarity (IA, pp. 44-45). A common theme throughout the exploration of each of the problems is the complexity of Member States having different regulations and codes relating to shareholder engagement. It is consistently highlighted that a harmonisation of regulations could make the process of increasing shareholder engagement more probable and is supported in the main by the consulted stakeholders.

No national parliament raised any subsidiarity concerns on this proposal by the deadline foreseen (10 June 2014). Of all the national parliaments which provided some contributions, the German Federal Council (Bundesrat) is the one that raises some points of interests for the IA. The Bundesrat, while supporting the overall aims of the proposal, is of the opinion that shareholders are more typically driven by short-term interests, in order to quickly boost their return, and may not be best placed to vote on the pay of the management board. It advocates a fixed limit of variable parts of remuneration, which must not be exceeded in order to prevent incentivising management to undertake risky operations seeking a high return. Finally the Bundesrat feels that a shareholder vote on RPTs over 5 per cent of company assets will lead to paralysis, especially when a quick decision is required. In the context of political dialogue, the Commission replied that: the shareholders' vote on pay would provide an additional legitimation in the control of the remuneration policy; that remuneration structure is out of the scope of the proposal; that similar provisions adopted in the banking sector would not be justified for all listed companies; and that the intention of the shareholder vote on RPT over 5 per cent of company asset is, amongst others, to protect minority shareholders.

SME test / Competitiveness

Although the main assessment of the impact on SMEs takes place in relation to the economic impacts of the proposal, a fully-fledged test for SME is not undertaken in the IA. It is also noteworthy that this proposed legislative action only applies to listed SMEs, which are a small minority in EU stock exchanges. It is established that '13% of Europe's largest companies account for 93% of Europe's market capitalisation, 85% of the number of trades and 96% of turnover [...] FESE [the Federation of European Stock Exchanges] is of the opinion that EU capital markets focus more on the trading of blue chips, i.e. the largest traded companies – at the expense of the needs of the much more numerous but smaller listed companies that play a critical role in growth and employment in Europe' (IA, p. 48). The intention of the proposal is to 'positively impact the long-term sustainability of listed companies, including SMEs' (IA, p. 77). According to the Commission, this would have a positive impact on SMEs through enabling them a greater access to capital markets.

The Commission states that there will be some costs for SMEs, as with large companies, for instance for improving transparency requirements for RPTs over 1 per cent and facilitating a shareholders vote of RPTs over 5 per cent of assets. As previously discussed, obtaining a fairness opinion regarding RPTs over 1 per cent of assets could result in reasonably substantial costs. Approximately 1 550 companies have an RPT equal or above 1 per cent of their revenue per year (IA, p. 59). However, the proportion of that 1 550 that are SMEs, and thus will be subject to these costs, is not specified. Likewise, the IA does not consider whether these thresholds would disproportionately affect SMEs. Parliament, in its resolution on the subject referred to above, stated that corporate governance measures 'should be proportional to the size, complexity and type

of company' (P7_TA(2012)0118). The European Economic and Social Committee, in its opinion on the Commission proposal, raised concerns about the possibility of an additional administrative burden on SMEs.

Simplification and other regulatory implications

The current regulatory framework in this remit amounts to the EU corporate governance framework. This is a combination of legislative rules and soft law, in particular corporate governance codes.[4] Concerning existing Member States' codes, the proposal is seeking to harmonise the differing codes, particularly in order to simplify the process of cross-border shareholder engagement. The various options are rated according to the criteria of coherence, presumably with reference to the various pieces of legislation which are connected to this proposal, such as the Accounting Directive. International accounting standards are also at least mentioned.

Relations with third countries

It is established in the IA that 22 per cent of ownership of EU listed companies is owned by investors from outside the EU (IA, p. 105). However, the impacts that the legislative proposal with have on these foreign investors and the relations between them and the EU is not discussed at any length. Likewise, sovereign wealth funds are briefly mentioned among the institutional investors (IA, p. 11; p. 19), but are then left out of the analysis.

Quality of data, research and analysis

The IA refers to a large amount of external studies. One major study concerning monitoring and enforcement practices in corporate governance in the Member States[5], receives particular attention. A summary of its main findings can be found in Annex V. The Commission benefited from the advice of the European Corporate Governance Forum, which consists of fifteen senior experts in the field including issuers, investors, academics, regulators and auditors. The Commission also utilised the advice of the Company Law Experts Group and conducted a number of technical discussions with experts from groups of the identified stakeholders. Despite this wealth of research, the framing of the options affects to some extent the overall quality of the analysis. Moreover, the constraints placed on the analysis by data scarcity are particularly relevant for some areas, such as proxy advisors. Finally, the IA occasionally uses, especially for the estimation of costs, data the relevance of which is not elaborated upon.

Stakeholder consultation

The IA identifies the main stakeholders as individual Member States, those involved in pension funds and 'asset managers, issuer companies, retail investors, employees, proxy advisors, stock exchanges and regulators' (IA, pp. 7-8). Whilst employees are classed as stakeholders and ultimate beneficiaries within the IA, it does not mention whether employees or employee groups were specifically consulted regarding the proposed legislative changes. The Commission undertook two public consultations. The first concerned corporate governance in financial institutions. The consultation was launched on 2nd June 2010 in conjunction with the adoption of a Green Paper. It closed on 1st September 2010 and over 200 answers were received. The second public consultation concerned the EU corporate governance framework. The consultation was launched on 5th April 2011, together with the adoption of a Green Paper, and closed on 22 July 2011, having received over 400 answers (IA, p. 83).

[4] A list of the main EU measures in the area of corporate governance is provided in Annex II of the IA.
[5] The RiskMetrics Group, Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States, accessible on http://ec.europa.eu/internal_market/company/docs/ecgforum/studies/comply-or-explain-090923_en.pdf

Monitoring and evaluation

Firstly, the IA lists a number of possible relevant monitoring indicators, such as the level of shareholder turnout and price differences for exercising shareholders' rights across the borders. (IA, p. 78).

Moreover, it is stated in the IA that 'on the basis of the data collected, and five years after the expiration of the transposition deadline, the Commission would consider the need to produce an ex-post evaluation report [...] Feedback from monitoring and evaluation will also be considered with a view to propose further amendments where appropriate' (IA, p. 79). However, there does not seem to be any provision in the proposal clearly stating what requirements are to be met in order for the evaluation to take place.

Commission Impact Assessment Board

The Impact Assessment Board gave an initial negative opinion of the draft IA on the 19 July 2013. They returned with a positive opinion of the re-submitted IA on the 29 October 2013. Whilst it was acknowledged that the IA had been improved, the Board felt that the IA was still lacking in certain areas. It considered that the IA lacked a quantitative underpinning of the problems relating to proxy advisors and RPTs and that it failed to specify the costs in relation to the expected benefits of transparency in improving shareholder engagement. Finally, it felt that the IA did not highlight the need to legislate quickly regarding proxy advisors. Although the draft version of the IA on which this opinion is based is not publicly available, some of these comments appear still relevant. Where costs are provided, some assumptions appear questionable.

Coherence between the Commission's legislative proposal and IA

On the whole the legislative proposal reflects the conclusions of the IA. However, it is noteworthy that the empowerment of the Commission to adopt Implementing Acts is highlighted consistently in the legislative proposal in relation to the developments that may arise after the implementation of the preferred options. However, implementing acts are not discussed at any length within the IA.

Conclusions

To sum up, this Impact Assessment clearly identifies and defines problems in need of EU action, echoing Parliament's resolution of March 2012 in this field. However, the solutions proposed revolve mainly around the type of legislative instrument to be used and arguably do not provide a sufficiently developed choice among competing strategic options, in terms of content. This begs the question as to whether other avenues might have been explored in order to achieve the declared objectives. Moreover, although the IA is based on a wealth of research and consultation, data scarcity places constraints on the analysis of some areas, such as proxy advisors; finally, the basis for assumptions behind some of the cost estimations is not always entirely clear.

This note, prepared by the Ex-Ante Impact Assessment Unit for the Committee on Legal Affairs (JURI) of the European Parliament, analyses whether the principal criteria laid down in the Commission's own Impact Assessment Guidelines, as well as additional factors identified by the Parliament in its Impact Assessment Handbook, appear to be met by the IA. It does not attempt to deal with the substance of the proposal. It is drafted for informational and background purposes to assist the relevant parliamentary committee(s) and Members more widely in their work.

This document is also available on the internet at: www.europarl.europa.eu/thinktank

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