



**Stanford – Vienna
Transatlantic Technology Law Forum**

A joint initiative of
Stanford Law School and the University of Vienna School of Law



European Union Law Working Papers

No. 32

**The Mythical Value of Voice and
Stewardship in the EU Directive on Long-
term Shareholder Engagement: Rights Do
Not an Engaged Shareholder Make**

Deirdre Ahern

2018

European Union Law Working Papers

Editors: Siegfried Fina and Roland Vogl

About the European Union Law Working Papers

The European Union Law Working Paper Series presents research on the law and policy of the European Union. The objective of the European Union Law Working Paper Series is to share “works in progress”. The authors of the papers are solely responsible for the content of their contributions and may use the citation standards of their home country. The working papers can be found at <http://ttlf.stanford.edu>.

The European Union Law Working Paper Series is a joint initiative of Stanford Law School and the University of Vienna School of Law’s LLM Program in European and International Business Law.

If you should have any questions regarding the European Union Law Working Paper Series, please contact Professor Dr. Siegfried Fina, Jean Monnet Professor of European Union Law, or Dr. Roland Vogl, Executive Director of the Stanford Program in Law, Science and Technology, at:

Stanford-Vienna Transatlantic Technology Law Forum
<http://ttlf.stanford.edu>

Stanford Law School
Crown Quadrangle
559 Nathan Abbott Way
Stanford, CA 94305-8610

University of Vienna School of Law
Department of Business Law
Schottenbastei 10-16
1010 Vienna, Austria

About the Author

Professor Deirdre Ahern is an Associate Professor at Trinity College Dublin's Law School. As a member of the School's Corporate Law, Governance and Capital Markets Research Group, her primary research areas are corporate law, comparative corporate law, corporate governance and FinTech regulation. Professor Ahern is on the editorial boards of *The Company Lawyer* and the *Journal of Business Law* and she is the co-editor of the *Irish Business Law Review*.

General Note about the Content

The opinions expressed in this paper are those of the author and not necessarily those of the Transatlantic Technology Law Forum or any of its partner institutions, or the sponsors of this research project.

Suggested Citation

This European Union Law Working Paper should be cited as:
Deirdre Ahern, *The Mythical Value of Voice and Stewardship in the EU Directive on Long-term Shareholder Engagement: Rights Do Not an Engaged Shareholder Make*, Stanford-Vienna European Union Law Working Paper No. 32, <http://ttlf.stanford.edu>.

Copyright

© 2018 Deirdre Ahern

Abstract

Through the lens of assessing the likely regulatory impact of the 2017 EU Directive on Long-term Shareholder Engagement's amendments to the Directive on Shareholder Rights, this article considers the mythical voice and stewardship role attributed by the EU to shareholders as active corporate governance gatekeepers and drivers of its long-term sustainability agenda. It identifies limitations of the Directive itself and practical challenges concerning the provisions on shareholder identification, executive pay, related party transactions, proxy advisors and shareholder engagement policies. It is argued that there is a considerable normative gap between the EU narrative of engagement and the challenge of engaging shareholders away from self-interest and rational apathy to fulfil a stewardship role.

KEYWORDS: Shareholders, EU Company Law, Shareholder Engagement, Corporate Governance, Institutional investors, Proxy advisors, Stewardship

Table of Contents

I.	INTRODUCTION.....	2
II.	THE GENESIS AND PHILOSOPHY UNDERLYING THE REFORMS	4
III.	INVESTOR TRANSPARENCY TO FACILITATE SHAREHOLDER PARTICIPATION	9
A.	Facilitating exercise of shareholder rights	9
B.	Increasing investor transparency.....	10
IV.	INCREASING SHAREHOLDER OVERSIGHT?	13
A.	Say-on-pay	13
B.	Related party transactions	18
V.	THE ROLE OF TRANSPARENT INVESTMENT AND ENGAGEMENT POLICIES.....	22
A.	Institutional investors.....	22
B.	Proxy advisors	27
VI.	REFLECTIONS ON REGULATORY IMPACT	30
A.	Implementation	30
B.	Shareholder oversight of executive remuneration and related party transactions	31
C.	The mythical role of shareholders as corporate governance agents	33
D.	Cultural changes needed to achieve engagement and a long-term focus	37
E.	Missed opportunities and future policy directions	38
VII.	CONCLUSION	39

I. INTRODUCTION

As Chander observes, ‘corporate law is largely motivated by fear of the abuse of control.’¹ Reflecting that, the EU’s regulation of publicly traded companies in the Directive on Long-term Shareholder Engagement² harks back to classic agency theory control deficits which present in companies with dispersed ownership models. Consistent with the accepted position of shareholders in corporate governance theory as residual owners, the earlier seminal 2007 Shareholder Rights Directive³ went some way to addressing perceived democratic deficits by enshrining a suite of voting and participatory rights for shareholders of publicly traded companies. Subsequently, a root and branch post-financial crisis review of corporate governance by the EU created the catalyst for amending the Shareholder Rights Directive to broaden its reach. While the Shareholder Rights Directive focused on expanding formal rights in the context of an AGM, the Directive on Long-term Shareholder Engagement seized upon the potential of transparency requirements and investor dialogue as transformative corporate governance tools in the hands of engaged investors.

In essence, the soul-searching engendered by the financial crisis prompted the EU to seek to bolster the latent potency of the shareholder organ’s corrective control function by focusing on facilitating the tools of oversight and weaving a narrative of active investor stewardship. This was done, not just in the cause of encouraging good corporate governance practices, but also to help ensure that management were steering an appropriate course to ensure the long-term survival of companies. Thus the revision of the Shareholder Rights Directive is consonant with the long-term sustainability agenda embraced by the EU for the

¹ A Chander, ‘Minorities, Shareholder and Otherwise’ (2003) 113(1) *Yale Law Journal* 119, p 150.

² Directive (EU) No 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement [2017] OJ L132/1 (“the Directive on Long-term Shareholder Engagement” or “the Directive”).

³ Directive (EC) No 2007/36 of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies [2007] OJ L184/17 (“the Shareholder Rights Directive”).

post-financial crisis era. This in turn shapes the context and content of shareholder engagement as seen in the Directive on Long-term Shareholder Engagement.

With the Directive not due for implementation until mid-2019, a full picture of regulatory implementation choices to be made by Member States has not emerged. It is nonetheless possible to provide some clear-headed projections on its anticipated regulatory impact based on probing the philosophy and aspirations underlying the Directive and weighing them against the challenges that stand in the way of accomplishing them. In particular, the central issue explored by this article in examining the philosophy and impact of the provisions of the Directive on Long-term Shareholder Engagement is the potential for a normative gap between EU policy narrative extolling shareholder voice and stewardship and the impact in practice of the Directive on shareholder behaviour. Has the EU been unduly optimistic in regarding increased transparency requirements and related soft incentives as leading almost inexorably to better shareholder oversight and increased active engagement and control by shareholders? A core question is also whether the Directive can deliver in terms of inculcating long-term investment perspectives in its target population. The article thus raises matters of concern to scholars, regulators and market players alike.

To investigate the likely impact of the Directive on Long-term Shareholder Engagement benchmarked against its avowed long-term stewardship objectives the article drills into the Directive's underlying policy origins and makes a realistic appraisal of market implementation in a single market context. It begins in Part II by looking at the driving forces behind the Directive through examination of the evolution and philosophy underlying the Directive from Proposal to adopted Directive including the central conception of the role of engagement and stewardship. From this foundational base, the article moves in Part III to examine how the Directive seeks to facilitate cross-border shareholder participation. Part IV questions the value of the contribution made by provisions aimed at increasing shareholder

visibility and oversight of executive pay and related party transactions. Part V evaluates the effect of the Directive's transparency requirements around investment and engagement practices of institutional investors and asset managers, and greater transparency of the workings of proxy advisory firms. Some overall reflections upon the likely regulatory impact of the implementation of the 2017 Directive, measured against the lofty aspirations which underpinned its genesis are provided in Part VI. The article's conclusion sounds a cautionary note concerning the potential for a pronounced disconnect between the EU's idealistic rhetoric surrounding shareholder stewardship when set against behavioural choices of Member States and shareholders that may emerge in practice.

II. THE GENESIS AND PHILOSOPHY UNDERLYING THE REFORMS

The Shareholder Rights Directive was rights-defining, focused on providing and buttressing substantive shareholder voting and participation rights in service of shareholder democracy, both for its own sake, but also to assist fulfilment of the shareholder body's role as a backstop against potential abuse of delegated power by the board against a listed company's interests.⁴ That Directive provided for a basket of shareholder rights exercisable in relation to companies' general meetings for companies trading on a regulated market in a Member State including the right to table agenda items such as draft resolutions⁵ and the right to ask questions related to items on the agenda of the general meeting.⁶ A decade later, the Directive on Long-term Shareholder Engagement bolsters that framework by adding supplementary provisions to the Shareholder Rights Directive which are in part rights-defining. However,

⁴ For a comparative contextual assessment see AR Pinto, 'The European Union's Shareholder Voting Rights Directive from an American Perspective: Some Comparisons and Observations' (2009) 32(2) *Fordham International Law Journal* 587.

⁵ See note 3 above, Article 6.

⁶ *Ibid*, Article 9.

most of the inserted provisions are enabling in nature, focused on providing or enhancing the milieu for the exercise of shareholder participation rights.

The publication by the Commission of its proposal for a directive on the encouragement of long-term shareholder engagement⁷ which would add new provisions to the Shareholder Rights Directive can be contextualised as a post-crisis ‘shoring up’ measure. It fitted into an EU crusade to improve both corporate governance and financial sustainability of listed companies. One concern was that boards had proved woefully inadequate at self-monitoring to prevent mismanagement. This dictated a need to find a hook upon which to hang improved corporate governance monitoring. That hook was crystallising a stewardship role for investors. The way forward from the failings of global financial crisis involved placing shareholders front and centre as a watchdog to ensure a more sustainable, long-term outlook. This policy position provided the catalyst for reforms to prod shareholder engagement with a view to fulfilling both (i) good corporate governance and (ii) long-term sustainability objectives.

The EU aspiration is that stewardship founded upon prudent long-term sustainability principles can address market failure to curb short-termism along with executive remuneration and asset management models that incentivise it. This philosophy and policy stance has developed in consultation with stakeholders over time. It was first clearly articulated in the 2012 Company Law and Corporate Governance Action Plan⁸ where the Commission eulogised the potential stewardship and engagement role of shareholders. The Directive on Long-term Shareholder Engagement enshrines this, seeing the engaged investor mindset as driving a more long-term sustainable business model ‘that needs to be

⁷ 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/2014/0213 final - 2014/0121 (COD) */ (“the Proposal”).

⁸ European Commission, *Action Plan: European Company Law and Corporate Governance: A Modern Legal Framework for More Engaged Shareholders and Sustainable Companies* COM/2012/0740 final.

encouraged’.⁹ In line with transparency and shareholder engagement representing two out of the three central objectives of the Action Plan,¹⁰ the Directive on Long-term Shareholder Engagement cements transparency as an accountability tool to inform active shareholder stewardship.

The rhetoric employed in the Directive on Long-term Shareholder Engagement and surrounding policy documents is striking in terms of the idealised hopes that are pinned on institutional investors who are presented as a form of a mythical knight in shining armour in the corporate governance landscape. The EU capitalised on the zeitgeist surrounding shareholder engagement including the international trend towards development of stewardship codes taking the lead from the UK’s leadership in this regard.¹¹ The monitoring role of shareholders undergirding the Directive is evident in the statement in the Directive’s Recitals in the statement that ‘[e]ffective and sustainable shareholder engagement is one of the cornerstones of the corporate governance model of listed companies, which depends on checks and balances between different organs....’¹² This encapsulates an idealised understanding of shareholder voice.¹³

A central plank of the EU economic response to the financial crisis hinged upon discrediting ‘short-termism’ as an appropriate corporate strategy.¹⁴ A scathing post-crisis assessment of widespread short-termism as detrimental to long-term corporate performance fundamentally shaped policy direction. Short-termism was characterised by the Commission

⁹ See note 2 above, Recital 14.

¹⁰ See note 8 above. Previous EU consultations covering relevant themes canvassed again in the 2017 Directive included European Commission, *Green Paper: Corporate Governance in Financial Institutions and Remuneration Policies* COM (2010) 284 final and European Commission, *Green Paper: The EU Corporate Governance Framework* COM (2011) 164 final.

¹¹ Financial Reporting Council, *The UK Stewardship Code* (2012).

¹² See note 2 above, Recital 14.

¹³ On shareholder voice see generally BS Black, ‘Agents Watching Agents: The Promise of Institutional Investor Voice’ (1992) 39(4) *UCLA Law Review* 811; DC Donald, ‘Shareholder Voice and its Opponents’ (2005) 5(2) *Journal of Corporate Law Studies* 305.

¹⁴ Although there is certainly a groundswell of opinion acknowledging the pitfalls of a purely short-term approach, not every commentator considers short-termism to be the problem that it is made out to be. See, for example, M Roe, ‘Corporate Short-Termism - In the Boardroom and in the Courtroom’ (2013) 68(4) *Business Lawyer* 977; R Anderson, ‘The Long and Short of Corporate Governance’ (2015) 23(1) *George Mason Law Review* 19.

in the Proposal as leading to ‘sub-optimal corporate governance and/or excessively short-term focused managerial decisions which result in lost potential for better financial performance of listed companies....’¹⁵ The EU’s thinking in this regard was also shaped in the context of the Green Paper on the long-term financing of the EU economy¹⁶ which led to the Regulation on European Long-term Investment Funds.¹⁷ This thinking played its part in supplying a wider economic lens on calling out management shortcomings. Thus the Directive on Long-term Shareholder Engagement is built in service of the financial sustainability model endorsed by the EU and its macro-level concern with the broader public economic interest in service of EU perspectives on what essentially represents a public good.¹⁸ This agenda framed a corresponding integration into the Directive’s narrative of a long-term outlook by companies, investors and other corporate governance stakeholders.

Understandably the Directive does not directly mandate a long-term approach in board decision-making. The EU heeded the sage counsel of the Reflection Group that ‘there is no basis for a mandatory rule providing that all EU listed companies should focus on the long-term development of their business (even at the cost of short term shareholder welfare)....’¹⁹ However, the EU also stopped short of implementing the Reflection Group’s suggestion that companies be permitted to amend their constitutions to embed a long-term sustainability goal.²⁰ Instead the Directive’s agenda focuses on shareholder influence to drive board behaviour towards a preferred focus on long-term economic performance.²¹

¹⁵ Ibid at 2. Results of Consultations with Interested Parties and Impact Assessment.

¹⁶ European Commission, *Green Paper on the Long-Term Financing of the European Economy* COM/2013/0150 final.

¹⁷ Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds [2015] OJ L123/98.

¹⁸ On this see D Ahern, ‘Turning Up the Heat? EU Sustainability Goals and the Role of Reporting under the Non-Financial Reporting Directive’ (2016) 13(4) *European Company and Financial Law Review* 599, 603-606.

¹⁹ Report of the Reflection Group on the Future of EU Company Law, Brussels, 5 April 2011, p 37.

²⁰ See note 19 above, p 38.

²¹ For a UK post-financial crisis policy perspective on this see J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (2012).

Recitals to the Directive note that ‘evidence shows that capital markets often exert pressure on companies to perform in the short term, which may jeopardise the long-term financial and non-financial performance of companies’²² Turning the spotlight around, the drive towards legislative reform to encourage shareholder engagement was propelled by concern that excessive risk-taking and short-termism by management was in fact supported, or at least not opposed, by shareholders.²³ Asset managers were also considered to fall short on the monitoring role attributed to them. The EU’s solution to an excessive focus on short-term gains largely going unchecked was to formalise institutional investors’ and asset managers’ stewardship role to focus on taking action to serve the long-term interests of the company.

Overall, it was wagered that the Directive as a whole, and in particular the provisions governing transparent investment and engagement strategies, would significantly improve ‘the level and quality of engagement’²⁴ of asset owners and asset managers with investee companies. On executive remuneration, the EU’s expectation was that shareholder oversight could create ‘a better link between pay and performance of company directors’.²⁵ It was also hoped to guard against abuses by providing for a level of transparency and shareholder oversight of related party transactions. Furthermore, the EU expected that transparency would deliver ‘reliability and quality’ of proxy advice thus benefiting shareholder recipients. The sections which follow examine the anticipated impact of these provisions set against the aspirations and philosophy which underlie the Directive on Long-term Shareholder Engagement.

²² See note 2 above, Recital 15.

²³ Ibid, Recital 2.

²⁴ See note 7 above, p 1.

²⁵ Ibid, p 2, Results of Consultations with Interested Parties and Impact Assessment.

III. INVESTOR TRANSPARENCY TO FACILITATE SHAREHOLDER PARTICIPATION

Ascertaining the ownership of companies' shares can be complex owing to the use of intricate equity investment chains and this presents a major impediment to shareholder engagement.²⁶ Fundamentally, if companies are unable to identify the ultimate owners of shares this prevents communication with them in order to facilitate the exercise of shareholder rights and to encourage shareholder engagement. The Shareholder Rights Directive fell short in not addressing the challenge to accessing shareholder participation rights presented by intermediary chains. The policy response to this in the Directive on Long-term Shareholder Engagement is to make amendments to the Shareholder Rights Directive to provide a formal channel for issuers to obtain shareholder identification and contact details in order to facilitate corporate governance communications and to ensure that intermediaries provide the means for shareholders to exercise their rights.

A. Facilitating exercise of shareholder rights

Anecdotal evidence suggests that it is not uncommon for voting instructions not to be executed, particularly in a complex intermediated chain. The Directive on Long-term Shareholder Engagement goes some way towards providing a supra-national solution to assist with the challenges of encouraging cross-border voting and general meeting participation. Under the inserted Article 3c Member States must ensure that intermediaries facilitate the exercise of shareholder rights by providing a means for their exercise. A responsibility to

²⁶ E Micheler, 'Custody Chains and Remoteness Disconnecting Investors from Issuers' Systemic Risk Centre Discussion Paper No 14 (2014) available at http://eprints.lse.ac.uk/59293/1/_lse.ac.uk_storage_LIBRARY_Secondary_libfile_shared_repository_Content_System%20Risk%20Center_Discussion%20Papers_dp-14.pdf.

transmit the electronic voting confirmation to the shareholder is also provided for.²⁷ This is designed to provide comfort to shareholders that their instructions have been acted upon. In doing so it addresses an obvious gap in the original Shareholder Rights Directive.²⁸ However, rather than sensibly requiring issuers and/or intermediaries to absorb the costs of compliance, the Directive allows Member States to choose whether to ban intermediaries from charging fees for the shareholder services envisaged including voting.²⁹ This grates when set against the underlying shareholder participation objectives. As a matter of principle it would undoubtedly have been preferable to provide for a harmonised ban on charging investors in the interests of removing voting costs as obstacles for investors, particularly retail investors.

B. Increasing investor transparency

Intermediaries are cast in the role of default shareholder identity information provider by the Directive.³⁰ The Directive grants listed companies the right to request intermediaries (such as custodian banks and central security depositories) to provide identity and contact details for their shareholders.³¹ Intermediaries must comply with an issuer request to supply shareholder identifying and contact information to enable direct communication. To achieve this, the Directive relies on information being effectively passed down chains of intermediaries.

Some comments can be made in relation to underlying policy choices made here. First, some matters of scope concerning the regime for shareholder identification merit mentioning. Member States are permitted to adopt a *de minimis* exception for very small

²⁷ Article 3c(2) inserted into the Shareholder Rights Directive.

²⁸ See further D Zetsche, 'Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive' (2008) 8(2) *Journal of Corporate Law Studies* 289, pp 327-328.

²⁹ Article 3d(3) inserted into the Shareholder Rights Directive.

³⁰ There is some flexibility for Member States in implementing this in that they may choose to allocate the information collection and dissemination role to a central securities depository, intermediary or services provider.

³¹ Article 3a inserted into the Shareholder Rights Directive.

shareholdings (0.5% or less). It might be argued that, while pragmatic as a matter of logistics, as a matter of principle this would mean that all shareholders of the same class do not receive equal treatment. However, what is involved here is simply information provision to the issuer - shareholder rights of participation and voting are not contingent upon this process, communication and facilitation of which is laid at the door of intermediaries not issuers. Of greater significance is the fact the Directive does not tackle the issue of beneficial ownership.³² It seems that the European Parliament, responding to retail investor privacy concerns, was concerned to respect the privacy of the owners of bearer shares.³³ This creates some dissonance with the position which obtains in relation to mandatory transparency notifications which includes indirect ownership within the net.³⁴

Secondly, looking to practicalities of the shareholder identification regime in practice, it is fundamentally of concern that passing information down a chain of intermediaries may frequently prove not to be a seamless process. The Directive is non-prescriptive in relation to how information passes down the chain. This may be helped by guidance emerging from the Commission³⁵ as well as development of best practice self-regulatory guidelines by relevant market actors. However, the Directive is lacking on consequences for non-compliance or delayed compliance somewhere along the chain (this is aside from the practical difficulties of determining which link in the chain has proved weak). Although the inserted Article 3a(3) contemplates information being provided on a timely basis ‘without delay’, the Directive omits to provide for any consequential remedy and enforcement mechanism for failing to comply. Instead Member States are expected to determine ‘effective, proportionate and

³² For a discussion of the issue in a UK context see RC Nolan, ‘Indirect Investors: A Greater Say in the Company?’ (2003) 3(1) *Journal of Corporate Law Studies* 73.

³³ See note 8 above, 2.3 Shareholder Identification.

³⁴ See note 37 above, Article 2(1)(e).

³⁵ The amended Shareholder Rights Directive enables the Commission to adopt rules to specify minimum requirements in relation to shareholder identification (Articles 3a(8)), transmission of information (Articles 3b(6)), and facilitating the exercise of shareholder rights (Articles 3c(3)).

dissuasive' penalties for this and other provisions.³⁶ If Member States fail to rise to the challenge, a weak enforcement and penalty regime may well prove a recipe for indifferent and tardy compliance.

An alternative less cumbersome mechanism could have been deployed to achieve the ends sought in terms of facilitating shareholder participation. A more targeted approach could have been utilised to alert issuers to share ownership, such as one modelled on issuer notifications under the Transparency Directive.³⁷ Another alternative put forward by Böckli *et al* as a better solution to that adopted in the Directive would involve requiring the most proximate intermediary to the investor to issue an electronic certificate of entitlement to vote on the company's voting platform.³⁸ This would open the door to other shareholder rights being deployed and would conveniently sidestep the bottleneck problem which will inevitably present under the Directive's chain-based approach to information passing.

Looking through the lens of facilitating the overall engagement objectives of the Directive, these investor transparency provisions are about providing an enabling mechanism to equip issuer communication with their shareholders rather than obliging direct communication. Even leaving aside the considerable practical hurdles that present themselves in an intermediated chain, the EU regime on shareholder rights stops short of creating a duty on issuers to communicate directly with shareholders. Responsibility for communication of relevant information related to the exercise of rights such as the right to participate in general meetings and to vote rests with the relevant intermediary rather than the issuer.³⁹ Listed companies may therefore choose not to proactively communicate and engage with their

³⁶ Article 14b inserted into the Shareholder Rights Directive.

³⁷ Directive (EC) 2004/109 of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC including subsequent amendments [2004] OJ L389/38.

³⁸ P Böckli *et al*, 'Shareholder Engagement and Identification' (23 February 2015). Available at SSRN: <https://ssrn.com/abstract=2568741> or <http://dx.doi.org/10.2139/ssrn.2568741>.

³⁹ Articles 3b and 3c inserted into the Shareholder Rights Directive.

shareholders, particularly in a cross-border context, which somewhat deflates underlying dialogue ideals concerning investor relations.

IV. INCREASING SHAREHOLDER OVERSIGHT?

Before moving to examine the core concern of the Directive with mainstreaming shareholder engagement on a soft law basis, it is worth separately assessing the regulatory worth of the Directive's stance on shareholder voice in notorious areas where management self-interest can prevail over the interests of a company in the absence of an appropriate control mechanism – executive pay and related party transactions. Here the litmus test employed is what positive difference these provisions are likely to make to shareholder contribution to corporate governance practice in listed companies in the EU.

A. Say-on-pay

As part the EU's overarching long-term sustainability agenda and its drive towards improving corporate accountability, the Commission aimed to encourage a better connection between pay and performance when formulating the Proposal for the Directive on Long-term Shareholder Engagement. The Commission has form in this area, having previously adopted three separate Recommendations on directors' remuneration pushing for disclosure of remuneration policy, disclosure of individual remuneration for both executive and non-executive directors, and a shareholder vote on remuneration.⁴⁰ Insufficient Member State response to these regulatory carrots led to the introduction of a legislative stick, the catalyst

⁴⁰ Commission Recommendation (EC) No 2004/913 fostering an appropriate regime for the remuneration of directors of listed companies [2005] OJ L385/55; Commission Recommendation (EC) No 2005/162 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board [2005] OJ L 52/51; Commission Recommendation (EC) No 2009/385 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies [2009] OJ L120/28.

being the Commission's recorded dissatisfaction with optimal take-up being confined to a mere six Member States.⁴¹

Transparency in the form of a forward-looking remuneration policy, and transparency concerning its application in practice through provision of a backward-looking remuneration report is core to the Directive, as is provision for shareholder voice concerning executive pay. While the Directive on Long-term Shareholder Engagement can certainly assist in improving both shareholder and public transparency in relation to director remuneration, particularly variable remuneration, it stops short of regulating the mechanics of how remuneration is set. In short, the focus is on providing transparency not in directly prescribing how companies should reward their executives. Managerial discretion thus remains vested in the hands of the remuneration committee subject to nationally imposed duties on directors to act in the company's interests. Furthermore, while EU-wide legislative enshrinement of say-on-pay for listed companies sounds radical, as discussed below, the devil here is in the detail, most notably in the form of allowing Member States to opt-out of a binding shareholder vote.

1. Forward-looking director remuneration policy

The forward-looking remuneration policy required of companies by the Directive is underpinned by the sustainability agenda. Thus the remuneration policy must explain how it contributes to 'the company's business strategy and long-term interests and sustainability.'⁴² The Directive does not, however, require an outright cap on remuneration or impose other limiting restrictions in service of such goals. Its framework in respect of executive pay in listed companies is markedly less prescriptive as compared with that applicable to credit institutions and investment firms which provides for a maximum ratio of 1:1 between fixed

⁴¹ See note 7 above, 4.3 Insufficient link between pay and performance of directors.

⁴² Article 9a(6) inserted into the Shareholder Rights Directive.

and variable remuneration elements albeit with certain flexibility for shareholder approval of a ratio of up to 1:2.⁴³ This can be explained by the fact that greater prudential supervision is justified in relation to this category of market players given the potential for systemic risk. Furthermore, although it has become fashionable to measure executive pay in the form of a ratio judged against that of the average worker, disclosure of this metric is not required.⁴⁴ Instead the inserted Article 9a(6) indicates that the remuneration policy should explain how employee pay and conditions have been taken into account in formulating the remuneration policy and in setting actual remuneration. Average worker ratios are not, however, without difficulties.⁴⁵ More worryingly the Directive is silent on whether exit payments or ‘golden parachutes’ are caught. By contrast, the much-vaunted UK approach expressly covers loss of office benefits and in the United States it is an element of Dodd-Frank in certain triggering scenarios.

In terms of stewardship and shareholder voice, the provisions which the Directive inserts into the Shareholder Rights Directive on executive pay are underwhelming in terms of ambition. The remuneration policy must be put shareholder vote at least every four years or on the occasion of a ‘material change’ in the policy.⁴⁶ Most fundamentally there is the matter of the status of the vote. The inserted Article 9a(2) specifies a binding shareholder vote on the remuneration policy. However, a coach and horses is promptly driven through the principle of a binding shareholder vote as a single market base-line principle by Article 9a(3) which conveniently permits Member States to opt instead for an advisory vote. A binding vote has the significant consequence under Article 9a(2) that where a proposed remuneration policy

⁴³ Directive (EU) 2013/36 of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms OJ L176/338, Article 94(1)(g).

⁴⁴ Although required at Proposal stage this requirement had fallen by the wayside by the time of the Directive’s adoption.

⁴⁵ See further J Loh, ‘Could the Pay Ratio Disclosure Backfire: Examining the Effects of the SEC’s Pay Ratio Disclosure Rules’ (2017) 4(3) *Texas A&M Law Review* 417.

⁴⁶ Article 9a(5) inserted into the Shareholder Rights Directive.

does not receive shareholder approval, a revised policy needs to be submitted and approved at the next AGM. Some important consequences remain to be worked out. While Article 9a(2) indicates that a previously existing remuneration policy remains in place where not approved until a revised policy can be submitted, the significance of shareholder rejection of a new proposed remuneration policy is complex as the Directive opts to leave the consequences and associated procedures as a matter for individual Member States to specify.

2. *Backward looking-remuneration report and shareholder vote*

The inserted Article 9b rolls out the requirement to publish a report card in the form of a remuneration report describing how a company's remuneration policy was applied in the last financial year. The Commission is expected to introduce non-binding guidance for companies concerning the remuneration report which will assist with best practice and help to encourage standardisation and thus cross-company comparisons. Accountability in this context involves giving shareholders a right to an advisory vote on the remuneration report to indicate their support or otherwise for how the remuneration policy was applied in practice.⁴⁷ At base, an advisory vote against the remuneration report does not oblige a company to take specific action on foot of it in terms of adjusting remuneration. There is simply an obligation on listed companies in Article 9b(4) to account to shareholders in the following year's remuneration report for how the shareholder vote has been taken into account. One can expect an accountability deficit here as this may simply involving boards advising that the vote has been noted and taken into consideration without any measurable outcome deriving.

3. *Respecting the nuances of shareholder voice on executive pay*

⁴⁷ Article 9b(4) inserted into the Shareholder Rights Directive.

The exercise of shareholder voice is a nuanced concept in this sphere. In commercial reality executive remuneration resolutions generate unique voting behaviour which is not as binary as voting ‘yes’ or ‘no’.⁴⁸ Although the Directive opts not to specify the percentage of majority required to indicate shareholder approval, in market practice in many countries a substantial majority of at least 75% or 80% approval would be a hoped for scenario. In the UK there are plans to mirror market acceptance practices by creating a register to formally log voting records for companies where less than 80% support has been achieved for executive remuneration.⁴⁹ There is evidence to suggest that some shareholders appear to hold the view that there is no point in voting on remuneration where the vote is purely advisory.⁵⁰ In addition, within the general challenge of encouraging shareholders to vote, something which regulation centred on a binary voting model cannot readily address is the meaning of deliberate abstentions in the context of executive pay resolutions, which often carry their own silent message of disapproval as akin to or even stronger than a vote against, although not technically one.⁵¹

One should not underestimate other sources of shareholder power and influence, both formal and informal in this sphere. If so inclined and aligned the shareholder body may exercise an applicable overriding power of director removal where available under national law. Thus in some circumstances a non-binding say-on-pay vote may still lead to penalties such as loss of board seats. In the UK there is now a trend to vote against remuneration committee chairs who are not listening to shareholder voice on remuneration.⁵² Building

⁴⁸ M Schwartz-Ziv and R Wermers, ‘Do Institutional Investors Monitor their Large vs. Small Investments Differently? Evidence from the Say-On-Pay Vote’ (29 Jan 2018) available at ECGI: <http://ecgi.global/working-paper/do-institutional-investors-monitor-their-large-vs-small-investments-differently>.

⁴⁹ Department for Business, Energy and Industrial Strategy, *Corporate Governance Reform* (2017), p 18.

⁵⁰ E Ndzi, ‘UK Shareholder Voting on Directors’ Remuneration: Has Binding Vote Made Any Difference?’ (2017) 38(5) *The Company Lawyer* 139, p 141.

⁵¹ *Ibid*, pp 141-142; ‘State Street Ramps Up Pressure on Excessive Executive Pay’ *Financial Times* 3 February 2018.

⁵² ‘Individual Directors Targeted by Investors over Excessive Pay’ *Financial Times* 29 January 2018.

market pressure and media exposure may also force reduced remuneration.⁵³ Some jurisdictions have stepped up to the plate to back up market sentiment with hard law consequences. Under Australia's 'two-strikes' rule where at least 25% of shareholders indicate their dissatisfaction by voting against a remuneration report at two consecutive AGMs, the shareholders must be granted an opportunity to vote on re-election of the board.⁵⁴ Unlike the Directive, this takes the bull by the horns to legislatively embed defined consequences for directors where shareholders voice their continued disapproval.

B. Related party transactions

The impetus for legislating to provide for greater shareholder visibility and approval in relation to material related party transactions originates in a recommendation of the European Company Law Expert Group.⁵⁵ The gamut of circumstances in which related party transactions involving a company and its directors, controlling entities or shareholders arise varies widely depending in part on the level of concentration of ownership in the company and the differences in interests of controlling shareholders and minority shareholders. The EU responded to a concern that such transactions may not be in the interests of shareholders, particularly minority shareholders and that therefore greater oversight needed to be given in order to allow shareholders to protect their investment. The desirability of scrutiny of transactions where conflicts of interest may lead to transactions with the company where the company does not receive fair value is recognised in the IFRS accounting standards which

⁵³ ME Thompson *et al*, 'Do Directors Suffer External Consequences for Failing to Align Executive Pay Practices with Shareholder Preferences? Evidence from Say-on-Pay Votes' (31 August 2017). Available at SSRN: <https://ssrn.com/abstract=3069124> or <http://dx.doi.org/10.2139/ssrn.3069124>.

⁵⁴ Division 9 of Part 2G.2 of the Corporations Act 2001 inserted by the Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011.

⁵⁵ European Company Law Experts, 'A Proposal for Reforming Group Law in the European Union – Comparative Observations on the Way Forward (2016). The article is available on <https://europeancompanylawexperts.wordpress.com/>.

help to increase visibility of related party transactions.⁵⁶ Furthermore, recognised accounting standards have assisted by supplying agreed definitions of material related party transactions, and this legacy is evident in the descriptors employed by the Directive on Long-Term Shareholder Engagement.

The Commission's initial Proposal was ambitious in scope in putting forward a need for shareholder disclosure and approval in relation to related party transactions. During the gestation of the Directive, the regime envisaged for governing related party transactions shifted quite considerably. The final text yielded a far less strict regime. Most strikingly, the initial centrality of shareholder approval in the Proposal did not last the distance and the adopted regime has been appropriately characterised as 'remarkably lenient'.⁵⁷

1. Defining materiality

The Proposal covered related party transactions representing more than 5% of listed companies' assets or transactions with the potential to have a significant effect on a company's turnover or profits.⁵⁸ A separate public disclosure regime at the time of transaction conclusion was proposed in respect of transactions representing less than 1% of a listed company's assets along with the requirement to publish an accompanying report from an independent third party providing an assessment of the arm's length nature of the transaction and whether it appeared fair and reasonable from a shareholder perspective.⁵⁹ The Directive differs considerably from the Proposal in terms of determining materiality. In setting entry thresholds for related party transaction oversight, Member States have autonomy

⁵⁶ International Accounting Standard 24.

⁵⁷ A Tarde, 'Related Party Transactions in the Revised Shareholder Rights Directive' <https://www.law.ox.ac.uk/business-law-blog/blog/2017/02/related-party-transactions-revised-shareholder-rights-directive>.

⁵⁸ See note 7 above, p 24, Article 9c(2).

⁵⁹ Ibid, p 24, Article 9c(1).

to set ‘one or more quantitative ratios based on the impact of the transaction on the financial position, revenues, assets, capitalisation, including equity, or turnover of the company’⁶⁰ or to provide qualitative criteria to ‘take into account the nature of the transaction and the position of the related party.’ In part this reflects the fact that very different perspectives on and approaches to related party transactions exist across the Member States. However, the failure to provide a single rule to be applied through the EU is disappointing. The impact of these provisions will now depend in part on how Member States choose to define material transactions within the scope of discretion afforded to them by the Directive. It is unfortunate that the Directive did not bite the bullet by prescribing quantitative ratios, an approach is supported by the OECD which sees quantitative criteria as a more effective means of defining materiality than more amorphous non-quantitative means.⁶¹

The default exclusion for arm’s length transactions made in the ordinary course of business introduced by the European Parliament into the Directive is standard and uncontroversial.⁶² Of more interest is the formulation of the option given to Member States in the inserted Article 9c(6) to provide an exclusion for intra-group transactions. It is expressly limited to transactions with wholly-owned subsidiaries. This disappointed those who campaigned vigorously for a broader exemption for intra-group transactions.

2. *Disclosure and approval*

Rather than being robustly handled, the level of oversight the Directive provides for of material related party transactions is a rather à la carte affair for Member States. Departing

⁶⁰ For quantitative measures an anti-avoidance aggregation rule will apply in determining whether specified quantitative thresholds have been met. Thus the value of all transactions with the same related party within a financial year should be aggregated: Article 9c(8) inserted into the Shareholder Rights Directive.

⁶¹ OECD, *Related Party Transactions and Minority Shareholder Rights* (2012), <http://www.oecd.org/daf/ca/50089215.pdf>, p 9.

⁶² Article 9c(5) inserted into the Shareholder Rights Directive.

from the lofty ideals of mandatory shareholder approval enshrined in the Proposal, the Directive leaves it up to Member States to decide whether to embed shareholder approval.⁶³ Disclosure rather than approval is therefore the watchword of the final form of the related party provisions. Even then disclosure to the shareholder body does not have to be ex ante in relation to a proposed transaction, it can be satisfied by an ex post announcement of the fact of the relevant transaction having been entered into and provision of certain information concerning the parties and the transaction.⁶⁴ Providing this level of policy discretion to Member States on related party transactions enables the rug to be decisively pulled from under shareholder approval as the ultimate form of shareholder voice despite EU rhetoric concerning the corporate governance imperative of shareholder stewardship. The disconnect does not end there. The Directive as adopted also waters down the independent third party report requirement in that, unlike at Proposal stage, it is not mandatory but optional for Member States to prescribe if they wish (or to replace it with a report from the administrative or supervisory body of the company, the audit committee, or another committee with a majority composition of independent directors).⁶⁵

Other corporate governance gripes emerge. Although board independence in an approval process is a central concern in related party transactions the Directive misses the opportunity to embed it as the accepted norm. Clear conflicts of interest in the voting and approval process are also permitted in allowing voting participation by related shareholders provided that their voting power does not outweigh that of the independent shareholders.⁶⁶ All in all, where disclosure trumps accountability in the form of shareholder approval, the

⁶³ Article 9c(4) inserted into the Shareholder Rights Directive.

⁶⁴ Article 9c(2) inserted into the Shareholder Rights Directive.

⁶⁵ Article 9c(3) inserted into the Shareholder Rights Directive.

⁶⁶ Article 9c(4) inserted into the Shareholder Rights Directive.

challenge of securing an adequate approval and enforcement regime for related party transactions continues to loom large.⁶⁷

V. THE ROLE OF TRANSPARENT INVESTMENT AND ENGAGEMENT POLICIES

This section moves to explore the central concern in the Directive on Long-term Shareholder Engagement with shaping the nature of shareholder investment strategies and engagement. This is complemented by an examination of the handling of the EU's concern with the robustness and suitability of proxy advisory recommendations.

A. Institutional investors

Transparency in relation to how institutional investors (and asset managers) operate takes the form in the Directive of three-pronged public disclosure in relation to investment strategies, engagement policy and the implementation of both of these in practice. The EU objective is that this will aid accountability and help to counteract a lack of engagement by institutional investors and asset managers as well as steering their path away from a short-term approach to investing⁶⁸ as high portfolio turnover is considered to be detrimental to dialogue and engagement. The relevant provisions in the Directive build upon other principled initiatives such as the UK Stewardship Code, Eumedion's Best Practices for Engaged Share-Ownership, the European Fund and Asset Management Association's Code for External Governance and the International Corporate Governance Network's Global Stewardship Principles. Yet the

⁶⁷ L Enriques, 'Related Party Transactions: Policy Options and Real World Challenges (With a Critique of the European Commission Proposal)' (2015) 16(1) *European Business Organisation Law Review* 1, pp 32-33.

⁶⁸ See note 2 above, Recital 15. See also Report of the Reflection Group on the Future of EU Company Law, Brussels, 5 April 2011, p 49.

Parliament's suggestion of an EU-wide stewardship code for investors was not taken up.⁶⁹ Nor is reporting of adherence to a recognised code for proxy advisors required.

1. Investment strategy of institutional investors and arrangements with asset managers

At the kernel of requiring institutional investors to report on their investment strategy is obliging reporting on their long-term approach. The inserted Article 3h(1) requires institutional investors to publicly explain how their investment strategy coheres with their liability profile, particularly long-term liabilities, and how their investment strategy contributes to the medium to long-term performance of their equity investments. This is clearly designed to foster stewardship by institutional investors in place of a simple focus on short-term performance.⁷⁰ The Directive sets out its stall on investment strategy accountability as a perceived enabler of its stewardship agenda as follows:

A medium to long-term approach is a key enabler of responsible stewardship of assets. The institutional investors should therefore disclose to the public, annually, information explaining how the main elements of their equity investment strategy are consistent with the profile and duration of their liabilities and how those elements contribute to the medium to long-term performance of their assets.⁷¹

Aligned with this, where an asset manager acts on behalf of institutional investors such as insurance companies and pension funds, whether on a discretionary mandate or via a UCIT or alternative investment fund ('AIF'), the institutional investor is required under the

⁶⁹ *A Corporate Governance Framework for European Companies* - European Parliament resolution of 29 March 2012 on a corporate governance framework for European companies (2011/2181(INI)), para 34.

⁷⁰ On the concept of stewardship see A Reisberg, 'The Notion of Stewardship from a Company Law Perspective' (2011) 18(2) *Journal of Financial Crime* 126; L Roach, 'The UK Stewardship Code' (2011) 11(2) *Journal of Corporate Law Studies* 463; I H-Y Chiu, 'Reviving 'Shareholder Stewardship': Critically Examining the Impact of Corporate Transparency Reforms in the UK' (2014) 38(3) *Delaware Journal of Corporate Law* 983; M. Winner, 'Active Shareholders and European Takeover Regulation' (2014) 11(3) *European Company and Financial Law Review* 364; K Sergakis, 'EU Corporate Governance: The Ongoing Challenges of the Institutional Investor Activism Conundrum' (2014) 16(4) *European Journal of Law Reform* 728.

⁷¹ See note 2 above, Recital 19.

inserted Article 3h(2) to publicly disclose similar information on the arrangements with the asset manager, enabling an assessment to be made concerning how long-term the investment strategy is. Also of interest is the focus on requiring institutional investors to disclose how any arrangement with an asset manager incentivises the asset manager to align the investment strategy with the profile and duration of liabilities of the institutional investor and to make investment decisions which serve a medium to long-term outlook.⁷² How the financial rewards of asset managers are structured can skew them towards focusing on short-term performance benchmarks. However, fundamentally restructuring industry norms by indirect means of subtle pressure on institutional investors centred around transparency is a tall order. Here again the Directive on Long-term Shareholder Engagement relies on an optimistic view of shareholder interest in proactively serving broader goals than self-interest might naturally dictate.

2. *Disclosure of engagement policy and implementation*

Scholars who favour a director primacy model which leaves boards free to get on with the business of managing typically argue against increasing shareholder rights.⁷³ Others scholars argue against director primacy being beneficial to performance.⁷⁴ The Directive taps into a growing global awareness that shareholder influence is not limited to the formal exercise of voting rights in mainstreaming formalisation and visibility of shareholder engagement

⁷² Article 3h(2)(c) inserted into the Shareholder Rights Directive.

⁷³ See eg SM Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 119(6) *Harvard Law Review* 1735.

⁷⁴ See eg LA Bebchuk, 'The Myth that Insulating Boards Serves Long-Term Value' (2013) 113(6) *Columbia Law Review* 1637.

policies.⁷⁵ Engagement can be conceived of as a suitable halfway house between the poles of unchecked director primacy and ultimate shareholder power.⁷⁶

Yet it is surprising how little unpacking there is of engagement as a concept in the Directive. The Impact Assessment provided a helpful definition of shareholder engagement as ‘generally understood as the active monitoring of companies by shareholders, engaging in a constructive dialogue with the company’s board, and using shareholder rights, including voting, to improve the governance and financial performance of the company.’⁷⁷ This steer is absent from the Directive which provides a more generic take on this. Engagement is broadly defined in the inserted Article 3g(1)(a) as:

how [institutional investors and asset managers] monitor investee companies on relevant matters, including strategy, financial and non-financial performance and risk, capital structure, social and environmental impact and corporate governance, conduct dialogues with investee companies, exercise voting rights and other rights attached to shares, cooperate with other shareholders, communication with relevant stakeholders of the investee companies and manage actual and potential conflicts of interests in relation to their engagement.

Unfortunately this definition focuses solely on the subject-matter of engagement rather than how it is realised. It would be sensible to regard it as indicative rather than all-embracing given the broad spectrum of activities that could fall within the rubric of engagement. Presumably engagement extends across a spectrum from monitoring to cover all communications whether mutual dialogue, one-way communication right up to more

⁷⁵ MJ Mallow and J Sethi, ‘Engagement: The Missing Approach in the Bebchuck-Strine Debate’ (2016) 12(2) *New York University Journal of Law and Business* 385.

⁷⁶ *Ibid.*

⁷⁷ Commission Staff Working Document, 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’) SWD/2014/0127 final, 4.1, Background.

aggressive tactical activism alone or in concert with other interested parties.⁷⁸ The intent and intensity of such activities may also vary widely. Reflecting this, Winter distinguishes between three levels of engagement: compliance, intervention and stewardship.⁷⁹ Arguably stewardship can be understood as requiring internalised public interest values in a way that compliance and intervention do not.

Rather than opting for a mandatory approach by obliging the adoption of an engagement policy by institutional investors and asset managers, an intermediate ‘comply or explain’ approach is adopted both in relation to the existence and disclosure of an engagement policy and how it is implemented.⁸⁰ Institutional investors must explain how investee company engagement forms part of their investment strategy or provide a ‘clear and reasoned’ explanation for why it does not. In tune with the EU’s long-term agenda, these provisions envisage institutional investors (and asset managers) disclosing the manner in which their engagement policy aligns with the medium to long-term performance of their investment. The classic limitations of any soft law ‘comply or explain’ corporate governance regime without public monitoring apply here.⁸¹

A fear also arises that a sledgehammer has been used to crack a nut. This concern arises in relation to the requirement in the inserted Article 3g that institutional investors annually disclose how they have implemented the shareholder engagement policy in practice.⁸² Public disclosure of what would have been up until now private discussions and lobbying of investee companies behind closed doors seems likely to prove counter-productive. Regulation can create disincentives and unintended consequences. Often reliant

⁷⁸ For some discussion on defining engagement see note 75 above, pp 390-391.

⁷⁹ J Winter, ‘Shareholder Engagement and Stewardship: The Realities and Illusions of Institutional Share Ownership’ (2011). Available at SSRN: <https://ssrn.com/abstract=1867564http://dx.doi.org/10.2139/ssrn.1867564>, p.12.

⁸⁰ Article 3(g).

⁸¹ See eg M.T. Moore, ‘Whispering Sweet Nothings: The Limitations of Informal Conformance in UK Corporate Governance’ (2009) 9(1) *Journal of Corporate Law Studies* 95.

⁸² Asset managers are included within the net as they may be tasked with implementing institutional investors’ engagement policies and voting preferences.

upon a softly, softly approach, designed to build trust between the parties, disclosure of engagement dialogue may undermine its essential deftness, fluidity and focus on achieving a ‘win-win’ outcome for both parties. Public disclosure may fundamentally change the type and frequency of engagement and more robust and adversarial-type interactions may result. Accordingly, Strand rightly highlights that the public disclosure required by the Directive worryingly risks undermining the success of informal private engagement by institutional investors.⁸³

B. Proxy advisors

In providing recommendations and voting services the proxy advisory industry inherently works against active shareholder engagement by companies. Nonetheless proxy advisory firms have a vital role to play in assisting institutional investors in voting the proxies they hold. Given the strong correlation between proxy advice and voting outcomes, the EU was keen to take the opportunity to set some markers for the industry. Much debate has been generated concerning the need for regulation of proxy advisory firms to ensure accountability and what form it should take.⁸⁴ Gallego Córceles favours mandatory regulation in the form of a registration requirement for proxy advisors coupled with legal duties with hard law consequences for non-compliance.⁸⁵ However, the regulatory approach to proxy advisors under the Directive is far less stringent. The Proposal set the tone in outlining that proxy

⁸³ T Strand, ‘Short-Termism in the European Union’ (2015) 22(1) *Columbia Journal of European Law* 15, p 38.

⁸⁴ See, for example, LA Stout, ‘Why Should ISS Be the New Master of the Corporate Governance Universe?’ *Corporate Governance* 4 January 2006; TC Belinfanti, ‘The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control’ (2009) 14(2) *the Stanford Journal of Law, Business & Finance* 384; S Choi *et al*, ‘The Power of Proxy Advisors: Myth or Reality’ (2010) 59(4) *Emory Law Journal* 869; S Edelman, ‘Proxy Advisory Firms: A Guide for Regulatory Reform’ (2013) 62(5) *Emory Law Journal* 1369; A Gallego Córceles, ‘Proxy Advisors in the Voting Process: Some Considerations for Future Regulation in Europe’ (2016) 13(1) *European Company and Financial Law Review* 106; G Balp, ‘Regulating Proxy Advisors through Transparency: Pros and Cons of the EU Approach’ (2017) 14(1) *European Company and Financial Law Review* 1.

⁸⁵ Gallego Córceles, note 84 above, p 132.

advisors would ‘only be subject to some basic principles to ensure accuracy and reliability of their recommendations.’⁸⁶

1. Methodologies

The EU wanted to ensure that proxy advisors are prepared to stand over their contribution as robust and suitably customised for individual clients’ needs. The Commission was concerned that in a cross-border context proxy advisors’ methodologies might not be sufficiently attuned to the national market and regulatory landscape. ESMA also championed the need to hold proxy advisory firms to account in terms of providing transparent justifications for the approaches taken.⁸⁷ Proxy advisors will therefore need to publicly account on an annual basis on their website for their methodologies by providing information in relation to key matters such as methodologies and models employed, information sources, quality control mechanisms, voting policies for each market, corporate and stakeholder dialogue, and conflicts of interest policies.⁸⁸

2. Independence

The EU also wanted to tackle the problem of impaired independence where proxy advisors provide services to issuers which may impact upon their ability to provide independent and objective advice. To address this there is a requirement for proxy advisors to notify clients of

⁸⁶ See note 7 above.

⁸⁷ European Securities and Market Authority, Discussion Paper - *An Overview of the Proxy Advisory Industry: Considerations on Possible Policy Options* Discussion Paper (2012); European Securities and Market Authority, Final Report, *Feedback Statement on the Consultation regarding the Role of the Proxy Advisory Industry* (2013); European Securities and Markets Authority, *Report: Follow-up on the Development of the Best Practice Principles for Providers of Shareholder Voting Research and Analysis* ESMA/2015/1887 (2015).

⁸⁸ Article 3j(2) inserted into the Shareholder Rights Directive.

‘actual or potential’ conflicts of interest or business relationships that may influence their research, advice or voting recommendations and what steps are taken to manage these.⁸⁹

3. *Adherence to a code of conduct*

The EU has chosen not to provide direct prescriptive regulation of the proxy advisory industry. Furthermore, the Directive falls short of biting the bullet to provide that proxy advisors must follow a recognised code of conduct. Instead a softer ‘comply or explain’ approach in the inserted Article 3j(1) requires proxy advisors to disclose if they follow a code of conduct and explain any departures from it or explain why no code of conduct is followed. It remains to be seen how monitoring will pan out at national level. The soft code of conduct model rather than direct regulation follows the lead taken by ESMA - ESMA favoured a code of conduct drafted by an independent committee with large representation from the proxy advisory industry.⁹⁰ In 2015 ESMA indicated that the majority of the proxy advisory industry had signed up to the resulting Best Practice Principles.⁹¹ Therein lies the rub: it remains possible for some market players to snub adherence to a code of conduct (or selected elements of a code) so long as a rational explanation is furnished. The regulatory approach taken in this respect lacks teeth because it omits both carrot and stick. Consequently, the self-regulatory nature of codes such as the Best Practice Principles and the lack of meaningful enforcement is problematic.

This could not be accused of being overly intrusive regulation. Creating transparency in relation to proxy advisors’ methodologies will not of itself change the level of engagement displayed by institutional investors who rely heavily on packaged advice from proxy advisory firms. It may, however, make it easier for them to stand over acting on recommendations

⁸⁹ Article 3j(3) inserted into the Shareholder Rights Directive).

⁹⁰ See note 87 above: *Final Report*, p 16, para 14.

⁹¹ *Ibid*, *Report: Follow-up on the Development of the Best Practice Principles for Providers of Shareholder Voting Research and Analysis*, p 3.

given. More worryingly, the existence of regulation albeit mostly founded upon disclosures, may create an undeserved perception among institutional investors that proxy advisors in the EU are well-regulated and that there is no need to second guess them. As Eckstein has pointed up, the danger with proxy advisory regulation is that it can create an expectation gap – an unjustified public expectation in relation to the efficacy of regulation of the industry.⁹² This is particularly problematic where regulation is far from robust.

VI. REFLECTIONS ON REGULATORY IMPACT

A. *Implementation*

The Directive on Long-term Shareholder Engagement comes with a large amount of deference to national sovereignty such that there is plenty of scope for Member States to water down its heady corporate governance ideals. In terms of regulatory impact much will depend on whether Member States choose a race to the top or alternatively the path of least resistance on significant corporate governance bellwether issues such as binding versus advisory votes on executive remuneration and approval mechanisms for related party transactions. It is therefore difficult to see a level playing field emerging for relevant corporate actors. The contours of regulatory convergence and divergence within Europe both inside and outside the EU and EEA will prove worth observing. The Brexit vote in 2016 removed the United Kingdom from a prime influencing position during the Directive's gestation. This was also hugely significant because many listed companies as well as a large proportion of institutional investors and asset managers are domiciled in the UK where the more prescriptive UK Stewardship Code⁹³ will apply rather than the Directive. Other third

⁹² A Eckstein, 'Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation' (2015) 40(1) *Delaware Journal of Corporate Law* 77.

⁹³ See note 11 above.

countries such as Switzerland will also have to consider how to respond to differences in treatment.

Implementation of the Directive will not provide an answer to many practical challenges to cross-border voting and participation. As recognised by the OECD, ease of electronic voting and electronic distribution of proxy forms are practicalities that need to be attended to in order to facilitate ease of participation by cross-border investors.⁹⁴ This was also documented in the Impact Assessment.⁹⁵ Practically speaking, major technical obstacles to voting will continue present themselves in the absence of large-scale investment in suitable electronic mechanisms for voting. In the absence of constraints on this, the likelihood that the costs of facilitating the cross-border participation, voting and transmission of information envisaged by the Directive will be passed on to investors is unfortunate.

B. Shareholder oversight of executive remuneration and related party transactions

The EU's trumpeted role for shareholders as corporate governance agents is dealt a severe blow by how readily the formal veto rights the Directive provides can be contracted out of by Member States. Member State opt-out rights considerably weaken the arsenal of the shareholder body as a corporate governance backstop with the result that provision of information rights may trump genuine shareholder oversight in the form of robust approval rights.

Permitting Member States to choose between binding and advisory votes on executive pay will create an unfortunate imbalance concerning regulation of executive pay across the Union. Those Member States that are already engaged in a race to the top and have a more onerous regime are unlikely to take a step backwards. The say-on-pay provisions in the

⁹⁴ G20/OECD, *Principles of Corporate Governance* (2015), p.21.

⁹⁵ See note 77 above, 4.6.3 Price discrimination by intermediaries for cross-border transmission of information, including exercise of shareholder rights.

Directive are premised upon the EU's idealised understanding that '[s]hareholder control prevents directors from applying remuneration strategies which reward them personally, but that may not contribute to the long-term performance of the company.'⁹⁶ However, embedding a shareholder advisory vote mechanism and remuneration policy approval will not ipso facto create an appropriate link between pay and performance. Requiring legislative endorsement of some form of shareholder voice on executive pay allows for valuable market feedback which companies would be foolish to dismiss. That said, there are problems with the mythical notion that say-on-pay is a panacea to excessive remuneration. Rather than engaged oversight, complacency may arise among investors in relation to executive remuneration where some degree of regulation is introduced, however minimal. In addition, comparability across the executive hire market which transparency permits may well drive up market remuneration norms. It is instructive that in the US the introduction of a non-binding vote is regarded as having led to shareholder approval of remuneration being usual, and in even higher executive pay levels.⁹⁷

As regards related party transactions, despite the rhetoric of the checks and balances function provided by shareholders in relation to ensuring fair value for the company, this may be more notional than real. The Directive's provisions in this domain are far from robust and represent an underwhelming fudge, allowing Member States to simply provide for ex post disclosure to shareholders rather than ex ante approval rights.

⁹⁶ See note 7 above.

⁹⁷ See note 83 above, p 40.

C. *The mythical role of shareholders as corporate governance agents*

As Black puts it, '[s]hareholder monitoring is one strand in a web of imperfect constraints on corporate managers.'⁹⁸ Nonetheless for the EU, the solution to sub-optimal corporate governance is closely tied to shareholder engagement, with shareholders being mythologised as essential drivers of good corporate governance practices. Harmonised disclosure requirements can help to address asymmetries of information for shareholders in both domestic and cross-border contexts within the EU and facilitate companies and their managers being held to account. That said, caution is needed in relation to the fabled gatekeeper role afforded to shareholders who traditionally have not proved interested in a quasi-public interest monitoring role. Post-implementation of the Directive, the level and nature of shareholder engagement which occurs will come down to complex motivating factors in individual cases and different national settings. The Directive is at least likely to propel institutional investors and asset managers into maintaining transparent investment and engagement strategies although no doubt generic boiler-plate language will emerge. The absence of an enforcement lever signifies that the meaningfulness of these policies is likely to be a potential weak spot. In the UK the possibility that the UK Stewardship Code compliance statements will be among the sample reviewed and publicly flagged as needing improvement by the Financial Reporting Council provides a deterrent in this respect which the Directive lacks.

The EU's rhetorical flourishes on shareholder voice and stewardship expose a large chasm between the rhetoric of declared objectives and likely eventual outcomes deriving the Directive as adopted and implemented. Aside from weaknesses in the Directive's text and its porosity, both practical matters and matters of corporate governance theory signal that

⁹⁸ See note 13 above, Black p 831.

replacing relative stultification with awakening shareholder participation is an arduous challenge. Presenting shareholders in a monolithic fashion as homogenous active corporate governance monitors defies the fact that they come in all shapes and sizes including small retail investors, cross-border investors and pension funds with entirely different investment and participation agendas.⁹⁹ Furthermore, the archetypal dispersed shareholder model of publicly traded companies beloved of corporate governance literature is displaced by the concentrated blockholder model in many Continental countries. This makes it less easy to assume a unified response to a given regulatory stimulus in the Directive on Long-Term Shareholder Engagement. The review of the implementation and effectiveness of the Directive which the Commission in conjunction with ESMA is scheduled to undertake by mid-2023 will permit a cold eye to be cast over the realities of Member State and market take-up.

The crux is whether shareholders who have access to the information needed prove sufficiently interested in taking up the stewardship mantle being thrust upon them. All rights are theoretical in the absence of a holder being (i) suitably informed, and (ii) suitably engaged to exercise them. The bulwark against change of approach presented by path dependence is always a large one. Furthermore, the notion that shareholder engagement can solve the problem of short-termism has been aptly described as ‘conceptually flawed’ given the role of rational apathy based on a cost-benefit analysis by shareholders in making a rational choice to participate or not and to what extent.¹⁰⁰ As Birkmose compellingly points out, both shareholder theory and the clear inadequacies of shareholder monitoring revealed by the

⁹⁹ On this in a UK context see BR Cheffins, ‘The Stewardship Code’s Achilles’ Heel’ (2010) 73(6) *Modern Law Review* 1004.

¹⁰⁰ See note 83, p 22.

financial crisis, make it difficult to see shareholders as being trusted in the role of safeguarding corporate governance.¹⁰¹

A stumbling block to realising the stewardship ideal is that there is no underlying duty on institutional investors to vote or engage. Although the Directive takes steps to enhance the possibility of shareholder participation, it stops well short of legally mandating shareholder voting or other forms of participation including engagement.¹⁰² The result is that the voice of institutional shareholders may be more passive than active, often unquestioningly leaning on the support provided by proxy advisory firms. By contrast, in Switzerland an obligation to vote is imposed in certain circumstances on pension funds. It seems that EU proceeded on the basis that a mandatory approach would lead to mechanistic rather than meaningful compliance. Expecting a principled stewardship approach focused on an investee company's long-term sustainability to be adopted by institutional investors and asset managers is to expect rather a lot. The predominant deployment of porous enabling and soft law provisions leaves the nature and level of shareholder buy-in to the EU's stewardship agenda largely to a matter of rational choice based on a cost-benefit analysis. The EU's call to long-termism and engagement presents no obvious match to basic well-established tenets of corporate governance theory. These include the well-studied shareholder passivity and free rider phenomena.¹⁰³ Shareholders who are satisfied with performance are often passive. Furthermore, in terms of voice, it is well-known that dissatisfied shareholders are more likely to vote with their feet by selling their shares than to engage, ask questions or vote. Hirschmann's classic thesis is that in the absence of loyalty, shareholders leave rather than

¹⁰¹ HS Birkmose, 'Forcing Shareholder Engagement – Theoretical Underpinnings and Political Ambitions' forthcoming 2018 *European Business Law Review*.

¹⁰² For a distributive justice argument as to the social duty of institutional investors to engage see C Villiers, 'Controlling Executive Pay: Institutional Investors or Distributive Justice?' (2010) 10(2) *Journal of Corporate Law Studies* 309.

¹⁰³ On rational apathy see JN Gordon, 'The Mandatory Structure of Corporation Law' (1989) 89(7) *Columbia Law Review* 1549, p 1576; BS Black, 'Shareholder Passivity Re-examined' (1990) 89(3) *Michigan Law Review* 520.

exercise voice.¹⁰⁴ Exit is therefore both a legitimate and a common choice.¹⁰⁵ Yet with the EU's blinkered focus on long-termism, divestment is ignored by the EU as a common and eminently rational investment strategy response.

Can institutional investors live up to the mythical gatekeeper status the EU endows them with? The Commission is right when it says '[t]he extent to which institutional investors and asset managers will decide to engage more with investee companies depends, amongst others, on the costs and difficulties attached to it.'¹⁰⁶ However, this really is only a small part of the equation. Providing appropriate mechanisms and information represent part of the jigsaw but not all of it. The actual monitoring role of shareholders can be easily exaggerated - even where they have the ability and the information to take on the complexity of the task, they may not have the interest. Voluntary behavioural choice is the dominant issue here. Rational apathy and engagement deficiencies have many nuances and are difficult to address using blunt hard law or soft law measures. In the end there may be no match for either shareholder apathy or shareholder preference for a short-term investment strategy. The problem of leading a horse to the water but not being able to make it drink is well-known in the context of the UK Stewardship Code¹⁰⁷ and with 'comply or explain' corporate governance regimes more generally. As the Commission itself noted in relation to the UK Stewardship Code, 'evidence seems to suggest that it did not really result in a change in the investors' attitude towards engagement'.¹⁰⁸ Moreover, as this author has argued elsewhere, 'within Europe stakeholder engagement has been sluggish despite valiant post-financial crisis

¹⁰⁴ AO Hirschmann, *Exit, Voice and Loyalty: Responses to Declines in Firms, Organizations and States* (Harvard University Press, 1970).

¹⁰⁵ See generally in a US context AR Admati and P Pfleider, 'The 'Wall Street Walk' and Shareholder Activism: Exit as a Form of Voice' (2009) 22(1) *The Review of Financial Studies* 2645; A Gorman, 'Exit versus Voice: A Comparison of Divestment and Shareholder Engagement' (2017) 72(1) *New York University Annual Survey of American Law* 113.

¹⁰⁶ See note 77 above at 4.1 Background.

¹⁰⁷ D Arsalidou, 'Corporate Governance in the Aftermath of the Global Financial Crisis: Issues and Action' (2017) 38(2) *Business Law Review* 42.

¹⁰⁸ See note 77 above, 5.1 Baseline scenario.

efforts to whip up momentum at a policy level.¹⁰⁹ Patience is needed as shareholder engagement in its many forms is still evolving. In that light, the Directive's enforced stilted reporting on engagement undertaken by or on behalf of institutional investors may hinder rather than assist its development as an agile corporate governance tool.

D. Cultural changes needed to achieve engagement and a long-term focus

The alterations made to the Shareholder Rights Directive focus on creating a basket of complementary disclosures designed to chivvy investors to turn away from short-term investment and disengagement by integrating long-term benchmarks. Whether this approach provides sufficient incentive for institutional investors is debatable. The European Parliament proved alive to this quandary when it stated, 'shareholders' engagement with the company should be encouraged by enhancing their role, but ... this involvement should be a discretionary choice and never an obligation.'¹¹⁰ It would be fanciful to assume that transparency of approach will alone blow a short-term focus entirely out of the water in favour of a long-term outlook.¹¹¹ High portfolio turnover is well-ingrained with an EU average holding period for shares of approximately eight months.¹¹²

Ultimately, although the Directive works hard to shift the locus of corporate power, it is not at all clear that all institutional investors will want to take up the stewardship baton thrust upon them. Relying on bringing soft law pressure to bear on an industry relies on culturally shifting entrenched attitudes. A battle for hearts must be won as well as the battle for minds otherwise a minimum compliance approach may be taken. Cultural changes are

¹⁰⁹ See note 18 above, p 627.

¹¹⁰ *A Corporate Governance Framework for European Companies* - European Parliament resolution of 29 March 2012 on a corporate governance framework for European companies (2011/2181(INI)), para 29.

¹¹¹ HS Birkmose, 'European Challenges for Institutional Investor Engagement: Is Mandatory Disclosure the Way Forward?' (2014) 11(2) *European Company and Financial Law Review* 214, p 242. For a radical structural solution see E Duruigbo, 'Stimulating Long-Term Shareholding' (2012) 33(4) *Cardozo Law Review* 1733.

¹¹² See note 77 above, Figure 2 Average Holding Period – Selected Exchanges.

needed to ensure that investors integrate a long-term sustainability and stewardship approach. A good example is seen in the UK-based Investment Association's request to companies to stop quarterly reporting and earnings guidance which has resulted in a considerable decline in the practice.¹¹³

E. Missed opportunities and future policy directions

The Directive stands aloof from the threshold issue of defining who is a shareholder, something which is needed to arrive at a truly cross-border solution.¹¹⁴ As with the Shareholder Rights Directive, the definition of a shareholder is left to Member State law. Divergent Member State responses cut across the equivalence ideals for a cross-border investment market. Furthermore, although prominence is given to the need for shareholder co-operation by the OECD,¹¹⁵ the Directive side-steps the crucial issue of facilitating shareholders to communicate with each other and form alliances on corporate governance matters. This dampens the prospect of activist shareholders gathering support for votes against company resolutions. Resolving the collective action barrier to enable real monitoring is central to achieving peer engagement and proxy activism. There is therefore a pressing need for the EU to revisit acting in concert rules in order to ensure that they do not deter appropriate shareholder co-operation.

Looking to future bigger picture policy and theoretical issues that European company law needs to grapple with, this territory highlights complex unanswered questions concerning the need to move beyond a unipolar rights-based focus to realistically consider the

¹¹³ Investment Association press release 'Quarterly Reporting Falls as Companies Focus on the Long-Term' 4 September 2017 <https://www.theinvestmentassociation.org/media-centre/press-releases/2017/quarterly-reporting-falls-as-companies-focus-on-the-long-term.html>.

¹¹⁴ J. García Aparicio, 'Enhancing Shareholder Rights in Intermediated Securities Holding Structures Across Borders' (2017) 13(2) *New York University Journal of Law and Business* 465.

¹¹⁵ See note 94 above, pp 23-24.

appropriateness of imposing counterbalancing duties on shareholders, particularly majority shareholders. Indeed, as has occurred in the United States, activist shareholders pursuing their own selfish agenda will become an increasing matter of concern in Europe.¹¹⁶ This terrain raises the need for a duty on shareholders to consider the interests of the company and other shareholders.¹¹⁷ Shareholder voice may therefore not always mean unbounded freedom.

VII. CONCLUSION

Through the lens of assessing the likely regulatory impact of the 2017 EU Directive on Long-term Shareholder Engagement this article has examined the mythical nature of the voice and stewardship role attributed by the EU to shareholders as corporate governance gatekeepers and drivers of its long-term sustainability agenda. It finds that there is a considerable normative gap between the EU's stewardship narrative and the likely achievements of the Directive on the ground. A startling disconnect is apparent. Limitations of scope presented by the text of the Directive itself as well as practical challenges concerning the application of core provisions in practice have been highlighted as impinging significantly upon fulfilment of the EU stewardship vision across EU capital markets. A romanticised policy perspective on what companies and investors ought to do in the interests of the wider EU economy in the long-term will not easily upend director primacy, short-term investing or shareholder rational apathy.

In permitting Member State dilution of shareholder approval and oversight of executive remuneration and related party transactions, the Directive deals a heavy blow to its shareholder stewardship ambition. The tangible effect of transparency alone is difficult to measure but it is no substitute for the control function provided by embedded shareholder

¹¹⁶ I Anabtawi and LA Stout, 'Fiduciary Duties for Activist Shareholders' (2008) 60(5) *Stanford Law Review* 1255; JG Hill, 'Good Activist/Bad Activist: The Rise of International Stewardship Codes (2018) 41 *Seattle University Law Review* 497.

¹¹⁷ OECD, *Related Party Transactions and Minority Shareholder Rights* (2012), p 14.

approval requirements. It will be instructive to observe the varied implementation choices made across the EU as well as how institutional shareholders and asset managers respond to the gauntlet laid down. In achieving the status of engaged corporate governance monitor and long-term sustainability champion, much depends on investors and assets managers who have not already done so making a paradigm shift to choose to go beyond a minimum compliance mentality. Sunlight helps but path dependence rears its head as a formidable obstacle to shareholders moving away from ingrained self-interested passivity to fulfil the envisaged stewardship role in all its dimensions.

In conclusion, the EU's overarching sustainability goal of eradicating a short-term approach to corporate performance is unlikely to be achieved simply by virtue of soft disclosure-based incentives of the type exhibited in the Directive on Long-term Shareholder Engagement. Law ensures compliance, but in the gaps business has its own way of doing things. The perceived need to shore up the Shareholder Rights Directive by concentrating on encouraging engagement highlights an age-old problem that rights are likely to languish unless the holder of those rights sees fit to exercise them. The exercise of shareholder rights comes down not just to faciliatory regulatory drivers, but also to a complex cost-benefit calculation. Myths aside, rights do not an engaged shareholder make.