CLIFFORD CHANCE

Briefing note

October 2014

# Shareholder Rights Directive II – is it on your radar?

Earlier this year the Commission published a proposal to amend the 2007 Shareholder Rights Directive (the Directive). Both the original Directive and its proposed replacement are first and foremost instruments of company law, with improved corporate governance as their underlying policy objective. However, the legislation has important implications – not all of them positive – for asset managers, custodians and other financial intermediaries holding dematerialized securities for themselves and their clients. Amidst the plethora of new financial regulation with which financial market participants are currently grappling, there is a danger that this Directive could slip under the radar. This briefing note provides an outline of the new legislation highlighting some key areas of concern.

We expect a final text of the Directive to be adopted some time in late 2015 or early 2016. The current draft envisages implementation by Member States within 18 months of the legislation's entry into force.

## Who is a shareholder?

The Commission proposal does not anticipate a change to the definition of "shareholder" which, under the current Directive means "the natural or legal person that is recognised as a shareholder under the applicable law." However, new shareholder identification rules mean that it may no longer be possible simply to construe the Directive's shareholder definition as referring to the *legal* owner.

Under the Commission proposal any "intermediary" (the definition is broad enough to cover any EU custodian, broker or asset manager that provides securities accounts for its clients, whilst other provisions expressly bring into scope EU branches of third country intermediaries despite their falling outside the definition) will be required to offer companies the right to have their shareholders identified. In practice this means that a company can ask its proximate intermediary (the request would presumably go first to the custodian or nominee holding legal title to the share in the relevant CSD) to identify in writing as soon as possible the names and contact information of the company's shareholders (including, where the shareholder is a legal entity, its unique identifier). Where there is more than one intermediary in the chain (which will often be the case) the company's request and the relevant shareholder information are required to be transmitted between intermediaries without delay.

## Information transmission and shareholder rights

In cases where a company does not communicate directly with its own shareholders, the Directive requires intermediaries to transmit information to shareholders where the information is either necessary to exercise shareholder rights or is directed to all shareholders in shares of a particular class. In terms of communication in the other direction – from shareholders to the company (for example relating to the exercise of shareholder rights) the onus for transmission of the information to the company again rests with the intermediary. If an intermediary votes on behalf of a shareholder, it must transmit the voting confirmation to the shareholder (potentially via multiple intermediaries where there are several in the holding chain).

If the problem inherent in the new shareholder identification provisions is solved (i.e. working out exactly who the shareholder is) then the provisions on information transmission and the exercise of shareholder rights should in theory pose less of a burden for intermediaries. Many custodians and other intermediaries already conduct these sorts of activities as part of their standard service offering. However, the *obligation* to carry out such functions and the precise terms on which they are provided have not hitherto been prescribed by law and some of the Directive's stipulations may diverge from current standard custody practices. Once the Directive is adopted, custodians and other intermediaries will need to review their standard service documentation in order to ensure compliance with the new regime.

**Key definitions**

**Intermediary** – a legal person that has its registered office, central administration or principal place of business in the European Union and maintains securities accounts for clients. (Note, although the definition is tied to EU incorporation, the Directive's provisions on shareholder identification, information transmission, voting rights and costs transparency all expressly apply to third-country intermediaries with EU branches and would, for example, affect the London branches of US banks providing custody services);

**Shareholder** – the natural or legal person that is recognised as a shareholder under the applicable law;

**Proxy advisor** – means a legal person that provides, on a professional basis, recommendations to shareholders on the exercise of their voting rights;

**Related party** – has the same meaning as in the international accounting standards adopted in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council

## Cost transparency

Some of the Directive's provisions on fees and costs reflect civil law norms and may appear unhelpful and unnecessary to anyone with a common law background. For example, the proposal states that, "Member States shall allow intermediaries to charge prices or fees for the service to be provided under this chapter." We are not aware of any Member States whose national laws are so hostile to freedom of contract as to *prohibit* custodians from charging fees for services provided. Accordingly, the purpose and benefit of this type of provision is difficult to discern. Custodians already charge for their services and have not been waiting for "permission" from any legislature to do so. This variety of "permissive" drafting is particularly unhelpful because it raises all sorts of questions as to exactly what fees and charges fall within its scope and potentially as to the lawfulness of any fees and charges which turn out not to be within the scope of the provision.

Of even greater concern to intermediaries however will be the requirements that: (i) they publicly disclose prices, fees and any other charges separately for each service they provide; (ii) their fees be "non-discriminatory and proportional"; and (iii) any differences in the charges levied between domestic and cross border exercise of rights shall be "duly justified". Unhelpfully though, no indication is given as to how one may identify charges that are "proportional" and "duly justified" (though presumably normal rules of interpretation of EU legislation would apply). On the one hand, it seems almost inevitable that the Directive will introduce additional compliance costs for custodians, asset managers and other intermediaries. On the other hand however, the Directive's provisions on cost transparency may be expected to exert downward pressure on prices whilst also raising the spectre that supervisors might play some role in determining what a 'fair' price for various custody related services ought to be.

## Asset Managers – Shareholder Engagement

The Directive introduces a series of measures which will be of particular interest to asset managers and institutional investors. First, the Directive requires asset managers and institutional investors to develop a policy on shareholder engagement. *Inter alia*, the policy is supposed to determine how asset managers and institutional investors engage with the investee company, cooperate with other shareholders, use proxy advisor services and monitor company's performance. The policy should also provide a framework for managing conflicts of interest in the following situations:

(a) the institutional investor or the asset manager, or other companies affiliated to them, offer financial products to or have other commercial relationships with the investee company;

(b) a director of the institutional investor or the asset manager is also a director of the investee company;

(c) an asset manager managing the assets of an institution for occupational retirement provision invests in a company that contributes to that institution;

(d) the institutional investor or asset manager is affiliated with a company for whose shares a takeover bid has been launched.

The engagement policy requirements apply on a "comply or explain" basis. Asset managers and institutional investors that adopt an engagement policy will be required to disclose it publicly, and to disclose information on how they cast their votes in the meetings of companies in which they hold shares. Firms that do not adopt an engagement policy will be required publicly to explain why they have chosen not to.

## Investment strategy of institutional investors and arrangements with asset managers

Under the proposals, institutional investors will be required disclose to the public how their equity investment strategy is aligned with the profile and duration of their liabilities and how it contributes to the medium to long-term performance of their assets. Where an asset manager invests on behalf of an institutional investor, either on a discretionary, client by client basis or through a collective investment undertaking, the institutional investor will be required to publish details of its relationship with the asset manager with regard to the following issues:

(a) whether and to what extent it incentivises the asset manager to align its investment strategy and decisions with the profile and duration of its liabilities;

(b) whether and to what extent it incentivises the asset manager to make investment decisions based on medium to long-term company performance, including non financial performance, and to engage with companies as a means of improving company performance to deliver investment returns;

(c) the method and time horizon of the evaluation of the asset manager's performance, and in particular whether, and how this evaluation takes long-term absolute performance into account as opposed to performance relative to a benchmark index or other asset managers pursuing similar investment strategies;

(d) how the structure of the consideration for the asset management services contributes to the alignment of the investment decisions of the asset manager with the profile and duration of the liabilities of the institutional investor;

(e) the targeted portfolio turnover or turnover range, the method used for the turnover calculation, and whether any procedure is established when this is exceeded by the asset manager;

(f) the duration of the arrangement with the asset manager

These proposals to make public the content of the contracts between institutional investors and asset managers have already drawn criticism from industry associations. Investment managers may rightly ask what public interest is served by requiring the disclosure of detailed information relating to the terms of a commercial relationship between two private contracting parties. Also, the requirement that institutional investors publicly disclose the means by which they measure the performance of their fund managers could pose a compliance headache for pension funds and similar investors.

## Asset manager transparency

The proposals outline a requirement for asset managers to disclose, on a half-yearly basis to the institutional investors with whom they have a relationship, how their investment strategy and its implementation complies with the arrangement between the manager and investor as well as how the investment strategy contributes to the medium to long-term performance of the institutional investor's assets. Managers will also have to disclose several specific pieces of information to the institutional investor including, *inter alia*, the manager's policies on the use of proxy advisors, securities lending and whether or not, and if so how, the manager makes investment decisions on the basis of judgements about medium to long-term performance of the investee company (including non financial performance).

## Proxy advisor transparency

The Directive imposes a number of transparency obligations on proxy advisors, requiring them to adopt and implement measures to guarantee that their voting recommendations are "accurate and reliable, based on a thorough analysis of all the information that is available to them". Proxy advisors will also have to make an annual disclosure of certain information relating to their voting recommendations, including:

(a) the essential features of the methodologies and models they apply;

(b) the main information sources they use;

(c) whether and, if so, how they take national market, legal and regulatory conditions into account;

(d) whether they have dialogues with the companies which are the object of their voting recommendations, and, if so, the extent and nature thereof;

(e) the total number of staff involved in the preparation of the voting recommendations;

(f) the total number of voting recommendations provided in the last year

Under the new rules, proxy advisors will also be required to identify and disclose without undue delay to their clients and the company concerned any actual or potential conflict of interest or business relationships that may influence the preparation of the voting recommendations and the actions they have undertaken to eliminate or mitigate the actual or potential conflict of interest.

## Right to vote on the remuneration policy

The Directive will guarantee the right of shareholders to vote on a company's remuneration policy for directors. Director pay will have to accord with a remuneration policy that has been approved by shareholders and reviewed every three years. There will be limited scope for pay outside the terms of the policy for new directors and subject to certain specific criteria. The company's remuneration policy is required to be "clear, understandable, in line with the business strategy, objectives, values and long-term interests of the company." The policy must also incorporate measures to avoid conflicts of interest.

Remuneration policies will have to set clear criteria for the award of fixed and variable remuneration (including any form of benefits) whilst also setting overall remuneration caps. Policies will also have to identify the ratio between the average remuneration of directors and the average remuneration of full time employees of the company other than directors and explain why this ratio is considered appropriate. Only in exceptional cases may this ratio be omitted from the policy.

## Information to be provided in the remuneration report and right to vote on the remuneration report

Under the proposals, companies will have to draw up a clear and comprehensible remuneration report providing a full overview of the remuneration, including all benefits in whatever form, granted to individual directors, including to newly recruited and former directors, in the last financial year. The report is also required to include certain specific pieces of information, including how total remuneration is linked to long-term performance. Shareholders will be able to vote on the report annually. Where shareholders vote against the report at the AGM the company will be required to explain in its next remuneration report whether or not and, if so, how, the vote of the shareholders has been taken into account. The Directive will also amend the Accounting Directive (2013/34/EU), so that the remuneration report forms part of the corporate governance statement that companies are required publish in accordance with Article 20 of the Accounting Directive.

## Right to vote on related party transactions

The proposal envisages new controls over related party transactions. Under the Directive, transactions with related parties representing more than 5% of a company's assets, or transactions that could have a significant impact on profits or turnover will require shareholder approval. Where the related party transaction involves a shareholder, this shareholder is to be excluded from the vote. The Directive will prevent a company from concluding the transaction before shareholder approval has been obtained though will permit conclusion of the transaction on a conditional basis, pending shareholder approval.

Transactions with the same related party that have been concluded during the previous 12 months and which have not been approved by shareholders are required to be aggregated. If the aggregate value of the transactions exceeds the 5% threshold then the transaction that would take the aggregate value above the threshold and any subsequent transactions with the same related party have to be submitted to a shareholder vote and may only be unconditionally concluded after shareholder approval.

Transactions with related parties that represent more than 1% of a company's assets will be subject to public announcement when the transaction is completed. The announcement will be required to be accompanied by a report from an independent third party assessing whether or not it is on market terms and confirming that the transaction is fair and reasonable from the perspective of the shareholders, including minority shareholders.

## Conclusion

Underpinning the Shareholder Rights Directive is the idea that a lack of engagement by asset managers and institutional investors has bred a culture of short-termism in the pursuit of corporate profits. Shareholder engagement is also assessed to be impeded by lengthy investment chains involving intermediaries in different jurisdictions. This refresh of the Directive marks an earnest attempt to improve the long term sustainability of EU corporations. In many respects, it reflects attempts made under other legislation (in particular CRR) to change remuneration practices and to inculcate a different corporate culture in banks and other financial institutions following the financial crisis.

Laudable as the policy objective of improved corporate governance may be, as some commentators have observed (notably, Professor Lynn Stout of Cornell University Law School) putting shareholders on a pedestal creates its own problems. Arguably, some of the difficulties that the Directive attempts to address (including supposed short-term profit maximization at the expense of long term performance) may in part be a consequence of frameworks that place the shareholder at the centre of the corporate governance universe and which inevitably drive attempts to maximize "shareholder value" at all cost.

In a sense therefore, the Directive is a fairly unambitious piece of legislation that will probably disappoint groups hoping for greater stakeholder (i.e. employee and customer) involvement in corporate affairs. Many Member States' existing national regimes (notably Germany) already embrace a far more inclusive concept of corporate governance than anything proposed at the European level. Even the UK, with the concept of "enlightened shareholder value" established in Section 172 of the 2006 Companies Act takes a much more catholic approach than in the past.

All law makers should remember that shareholders have entered a bargain in which they stand to lose their shirts if the company fails to perform. Shareholder rights should be set in that context. Amidst all the exhortations for custodians, asset managers and other intermediaries to perform expensive somersaults for the *owners* of companies, it is quite striking that not a single mention is made anywhere in the draft Directive or its explanatory notes of a company's *customers* and how, if at all, these measures might benefit them.

# Contacts

**Chris Bates**
Partner

E: chris.bates
@cliffordchance.com

**Peter Chapman**
Senior Associate

E: peter.chapman
@cliffordchance.com

**Sean Kerr**
Senior Associate PSL

E: sean.kerr
@cliffordchance.com

**Caroline Meinertz**
Partner

E: caroline.meinertz
@cliffordchance.com

**Monica Sah**
Partner

E: monica.sah
@cliffordchance.com

**Dermot Turing**
Consultant

E: dermot.turing
@cliffordchance.com